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Where Has All the Demand Gone? Challenges to Growth in a "Neo-Mercantilist" Age

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Abstract

Extensive attention has been given to countries that run current account deficits, but little attention has been devoted to understanding why countries run large surpluses. This is surprising given that unsustainable international imbalances result from one as much as the other. We begin with a wide-ranging review of the literature to better understand the political and economic forces that lead to demand decreasing policies. We then demonstrate how the systemic choices made within the Bretton Woods and Post Bretton Woods periods constrained and enabled the generation of large surpluses. Next, we examine imbalances at the global level to determine whether they are getting bigger rather than trending toward external balance. We find evidence that the trend towards imbalance is strengthening. We then analyze the patterns of these surpluses in four countries noting where government policies have most prominently contributed to the surpluses, pointing out the differing motivations for and implementations of these policies across countries. This leads us to ask, finally, what these trends portend and what can be done to mitigate or reverse them if they bode ill for global economic well-being.

JEL Classification: F4, F6
Keywords: Global Demand, Neo-Mercantilism, Self-insurance, BOP Crises

1. Introduction

The issue of large current account imbalances among some nations has received attention in recent years among both economists and the popular press. While these imbalances have episodically been examined symmetrically, that is from the perspective of both the surplus and the deficit countries, critical attention has emphasized altering national policies that work towards deficits rather than those that promote surpluses. No matter which perspective one adopts, the global policy problem is that sudden stops to these financial flows are associated with economic contractions. Nations with large and persistent current account deficits often find that it may become increasingly difficult to borrow funds internationally. The United States is an exception, as it is able to attract additional foreign funds despite a net international investment position of \$-9.63 trillion as of September 30, 2018. Smaller countries are not so fortunate. For various reasons, some countries reach a point where the international financial community refuses to provide additional funding without an agreement in place with the International Monetary Fund (IMF), which imposes "conditions" on the borrowing countries' economic policies. These deals often require restrictive monetary and fiscal policies, cuts in government subsidies and pensions, or other politically unpopular measures in an effort to improve the long-run prospects for an economy.

Since current account balances globally must sum to zero, the existence of deficit countries must also mean that other countries must be running surpluses. The objective of this paper is to explore the motivation and recent experience of countries adopting economic policies that result in persistent current account surpluses. Policies that utilize a trade surplus to promote economic development can trace their origins back centuries at least to the "mercantilist" strategy promoted by Jean Baptiste Colbert, principal minister and advisor to Louis XIV of France in the 17th century. The intellectual history on this issue is rich as well, with contributions from contemporaries of Adam Smith to some of the most respected international economists of the 20th century.

We believe that, for various reasons, policies that utilize current account surpluses as part of an economic strategy are widely used in the world today and have been for many years. The growth of international reserves from less than \$2 trillion in 1999 to a peak of over \$12 trillion in 2014, a six fold increase in 15 years, is evidence of this. The IMF has recognized this trend with the establishment of an annual External Sector Report (the Seventh Annual Report was released in July 2018) which classifies nations' external balances as "higher than desirable" and "lower than desirable" based on an analytical model it has created.

The issue of nations experiencing "higher than desirable" surpluses raises several policy issues that make it worthy of study. First, surplus countries may be deliberately taking actions that restrain aggregate demand below their national output. If at the global level Say's Law applies, and supply creates its own demand, then the issue would be moot. Since this does not appear to be the case, especially in the short term, large surpluses might still be acceptable if there are other countries willing and able to run current account deficits. But what happens when deficit countries are suddenly unable (due to a sudden stop) or unwilling (because of a belief that the deficit, on balance, sends jobs and income overseas) to do so? If all countries attempt to run positive trade surpluses, the paradox of thrift tells us that such attempts will lead to a reduction in global economic growth. Second, deficit countries may decide that the best way to restore external balance is adopt protectionist measures to restrict imports from surplus countries. Since increasing trade restrictions typically lead to retaliation, the result would be a slowdown in trade that is undesirable for everyone. Third, large imbalances can also lead to resentment between surplus and deficit countries. In the Euro Area for example, nations that are currently experiencing surpluses may resent having to provide support to deficit countries, while deficit countries begrudge the surplus countries for not sufficiently supporting policies that help the deficit countries move back toward their potential output and employment levels.

To understand why we are where we are, and to consider what might be done to increase global demand should this be the ultimately desired policy, we examine the world from a number of perspectives. First, beginning in section two, we conduct a wide-ranging review of the literature to recognize the political and economic forces that lead to policies that can be succinctly summarized as maintaining an external trade surplus. We examine various motivations for and promulgations of these policies and compare their similarities and differences. In section three, we discuss how the breakdown of the Bretton Woods system of international finance in the 1970s allowed increases in either trade surpluses or deficits depending on a country's policy objectives. We then, in section four, empirically examine if external surpluses and deficits are getting bigger rather than trending toward external balance, and, if they are, determine whether the trend is strengthening or weakening. We find evidence that the trend is strengthening over time and that there is very strong path dependence of deficits and surpluses at the national level. In section five, we examine some countries that have maintained large surpluses. Policies that contribute to deficits have received a tremendous amount of attention, and we believe that shifting more attention towards surplus generating policies is overdue. Section six provides concluding remarks.

2. Literature Review

Economic policies that require a nation to run a current account surplus have often been referred to as mercantilist for centuries. In his Presidential Address to the 1973 Annual Meeting of the British Association for the Advancement of Science, Harry G. Johnson stated:

"Like any other body of thought and group of thinkers important enough to merit being called an '-ism,' mercantilism was a collection of often mutually contradictory ideas expressed with varying degrees of clarity by men of widely varying levels of intelligence and reasoning power.

Reduced to its bare essentials, however, and doing far less than justice to the percipience of many of the writers concerned, it amounted to two propositions: that the wealth of a country consisted in the quantity of precious metals in circulation or in hoards within its borders, and that the way to increase that wealth was to secure a surplus on the balance of payments, usually identified with a balance on merchandise trade, by policies of import substitution and export promotion." (Johnson, 1974)

Mercantilism does not derive from a theory of economic behavior. Likewise, it does not derive from a theory of political behavior. Rather, what is now thought of as mercantilism is a description of the political economic reality in some Northern European countries in the post medieval, pre industrial period (Grampp 1952). French mercantilism of Colbert (Allen 1988, Coleman 1988) was not quite the same as English mercantilism, although they did share many features. Mercantilism, as it is now understood, was characterized by a concern for power and plenty (Heckscher 1936, Viner 1948). Power was both military and economic. Power enabled national security by giving the country the wherewithal to wage and prevail in war (Viner 1948, Coleman 1988). Plenty was an employed, productive and content populace: the average person did not want. With plenty came domestic political stability and high national social welfare (Grampp 1952, McCusker 1996). For many, although not all (Pincus 2012), mercantilists the political economic world was zero-sum: your gain was my loss (Heckscher 1936, Viner 1948, Allen 1988, Coleman 1988, Irwin 1991, 1992). This worldview led to policies supporting colonial expansion, securing sources of foreign goods (for importation and re-export), dominance of trade routes and the promotion of exports to maintain a positive balance of trade. The aim of these policies was to maintain power and ensure plenty (McCusker 1996, Pincus 2013). To the extent that there was a consistent political goal, economic actors sought to use the achievement thereof to their individual benefit through rent-seeking activities (Ekelund and Tollison 1997), such as seeking protection from foreign competition (Pincus 2013) and monopoly privilege (Irwin 1991).

In the post-World War II period, a "New Mercantilism" emerged that focused on 'plenty' rather than 'power.' In this "new-mercantilism," the policy goal was one of achieving sustained economic growth and full employment (plenty) in one's own economy through trade surpluses coupled with the accumulation of foreign assets (no longer just specie). Joan Robinson (1966) dissected the aims and methods of the "new mercantilism", in her 1966 inaugural lecture as a full professor and fellow of Girton College at Cambridge University, setting out the issues that challenged policy makers then and continue to challenge policy makers today. Robinson highlights a tension between the efficiency argument underpinning free trade and the distributional outcomes of free trade. In her view, free trade promises the best outcome for the international economic system taken as a whole. It does not promise that each constituent economy will be better off. Second, she identifies the costly real adjustments countries running balance of trade deficits funded by international borrowing are required to take in order to equilibrate the system when capital inflows are no longer forthcoming. Third, she recognizes that countries pursuing policies that rely on running current account surpluses can only be successful in their aims if other countries run current account deficits. While everyone can be a free trader, not everyone can be a new mercantilist.

Recognizing the limitations of both free trade and new mercantilism, Robinson explains why countries seeking full employment and income growth often prefer new mercantilist rather than free trade policies. First, countries seek to protect their economies against external shocks by running a surplus. This surplus allows them to build up a stock of foreign financial assets that enables them to manage their exchange rate, insures them against attacks on their currency and/or allows them to offset capital outflows. Second, countries, perhaps understanding the high real costs of moving from deficit to balance or surplus, are loss averse, and prefer to gain rather than to lose reserves. This strengthens the tendency to maintain a balance of trade surplus by emphasizing production over domestic consumption. Third, surpluses allow the accumulation of foreign assets, which may promise a return in excess of what can be earned at home and which may provide diversification. However, this can be taken to an extreme when investing at home is preferable to investing abroad, but foreign investment continues to trump domestic investment since the risk of losing the surplus in the attempt to reallocate the investment portfolio is unacceptably high. Loss aversion again prevails. Fourth, countries wish to produce more than domestic demand would allow, thereby increasing employment.

But, when the deficit countries that hold up this house of cards pursue deficit-reducing policies to avail of the economic benefits thereof, the carefully balanced edifice may collapse. Avoiding this is as essential today as it was a half century ago when Robinson conducted her analysis. While the following discussion brings her analysis up to date, the issues remain the same, and the structural deficiencies are, if anything, worse.

A decade after Robinson's lecture near the end of the Bretton Woods international monetary system, Schmid (1974) declared the era of free trade dead. Schmid identifies the Bretton Woods era as an anomalous period characterized by economic and political stability and the unassailable economic dominance of the United States. During this period free trade, to the extent it was practiced, was not inimical to growth. Dooley, et al. (2003, 2004), examine the post Bretton Woods era as a recreation of the Bretton Woods system. They characterize the Bretton Woods fixed exchange rate system as having a free trade core – the United States – and a neo- mercantilist periphery of emerging, capital poor financially weak, economies – Europe and Japan. The economies in the periphery pursued an export-led growth strategy by maintaining undervalued exchange rates, imposing capital controls, and accumulating international reserve assets. At the core, the United States was the financial intermediary that made this possible. At the end of the Bretton Woods era, the European and Japanese economies had emerged: their capital stocks and financial institutions were internationally competitive, obviating the need for their exchange rates to remain fixed, and moving them into the core. While the Bretton Woods system broke down, the need for such a system to provide the economic framework for growth did not. Dooley, et al. contend that the Asian economies have recreated the Bretton Woods system with them as the periphery economies and the United States continuing in its core function, largely without the support of fellow members of the core as they cannot supply dollar denominated assets, supplying the reserve assets to the periphery economies to enable their export-led growth policies, the same policies as Europe and Japan had pursued earlier. Cwik (2011) also analyzes the neo-mercantilist policies of Asian economies, but argues, that they are doomed to failure, as the outcomes suggested by Dooley, et al. should not be expected or guaranteed by currency manipulation policies. Others, discussed below, also do not agree with the Dooley, et al., analysis. What is agreed is that reserve accumulation, where reserve assets are, largely, United States Treasury securities, is costly and dampens global demand, and that the United States provides the lion's share of the demand upon which the system depends.

Scott (2011) defines neo-mercantilist strategies (which he prefers to call enhanced mobilization strategies) as overarching economic development policies designed specifically to enable a country to catch up to its competitors. It generally requires that the country faces a recognized and internally accepted external threat or challenge that enables the promulgation of policies that require members of society to make current sacrifices to enhance the common good and ensure a better future. This requires market distorting policies that increase saving, reduce both wage and capital costs, increase the risk-adjusted returns to investment, both human and physical, ensure an undervalued exchange rate, and repress demand by shifting economic resources away from consumption toward production, reducing imports and promoting exports. If successful, these policies lead to rapid industrialization and growth. The weight of these policies fall squarely on the shoulders of the workers and savers who see wage growth and returns to saving repressed as it is by this means that investment and risk- taking is rewarded with over-market returns. The promised payoff to the workers is a more economically secure future for themselves and their children when the returns may be more equitably shared.

Wholly successful enhanced mobilization strategies are few, especially in liberal democracies. As Scott (2011) notes, these economies tend to founder when their initial goals have been achieved and a transition to a post-enhanced mobilization strategy is required. Sweden, Japan, and Ireland are examples of countries that had successful enhanced mobilization strategies but that were unable to make that transition and suffered severe economic setbacks as wages rose dramatically, productivity fell, and/or sheltered banking systems (which lent to the local firms operating in a distorted market that masked true market returns) causing financial crises from which it can take a long time to recover.

Recently, focus has shifted onto two of the economies that have most successfully weathered the 2007-09 financial crisis, China and Germany, where their successes have been identified to be at the cost of their trading partners: those that provide the demand. As the recent financial crisis loomed on the horizon, Palley (2006) suggested that China's neo-mercantilist/export-led growth policies, which rely heavily on the United States as a destination for China's manufactured goods, are a significant cause of the United States' burgeoning trade deficit, its declining manufacturing sectors, and its fragile financial sector. He worries that these factors together may undermine the strength of the US economy, forcing it to grow more slowly or fall into recession, either of which would lead to a reduction in demand for Chinese goods and thereby rebound on the Chinese economy, driving it into recession or lowering its rate of growth. To guard against this, Palley suggested that China needed to undo its neo- mercantilist policies by increasing domestic demand. To achieve this goal it must, among other things, end the repression of wages and the return to saving. If wages and the returns earned by small savers rise the benefits of its successful growth strategy will be shared via a more equal income distribution. In concert with other Asian economies, China should end competitive hoarding to maintain an undervalued currency (Aizenman and Lee 2008), and revalue its currency. Ending wage and financial repression, the foundation upon which neo-mercantilist policies are built, requires a fundamental restructuring of the Chinese economy that gives workers voice and demands that banks make and monitor loans on the basis of sound economic principles rather than industrial policy or other considerations. Although China has been taking hesitant steps in this direction, largely to establish the yuan as a reserve currency, these changes are easier said than done, and as Willett and Chiu (2012) suggest, domestic political exigencies and international power relationships (both in and between China and the US as well as elsewhere) militate against taking the difficult policy decisions needed until forced to do so by a crisis. Indeed, China's international infrastructural development policy is designed specifically to enhance its neo-mercantilist/hegemonic powers in Asia and beyond, consolidating its economic and political dominance in the region (Holslag 2010), behavior in many ways reminiscent of the English drive to dominate the trade routes, and thereby ensure power and plenty, in the seventeenth century (Irwin 1991). The view that China's policies are unabashedly neo-mercantilist is not shared by all (Prasad and Wei 2005), but whatever their motivation, the results in terms of external balance are largely the same.

While Germany's economy is much smaller than China's, its current account surplus is currently larger than China's. Since German reunification, Germany has pursued a manufacturing based export-led development strategy (Hassel 2013). This development strategy has been underpinned by welfare cutbacks and market liberalization, both of which have put downward pressure on factor costs, as well as an institutional structure that depresses domestic demand. Unions have agreed to wage and conditions of employment concessions to protect core staff while enabling firms to adjust employment at the periphery, even by shifting what had been core to the periphery, where employment can be part or short time, the so-called mini-jobs, and not well paid. Wages in service sector employment are held down by wages in manufacturing, which are seen as a natural cap, and the lowest wages are supplemented by social benefits. Without pressure from below, wages remain low thereby depressing domestic demand. The fiscal federalist tax and benefit structure, under which the low paid are highly taxed, further reinforces this demand repression. The structural changes required to encourage domestic demand are significant, and some argue if they are needed at all (Funk 2014), but the external, much of it emerging market, demand upon which the policy stands or falls cannot be guaranteed going forward.

Eichengreen and Panizza (2016) examine many instances in which high debt countries have successfully lowered their unsustainable debt loads. They find that this generally only occurs when indebted countries are able to run current account surpluses. So within the EU, matters will have to be arranged so that the highly indebted south can run a surplus. Continued surpluses among several Northern EU countries are not consistent with debt sustainability for the South. Jason (2015) puts the point bluntly. "A persistent German surplus makes it harder for the Eurozone as a whole and the southern peripheral economies in particular to recover from the current financial crisis by imposing a Europe-wide "deflationary bias" through pushing up the exchange rate of the euro, exporting feeble German inflation and projecting its ultra-tight macroeconomic policies onto crisis economies."[1] Fatás and Summers (2015) also insist that an increase in aggregate demand in the surplus countries of Europe, particularly Germany, is central to sustainable debt levels and employment levels in the south.

While some neo-mercantilist policies are designed to promote economic development, other policies, not necessarily neo-mercantilist in conception but rather in outward appearance, are designed more narrowly to self-insure against economic fluctuations caused by unforeseen international capital outflows and sudden stops. To self-insure, a country must accumulate a sizable quantity of highly marketable, international financial assets such as stocks of major international companies, bonds issued by creditworthy governments and corporations, and short-term, liquid assets, such as United States Treasury bills. While this stock of reserves is not invested in domestic investment projects that enhance a nation's capital stock, it does provide the economy with liquidity it may need when, as a result of external shocks, international funds dry up or capital flight occurs. This buffer stock enhances the economic stability of a country. Calvo, et al. (2013) find that self-insuring in this way reduces the probability of sudden stops as well as the costs thereof. Durdu et al. (2009) establish that this self-insurance is effective in combatting the vagaries of financial globalization and sudden stop risk, but not output fluctuations. Corbo and Schmidt-Hebbel (2013) show that the accumulation of net external assets, that is self-insurance, together with a flexible exchange rate regime, counter-cyclical monetary policy, more developed domestic financial and capital markets, and openness to trade have improved the economic growth performance of Latin American economies. Their description of effective policies is, clearly, not neo-mercantilist. Yet the reserve accumulation component, clearly reminiscent of the accumulation of specie in the Mercantilist period, still puts a brake on domestic demand. However, without it, countries are subject to sudden stops and balance of payment crises, even those in the Eurozone (Merler and Pisani-Ferry 2012), which operates more as a fixed-exchange rate system than a true monetary union thereby creating additional strategic inefficiencies (Hernandez and Trejos 2013). Sudden stops, also, do not only plague emerging markets and economies on the periphery of Europe but could also challenge the United States (Willett and Chiu 2012) and its special role in the international monetary system as both liquidity provider and insurer (Gourinchas and Rey 2014), suggesting that the United States may have to re-evaluate its position as the provider of liquidity to the system but in so doing undermining the system it supports.

Furthermore, as Aizenman (2008) has convincingly argued, the accumulation and hoarding of international reserves and sovereign wealth fund assets to self-insure, to guard against real effective exchange rate effects of terms of trade shocks, to allow more effective adjustment to external shocks, and, perhaps to promote exports via the equivalent of competitive devaluations, something which inextricably links the Asian economies, but perhaps not to their joint benefit, has adversely changed the international financial architecture into something more decentralized and less cooperative. In the next section, we argue that the ability of countries to engage in policies that grow international reserves and improve the net investment position of a nation was greatly enhanced by the demise of the Bretton Woods system in the 1970s.

[1] Schiliro (2017) examined the relation between current accounts and debt problems and found that fiscal union along with democratic legitimacy will be needed to successfully address these challenges.

3. The Rise of Neo-Mercantilist Opportunities

What has become known as the Bretton Woods system of international finance that lasted from 1947 to 1973 was a remarkable period in economic history. As the first half of the twentieth century was coming to a close, the world had experienced two world wars and a global economic depression. Policymakers were determined to create structures that would support both economic and political security. The designers of Bretton Woods were careful to balance the desires of individual countries to pursue national economic strategies with a need for global economic cooperation to foster worldwide economic growth. The strategy had several pillars. First, the General Agreement on Tariffs and Trade (GATT) was established to promote the multilateral reduction of trade barriers across the world. Through various rounds of trade agreements culminating in the establishment of the World Trade Organization in 1995, trade barriers were gradually eased and international trade flourished.

A second pillar was the establishment of a fixed exchange rate system pegged to the US dollar as a substitute for the Gold Standard. The US government tied its currency to the price of gold and other countries pegged their currencies to the dollar. Given that the United States possessed most of the world's monetary gold at the end of World War II, it agreed to allow official outflows to foreign central banks desiring to rebuild gold stocks in the post-war era. The International Monetary Fund was established to provide an international source of liquidity to countries addressing short-term balance of payments deficits under the system. However, the architects of Bretton Woods also understood the trilemma of international finance which holds that any nation must give up at least one of the following three policy choices: fixed exchange rates, international capital mobility, and domestic control over monetary policy. Under the Gold Standard as it was practiced in the late nineteenth and early twentieth centuries, countries followed the "rules of the game," which meant *inter alia* allowing balance of payments imbalances to affect the domestic money supply (i. e., no sterilization allowed). The designers of Bretton Woods, however, had a different idea. They allowed for nations to pursue their own monetary policy but implemented strict capital controls. This is an aspect of the Bretton Woods system that has received the least attention from economists.

Capital controls, however, were crucial in reducing the ability to engage in neo- mercantilist economic strategies. If capital controls were binding, it became more likely that current account balances had to be reasonably close to zero because surpluses (deficits) were not easily offset by increasing (decreasing) foreign assets. Of course, because official reserve movements (i.e., transactions between central banks) were allowed under Bretton Woods, it was possible to have surpluses or deficits if financed in this way. This allowed nations rebuilding their economies after World War II (e.g., Japan and West Germany) to initially finance deficits (partially with US aid programs such as the Marshall Plan) and subsequently run trade surpluses to foster more rapid economic growth and development. By encouraging the use of official reserve transactions to restore external balance, governments could monitor those countries experiencing surpluses and deficits, and through negotiation decide the best way to resolve them. In some cases, adjustments to pegged exchange rates (revaluation or devaluation) were used in addition to reserve movements to address imbalances.

The Bretton Woods system of fixed exchange rates and capital controls worked well until the mid-1960s, when inflation in the US and other countries began to increase. This caused real exchange rates to diverge, with real depreciations against the dollar in countries with inflation rates below the United States'. The real exchange rate changes exacerbated differences in international competitiveness and increased trade imbalances. Eventually, US President Richard Nixon announced on August 15, 1971 that the US gold window was officially closed, decoupling the dollar from gold. Within two years, the fixed exchange rate system was abandoned and the dollar was allowed to float freely on world markets.

Because the US dollar was floating freely against the world's currencies after February, 1973, it was no longer necessary to maintain capital controls on private international transactions. Capital controls were never popular with US international banks (Helleiner, 1996), so when the opportunity to remove them emerged with the abandonment of fixed exchange rates in 1973, the United States opened up its financial system to unrestricted capital flows. Over the next few years, all of the major economies did the same. It took some time after this for the international financial infrastructure to develop to handle significant increases in both short-term and long-term capital flows. The high real interest rates in the United States that the Federal Reserve under Paul Volcker adopted, led to significant capital inflows into the US, a large increase in the dollar's value, and large current account deficit. This, coupled with the emergence of financial derivatives to help financial institutions and investors manage rising interest rate and foreign exchange rate risks, assisted in building the capabilities to handle increasingly large capital flows among countries.

The restoration of international capital mobility allowed greater flexibility in managing current account imbalances. If a nation desired to run a trade surplus, it could do so without experiencing an exchange rate appreciation by increasing its stock of foreign assets. Conversely, if a nation wanted or needed to experience a trade deficit, it could borrow internationally if foreign investors were willing to lend. Countries desiring to pursue neo-mercantilist type strategies (for reasons described in the previous section) now had additional ways of doing so. Two common methods, raising trade barriers in the form of tariffs and quotas or deliberately undervaluing an exchange rate to make exports cheaper and imports more expensive (so-called beggar- thy-neighbor policies), were discouraged under Bretton Woods and criticized in the years that followed. National income accounting pointed to a third way. From national income accounting, it can be easily shown that the balance on trade in goods and services (NX) is equal to the difference between national saving (NS, the sum of private and government saving) and total investment (I). In other words,

$$NX = NS - I. \tag{1}$$

If a country could raise the national saving rate (through forced saving or discouraging consumption expenditures) above the level of domestic investment, then that nation would experience a trade surplus. It can be shown, for example, in a simple Mundell-Fleming model, that a tax increase (which raises national saving) in which the proceeds are invested in foreign currency reserves combined with an export promotion campaign would increase the current account balance without a change in aggregate demand that would affect real output or the exchange rate.

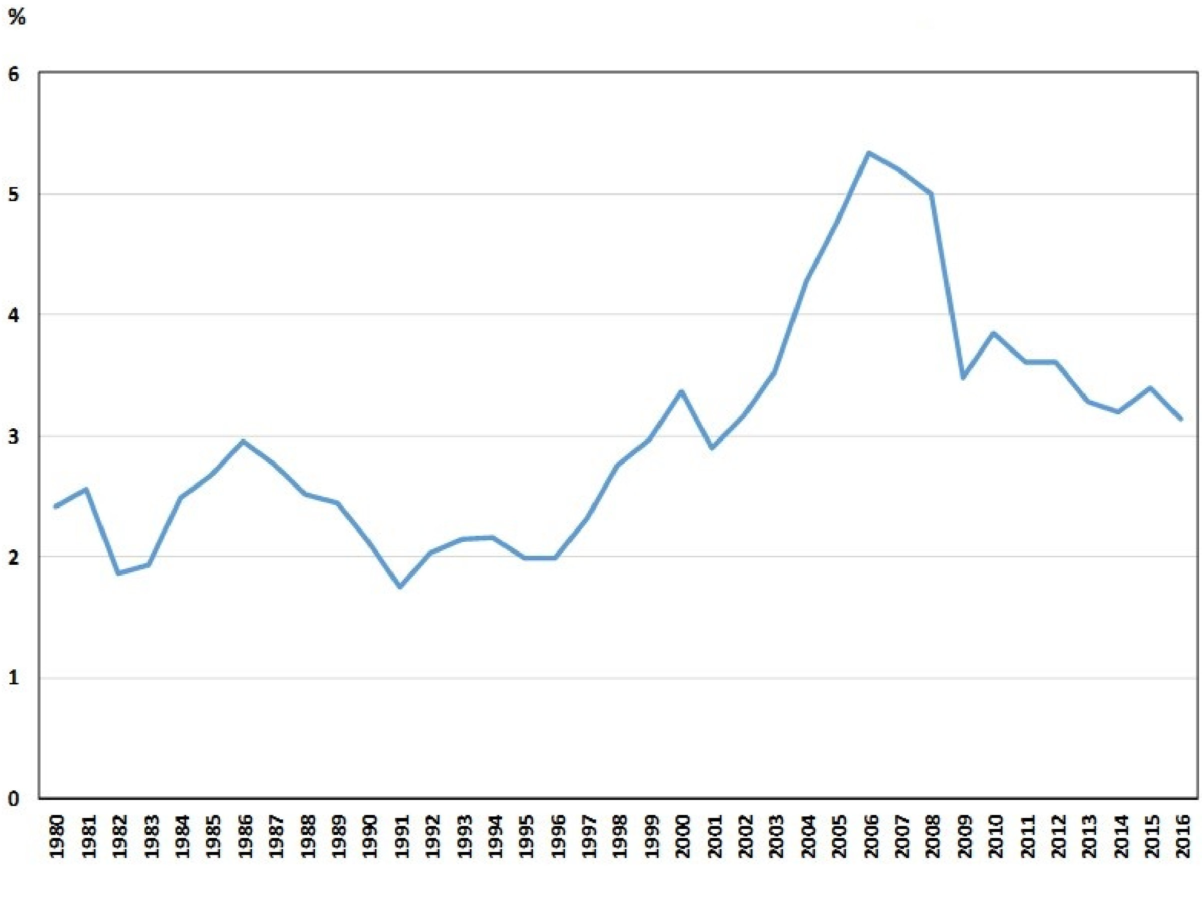
Conversely, if a country has a great need or more opportunities for profitable domestic investment beyond its ability to fund them through domestic savings, it can "import" foreign capital by running a trade deficit. Many economists applauded this change, believing that freer capital mobility would allow countries to smooth consumption intertemporally, raise domestic investment rates, and allow for greater portfolio diversification and risk-sharing. In the next section, we observe how this change manifested itself in greater trade imbalances without necessarily engaging in currency depreciation to achieve it.

4. Heuristic Evidence of Mercantilist-Type Strategies

In this section, we provide empirical evidence to support the idea that more countries have been engaging in strategies that result in large current account surpluses and deficits. To do this, we collected data from 58 countries which comprise 93% of 2014 world GDP according to the IMF World Economic Outlook database, (A list of countries is provided in the appendix). We collected annual data over the 1980-2016 period for all the countries (the WEO database has very little data available prior to 1980). We use the current account balance as our measure of overall international trade and factor payments, because the IMF has compiled data for all the countries in our sample going back to 1980.[2]

To learn whether there is evidence of greater current account imbalances in recent years, we follow the IMF methodology in its external balance reports in two respects. First, we take the absolute value of each country's current account balance for each year, sum them, and divide by total GDP. The resulting time series is displayed in Figure 1. It is clear that this measure increased in value over the sample period. One way to evaluate this is to compare the average of this measure from 1980 to 1997 with the average from 1998 to 2016. What we find is that the annual average rose from 2.28% in the early period to 3.73% in the later period, an increase of 63.6%. This supports the view that imbalances have increased in recent years.

Figure 1: Absolute Value of Current Account Balances Divided by GDP



Source: IMF World Economic Outlook Database, October 2018. The absolute values of current account balances, were summed, divided by GDP, and converted to percent for each year.

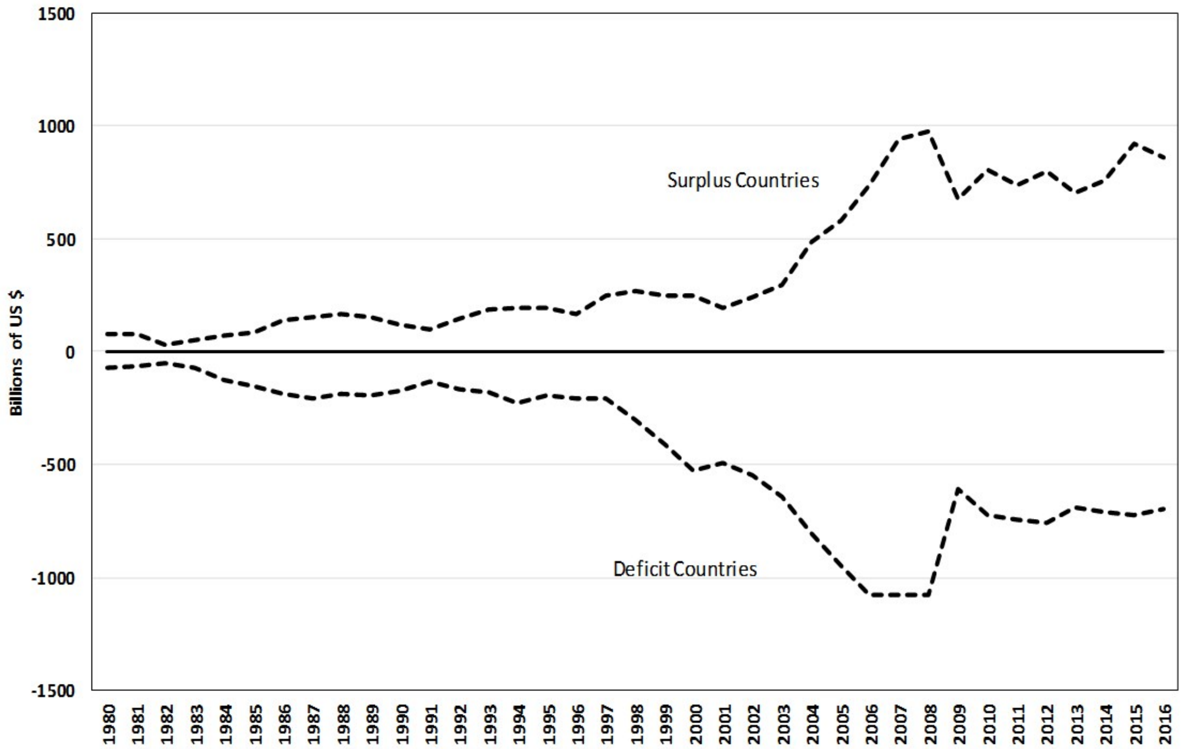
A second measure, also used by the IMF, is to compare, for each year, the five largest current account surpluses with the five largest deficits. Figure 2 illustrates this for the 1980-2016

[2] China started providing current account data to the IMF in 1997. Because of the size and importance of China in the world economy, we decided to keep China in the sample. All other countries report current account data throughout the period we are examining.

period. As one can observe, there was a substantial increase in the size of current account deficits among the top five deficit countries after 1997. Deficits reached a trough in the 2006-08 period, and have stabilized over the past five years at around $750 billion per year, more than triple the levels that prevailed prior to 1997. For the surplus countries, a similar pattern of growth can be observed, though the initial growth in surpluses among the top five was not as rapid. However, the size of the surpluses among the top five countries has hovered at around $750 billion per year since 2008. Virtually the same pattern is observed among the top ten surplus and deficit countries.

Figure 2

Sum of Five Largest and Smallest Current Account Balances (Billions of US $)



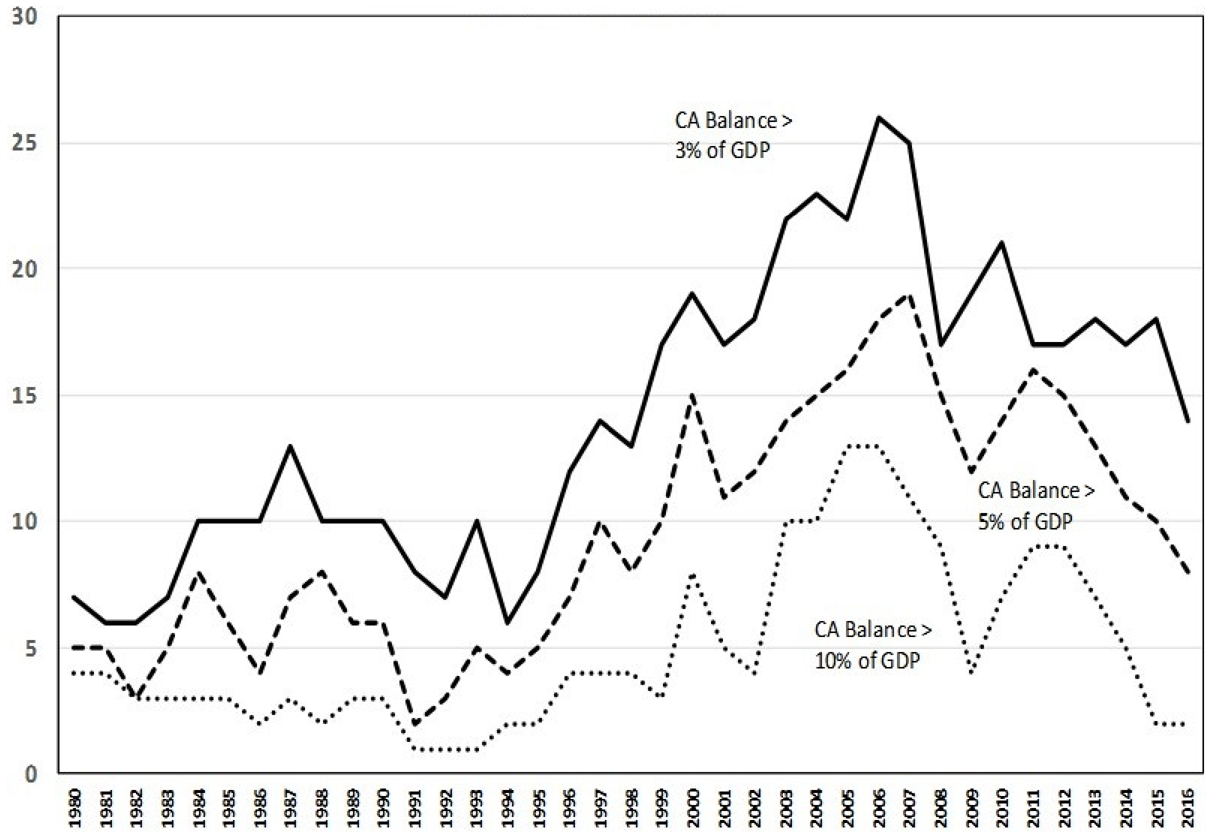
Source: IMF World Economic Outlook Database, October 2018.

To provide another means to examine the possibility of increased mercantilist activity, figure 3 depicts the number of countries experiencing current account surpluses of varying size by plotting the number of countries whose surplus exceeded 3%, 5% and 10% of GDP during the 1980- 2016 period. One can observe from Figure 3 that the number of countries running current account surpluses increased after 1995. One way to measure this is to compare the average number of countries with annual surpluses over each threshold during 1980-1997 period with the 1998-2016 period. For those countries with a surplus of 3% or more of GDP, the number of countries rose from an average of 9 in the1980-1997 period to 19 in the 1998-2016 period. For those with surpluses exceeding 5% of GDP, the average number went from 6 to 13 countries over the same periods, and for the 10% threshold, the number went from 3 to 7 countries.

Taken as a whole, we believe this is strong evidence that more countries are engaging in practices that lead to greater surpluses than was the case 20 years ago, and that imbalances remain high, though there has been some reduction in current account imbalances since the mid-2000s.

Figure 3

Current Account as Percent of GDP, Three Levels (Number of Countries)



Source: IMF World Economic Outlook Database, October 2018. Number of Countries based on a sample of 58 countries that reported current account balances from 1980 to 2016, with the exception of China which begun reporting in 1997.

To check for robustness, we also collected data on the balance on goods and services and found qualitatively similar results. In the next section, we provide some examples of countries engaging in long-term strategies that have enabled current account surpluses to persist.

5. Case Studies

In this section, we examine the current account surpluses of four countries: Germany, the Netherlands, Singapore and Thailand. These four nations were selected because in its 2018 External Sector Report, the IMF deemed their external position to be "substantially stronger than justified by medium-term fundamentals and desirable policies (current account gaps of more than 4 percentage points of GDP)…" (IMF, 2018, p.11).

5.1. Germany

At $291.1 billion in 2017, Germany has the largest current account surplus in the world today. Figure 4a shows the current account balance as a percent of GDP. The series starts in 1991 to avoid difficulties with data prior to German reunification. One can observe that Germany ran current account deficits throughout the 1990s as the process of reunification and investment in East Germany unfolded. In the early 2000s, however, Germany began to adopt labor market reforms that restrained wages and improved international competitiveness. The result was a rising current account surplus that grew to approximately 6% of GDP by 2007, and the surplus has grown in the decade since the global financial crisis.

Figure 4b shows the evolution of national saving and investment over the same period. This clearly shows that national saving bottomed out around 2003 and rose to 28% of GDP by 2017, while investment has hovered around 20% of GDP over the same period. Given that the German government budget has been in surplus for the past couple of years, we believe the level of the current account surplus in recent years should be regarded as a manifestation of Germany's economic policy choices broadly understood.

Figure 4a

Germany (Current Account as % of GDP)

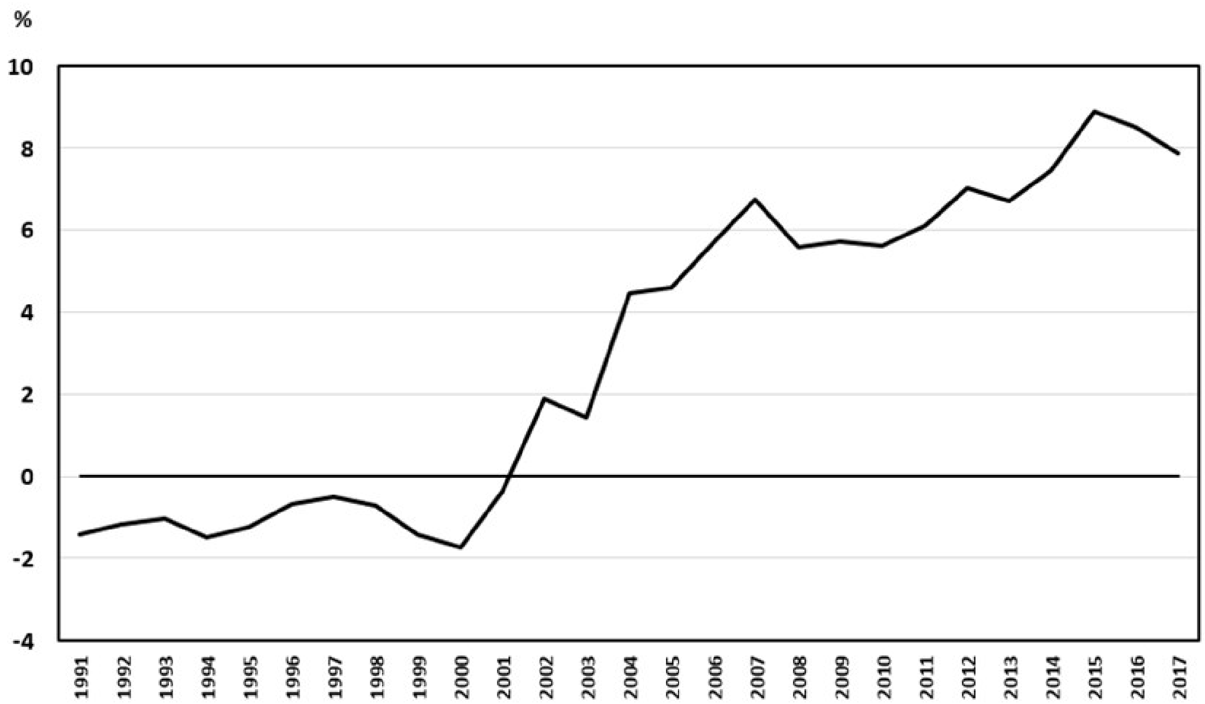
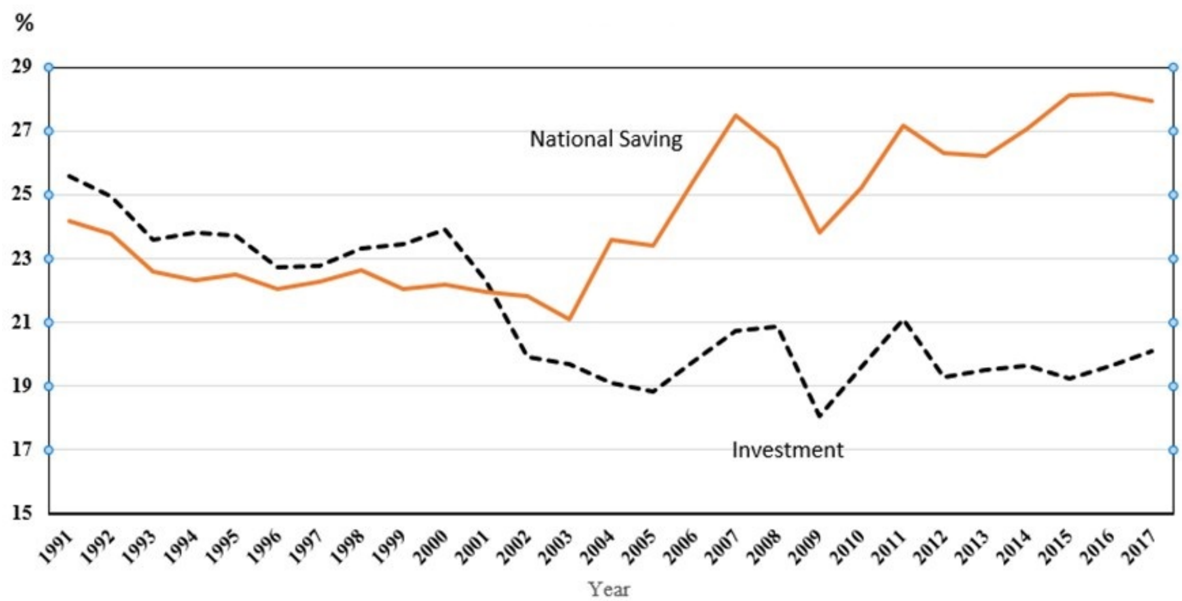


Figure 4b

Germany: Investment vs. National Saving (% GDP)



5.2 The Netherlands

Figure 5a shows the current account balance as a percentage of GDP. One can see that, at least since 1991, the current account has been in surplus. While it has moved up and down, the general trend has been increasingly positive, especially since 2008. In 2017, the Netherlands posted a current account surplus of $87.46 billion, which was 10.5% of GDP.

Figure 5a

The Netherlands: Current Account (% of GDP)

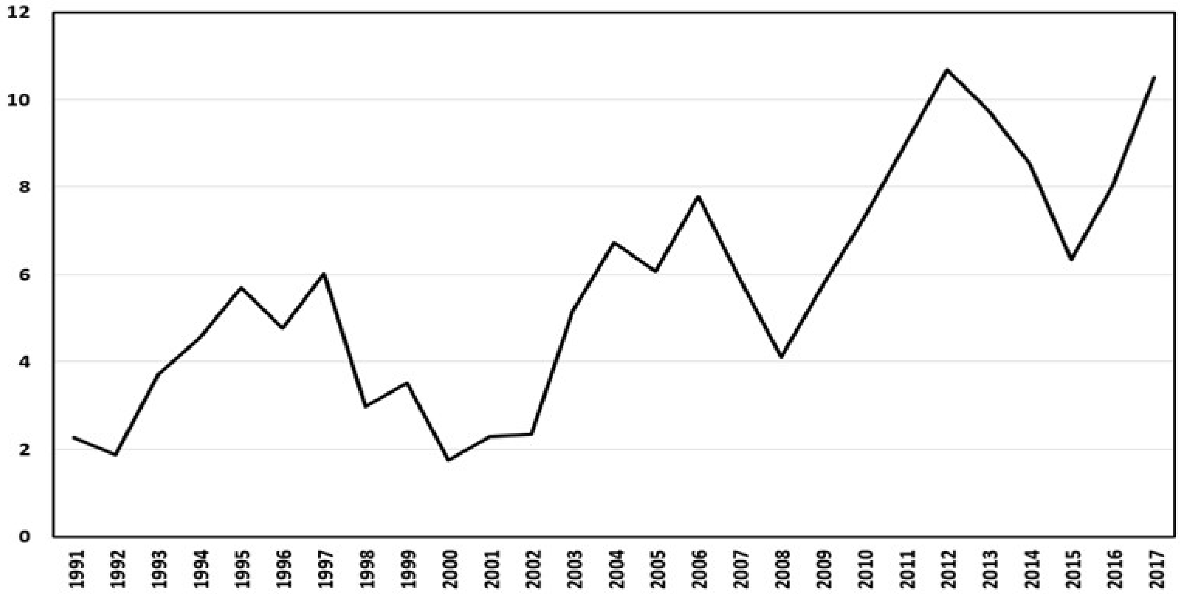
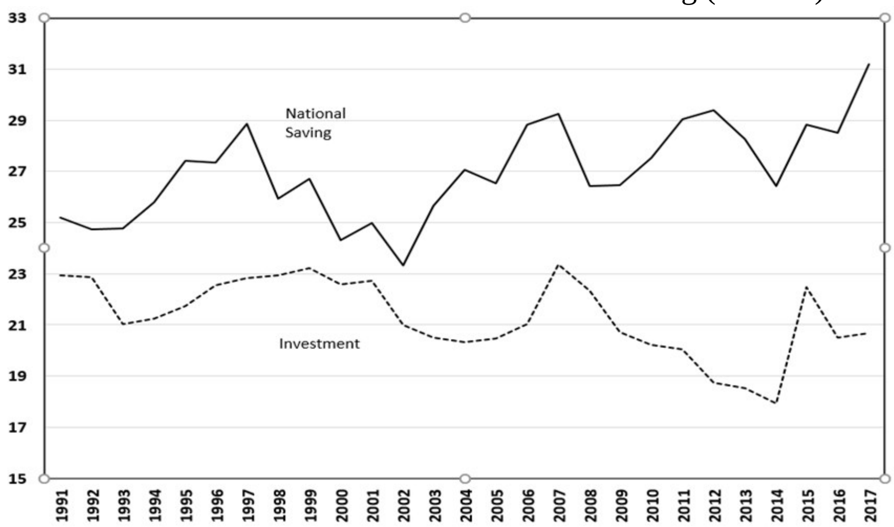


Figure 5b shows the division between national saving and investment. It is clear that national saving has been increasing and in 2017 stands at over 30% of GDP. At the same time investment has been between 19% and 21% for the last few years. Investment has fallen on average as a percentage of GDP since 2008. It would be interesting to explore further why both these Euro Area countries are producing significantly more than they are spending at a time when other Euro countries could benefit from an increase in aggregate demand.

Figure 5b

The Netherlands Investment vs. National Saving (% GDP)



5.3. Singapore

Despite being a small city-state of approximately 5.6 million people, Singapore ran a current account surplus of $61 billion in 2017, which was 18.8% of GDP. Figure 6a shows the current account balance as a percent of GDP since 1991. It demonstrates that Singapore's surpluses have been consistently sustained at over 10% of GDP for over 25 years and have exceeded 15% of GDP since 2009. Figure 6b breaks down the current account balance into national saving and investment. National saving has been between 45 and 50 percent of GDP since 2005, while investment has hovered between 25 and 30 percent. With policies like the National Provident Fund, Singapore has encouraged a culture of high national saving, which guarantees that it will have persistent current account surpluses.

Figure 6a: Current Account as % of GDP

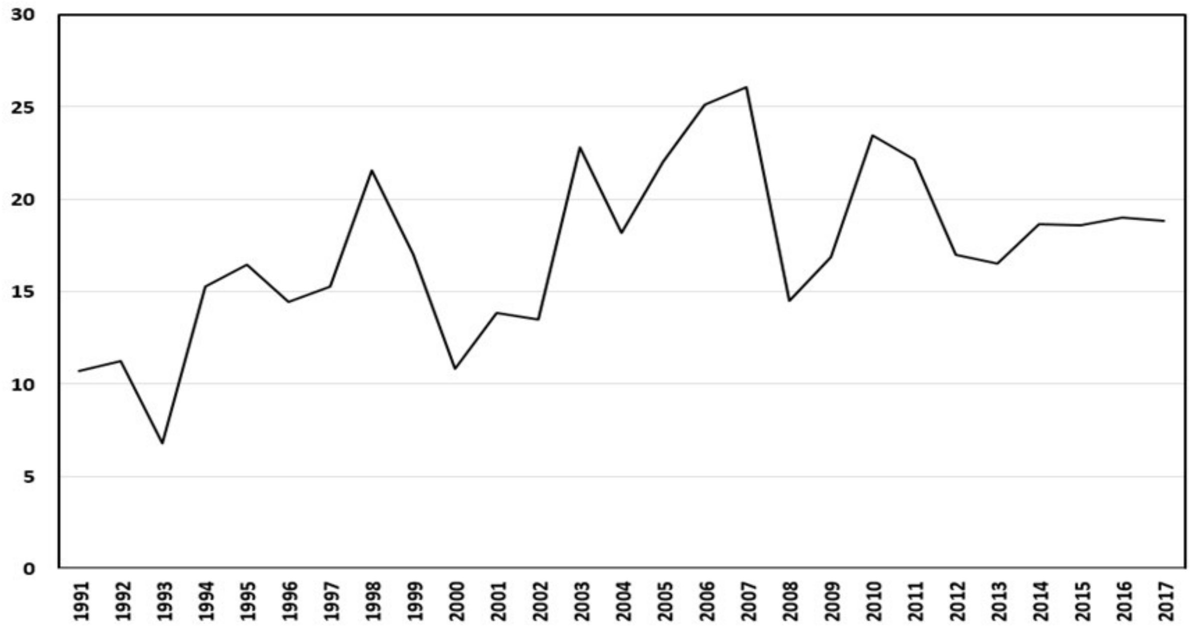
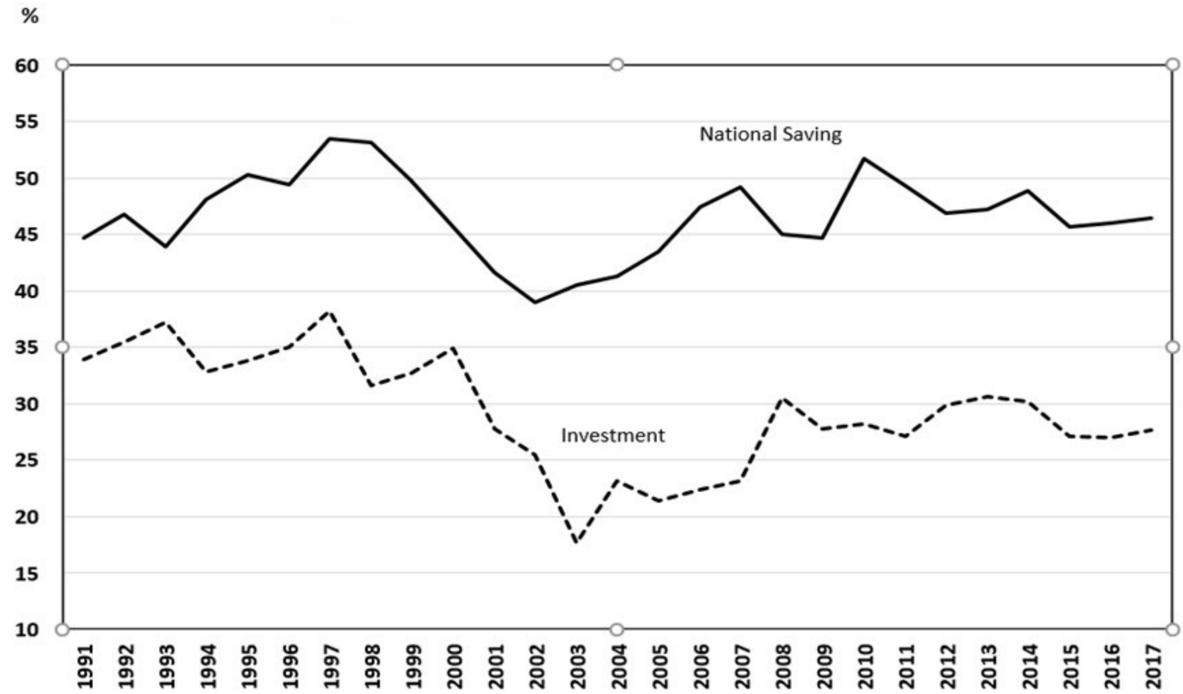


Figure 6b: Investment vs. National Saving (% of GDP)



5.4 Thailand

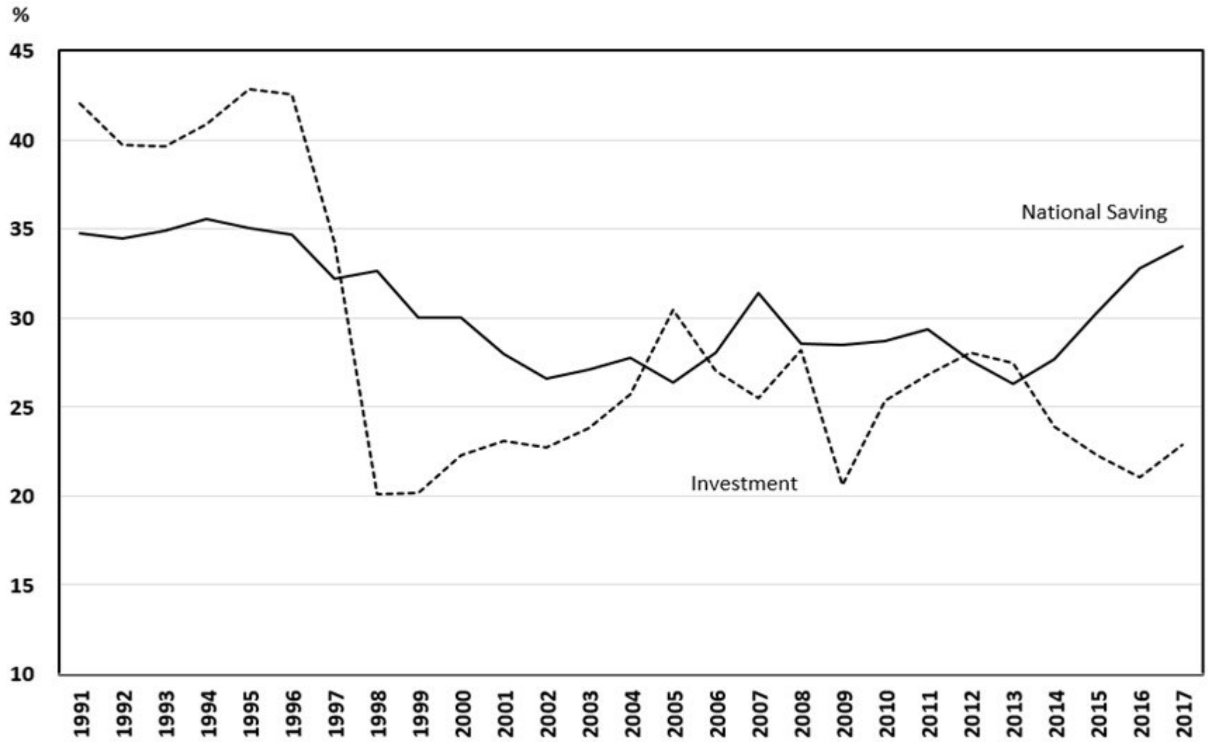
The fourth country that has experienced a "substantially strong" current account surplus according to the IMF is Thailand, which had a surplus of $51.1 billion in 2017 (11.2% of GDP). Figure 7a shows the current account balances since 1991. The country had experienced large deficits prior to the Asian financial crisis in 1997 which started in Thailand. Thailand had to rapidly move to surplus after the sudden stop, and since then has managed to remain in surplus. Since 2013, its surplus has increased, reaching over 10 percent of GDP in 2016 and 2017, which sum to approximately $100 billion for those two years.

Figure 7a: Thailand: Current Account as % of GDP

Looking at Figure 7b, one can see that national saving has risen by over 5 percentage points over the past four years. At the same time, total investment relative to GDP has fallen, so its current account has soared. According to the IMF, it attributes the rapid rise in the surplus to a boom in tourism coupled with weak domestic demand during a political transition. Unlike the other three examples, it is unclear if Thailand's high surplus will be sustained over time.

While these country examples are not conclusive, they support our view that a number of countries are continuing to pursue large current account surpluses well after the global financial crisis of 2007-09. During the crisis, a number of countries experienced sudden stops so their ability to maintain current account deficits became more difficult since foreign investors were unwilling to hold their financial assets (e.g., Greece, Ireland, Iceland, Spain, and Portugal). These and other countries were forced by events or IMF conditionality to adopt austerity policies to reduce their current account deficits. If deficit countries were using expenditure reducing policies to help restore external balance, then other countries needed to increase their demand to maintain or increase overall global demand. However, if the largest surplus countries were maintaining the policies of export enhancement that worked well for them in the past, then global demand would fall or, at best, increase at a slower rate, creating a challenging environment for robust economic growth. If these countries were persuaded to reduce their surpluses by adopting policies that increase aggregate demand, this could benefit countries which are struggling to grow.

Figure 7a: Thailand: Current Account as % of GDP



6. Concluding Remarks

While this research is hardly conclusive, it does suggest that a number of surplus countries are continuing to engage in policies that are increasing their surpluses. With the United States currently (as of June 30, 2018) experiencing a net international investment position of $ -8.6 trillion, it seems that America's historic role that some have characterized as the "importer of last resort" may be starting to change, especially if the new Administration's policy of "Make America Great Again" is carried out. If this does happen, then it is worth asking what will be the sources of growth of global demand in the future. It seems reasonable to suggest that nations that have run substantial surpluses in recent years increase their global demand to foster a better economic environment for global economic growth. Whether this can be accomplished in a spirit of international cooperation and long run mutual benefit remains to be seen.

The Trump administration has provided less support for multilateralism and the work of transnational organizations such as the IMF and World Bank than previous administrations. It is difficult to see how diminishing the role of multilateral institutions can make the adjustments of deficit countries easier. Higgott (2018) observes that declining US support for multilateralism has provided China with a much larger role in global leadership. While China's current account has made a remarkable turnaround, China's Belt and Road foreign investment program appears to be generating considerable resentment in the receiving countries and may contribute to nationalist reactions among deficit countries.[3] Much has been written recently about the rise of populism, but the US administration's policies, especially the extensive use of tariff polices to rebalance the current account, are more

[3] For a discussion of the debt implications of Belt and Road see Hurley, Morris et al. (2018) For an analysis of the Belt and Road Initiative from Yanis Varoufakis's (Varoufakis 2011) Global Surplus Recycling Mechanism Hypothesis, see Chohan (2018).

obviously examples of economic nationalism than populism. The heavy reliance on tariffs and trade restrictions clearly sets an example that deficit countries will be tempted to follow.[4]

A policy implication of the paper is that perhaps the IMF needs to take a more active role in encouraging countries running large, persistent current account surpluses to adopt policies that may reduce imbalances. If this can be done in a way to increase aggregate demand without causing higher inflation, this would potentially benefit global economic growth. Ironically, a decline in US support for multilateral solutions will make it more difficult for the IMF to achieve this goal.

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[4] Posner (2017) systematically sets out the case that President Trump's policies constitute a populist backlash against liberal internationalism. Ingelhart and Norris (2016) find that populism is caused by economic insecurity together with a cultural backlash.

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Appendix

List of countries used in section 4

Algeria	Egypt	Kuwait	Romania
Angola	Ethiopia	Malaysia	Saudi Arabia
Argentina	Finland	Mexico	Singapore
Australia	France	Morocco	South Africa
Austria	Germany	Netherlands	Spain
Bangladesh	Greece	New Zealand	Sweden
Belgium	Hong Kong SAR	Nigeria	Switzerland
Brazil	Hungary	Norway	Thailand
Bulgaria	India	Pakistan	Turkey
Canada	Indonesia	Peru	UAE
Chile	Ireland	Philippines	United Kingdom
China	Israel	Poland	United States
Colombia	Italy	Portugal	Venezuela
Denmark	Japan	Qatar	Vietnam
Ecuador	South Korea		