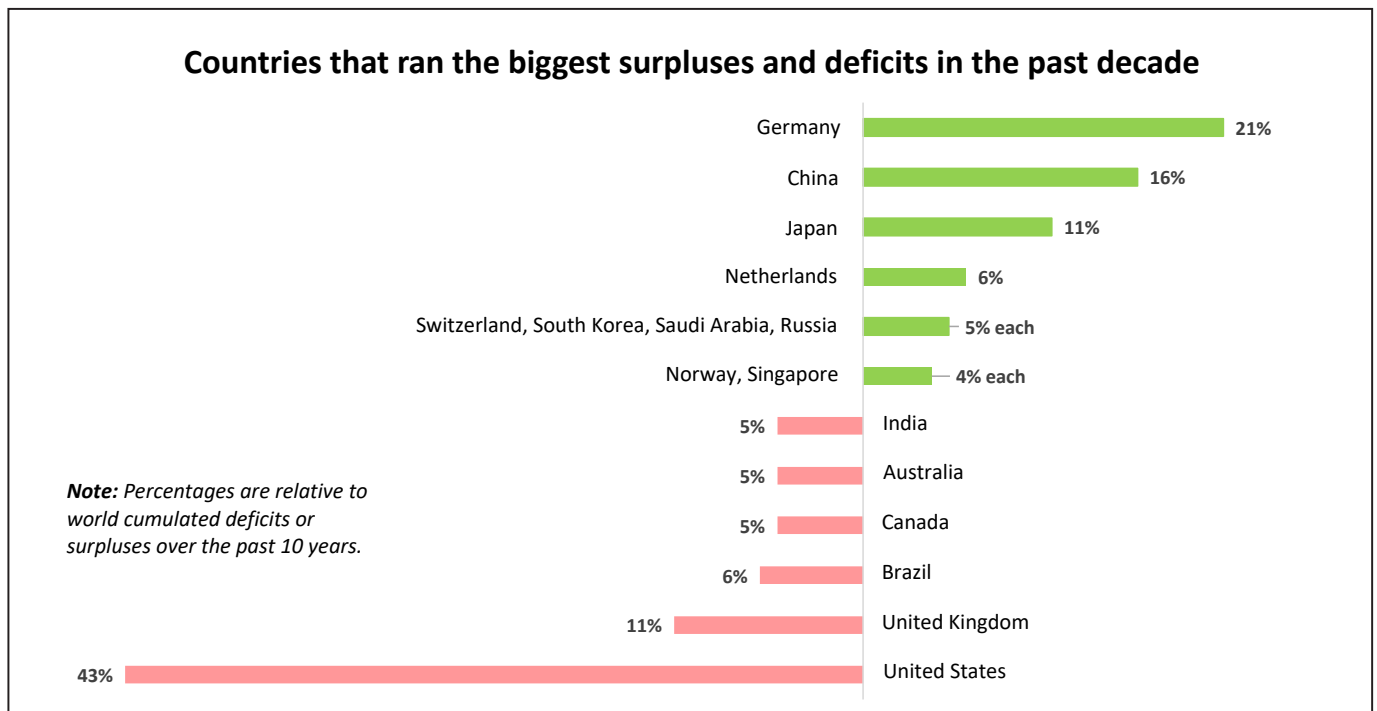


# Country trade imbalances are an existential threat to the global trading system

Written by: Stewart Paterson, Research Fellow



The US-China trade war has dominated financial and economic news in Asia in the past year. Similarly, in Europe and the UK, Brexit has been the dominant news story for three years now. Together, the two stories are being presented as posing an existential risk to the multilateral trading system and global prosperity. They are however a symptom of broader and enduring trade imbalances that are now affecting global trade and geopolitics in more than two ways.

This paper looks at the trade imbalances and economic shocks that have driven the global trade system away from equilibrium and contributed to the eruption of the US-China trade dispute. It identifies their causes and destabilizing consequences and formulates policy recommendations for achieving more equitable and sustainable trade outcomes.

The key conclusion is that nominal exchange rate flexibility, at the national level, is a prerequisite for preventing perennial trade imbalances, minimizing related balance of payments-induced risks to the financial system, maximizing trade outcomes and ultimately reducing geopolitical risks.

## Executive summary

- A sustainable trading system should show a tendency towards balance.
- The analysis of current accounts in nominal US dollar terms over the past decade tells us that imbalances have persisted over time and been highly concentrated in just a few countries that follow specific currency and industrial policies or enjoy an abundance of natural resources.
- The picture that emerges is one of constant disequilibrium with a large number of countries running severely out-of-balance current account positions, a situation that pre-dates the global financial crisis and has continued in its aftermath.
- Taking the past ten years (2009-2018 inclusive), on a cumulative basis, 66 countries have run deficits totaling USD 9.764 trillion and 32 countries have run surpluses totaling USD 12.073 trillion.
- Collectively, just eight countries account for 80% of the current account deficits run up during the decade from 2009-2018. The four “Anglo-Saxon” economies (United States, United Kingdom, Australia and Canada) which represent 31% of global GDP have accounted for 64% or nearly two-thirds of the trade deficit. These four countries do not control their nominal exchange rates and have a relatively “light-touch” approach to industrial policy.
- Trade surpluses are equally concentrated. In the last decade, collectively, six countries account for 66% or two-thirds of the cumulated trade surplus. All have an exchange rate arrangement that is in some way not market based.
- Germany has been the largest producer of current account surpluses in the last decade accumulating USD 2.57 trillion of surplus against China’s USD 1.97 trillion, accounting for 21% and 16% of the total respectively, despite the fact that Germany’s economy is about one-third the size of China’s.
- In the absence of free-floating nominal exchange rates, the slow pace of real effective exchange rate adjustment has prolonged the duration of these imbalances.
- Over a ten-year period only 16 countries, out of 96, have had an average current account position of +1% or -1% of GDP or less (i.e. more or less balanced). In contrast, 41 have run an average annual deficit of more than 3% of GDP while 19 have run an average annual surplus of more than 3% of GDP. Nearly two-thirds of countries have been running average annual current account positions that are severely out of balance. In fact, on average the mean current account deviation from balance among 96 countries over the past 10 years has been 6.7% of GDP.
- Persistent imbalances have affected financial stability, the quality of growth and trade outcomes, thereby also creating political and geopolitical tensions.
- Among these deficit countries, the United States stands out, accounting for 43% of the total accumulated current account deficit (and, as a reference, accounts for 26% of global GDP). The United Kingdom is the second largest deficit country.
- It is arguable that Brexit and the US-China trade war were a consequence and not the cause of global trade imbalances.
- Real exchange rate flexibility is essential for rebalancing the system and optimizing trade outcomes, particularly in terms of employment and growth.
- Nominal exchange rate flexibility is a precondition for real exchange rates to adjust on a time-scale fast enough to prevent the undesirable impact of prolonged trade imbalances.

## Introduction

As globalization has spread and deepened, trade imbalances have grown and become, in some cases, strongly persistent. In the absence of free-floating nominal exchange rates, the slow pace of real effective exchange rate adjustment has prolonged the duration of these imbalances, also elevating financial crisis risks, creating sub-optimal trade outcomes and heightening geopolitical risks.

**Prolonged and sizable trade imbalances threaten the financial system and heighten geopolitical risks.**

This paper looks at these global trade imbalances over the past decade, and over a longer time-frame for players running the biggest surpluses and deficits. Its aim is to understand the key causes for the US-China dispute and for the destabilization of our global trade system. The paper also formulates key recommendations for achieving a fairer, more equitable and therefore more sustainable global trading system, and by extension, for reducing geopolitical tensions.

## Methodology

The paper uses data from the World Bank Open Database for current accounts in US dollar nominal terms and relative to a country's own GDP. For India we have added the numbers for the year ended March 2019 from the Reserve Bank of India. All data is from the World Bank database unless otherwise specified (the real effective exchange rate data comes from the BIS for example). This represents a complete dataset for 98 countries which collectively account for 99% of world GDP. Data for a smaller number of crucial countries is available going back further in time.

**The paper reviews global trade imbalances for the past decade and presents a complete dataset for 98 countries which collectively account for 99% of world GDP.**

## Situation analysis

### Current account data exposes imbalances

Taking the past ten years (2009-2018 inclusive) covering the post global financial crisis period of current account data, on a cumulative basis, 66 countries have run deficits totaling USD 9.764 trillion and 32 countries have run surpluses totaling USD 12.073 trillion.

**Over the past 10 years, 32 countries have run a cumulative surplus of over USD12 trillion, and 66 countries have run a cumulative deficit of over USD 9.7 trillion.**

Since the global current account, by definition, balances, there is a measurement error of about USD 2.3 trillion over the 10 years or an average of USD 230 billion a year. This error cannot be explained by the absence of a small number of countries or customs entities from the dataset. It may be partly related to some countries 'adjusting' their data declarations but more importantly it shows that no one actually knows for certain how big the trade imbalances are, which is disquieting when one considers their impacts.

Despite the surplus being exaggerated (or the deficit understated), deficit countries outnumber surplus countries by more than 2:1.

### Deficit countries

Collectively, just eight countries accounted for 80% of the current account deficits run up during the decade from 2009-2018.

*The four "Anglo-Saxon" economies that represent 31% of global GDP have accounted for 64% or nearly two-thirds of that trade deficit*

Among those, the United States stands out. It accounts for 43% of the total accumulated current account deficit of the deficit countries (for context, it accounts for 26% of global GDP, although no matter how large or small an economy is, in equilibrium it should be running a balanced current account over the course of a cycle).

The United Kingdom is the second largest deficit country with a USD 1.1 trillion deficit in the past decade, accounting for 11% of the total (UK is a mere 4% of global GDP). Perhaps tellingly, the four large "Anglo-Saxon" economies of the United States, the United Kingdom, Australia and Canada have run up a cumulative current account deficit of USD 6.23 trillion over the past decade, accounting for 64% or nearly two-thirds of the entire total of deficits.

Two observations should be noted at this point. The four Anglo-Saxon economies each have their own currency and they do not intervene in the exchange rate, hence the market determines their exchange rate. Secondly, they each have a relatively "light-touch" approach to industrial policy.

*Brazil, India, Turkey and Mexico have accounted for another 17% of the total trade deficit*

The other big deficit countries over the past ten years have been certain emerging markets. Notably, Brazil has accounted for 6% of the total deficit and together with India, Turkey and Mexico. As a group they make up 17% of the total.

Developing economies tend to import capital to deepen their capital stock at a more rapid pace than domestic savings would facilitate. For these four economies, the current account deficits could therefore be a function of, and driven by, their capital account surpluses. Equally, none of the four have been as successful as other developing countries in their pursuit of export orientated industrial policy.

**Deficit countries have persistently outnumbered surplus countries by a ratio above 2:1**

**Just 8 countries accounted for the bulk of the past decade's trade deficit, with the USA accounting for 43% of the total.**

**Four Anglo-Saxon economies that accounted for about 2/3rd of the cumulated trade deficit do not control their nominal exchange rates and had a relatively "light-touch" approach to industrial policy.**

**Emerging market economies run deficits because they need to import capital.**

Table 1: Top 10 countries that ran a deficit between 2009 - 2018

#	Country	Accumulated current account deficit in the past decade (USD)	% relative to the world's total deficit
1	United States	4.17 trillion	43%
2	United Kingdom	1.09 trillion	11%
3	Brazil	544.9 billion	6%
4	Canada	513.3 billion	5%
5	Australia	458.6 billion	5%
6	India	441.1 billion	5%
7	Turkey	425.3 billion	4%
8	France	218.6 billion	2%
9	Mexico	197.4 billion	2%
10	Indonesia	145.3 billion	1%
11	South Africa	127.3 billion	1%
12	Greece	124.2 billion	1%
13	Colombia	120.4 billion	1%
14	Argentina	116.5 billion	1%
15	Poland	116.3 billion	1%

Source: World Bank Open Database

## Surplus countries

In the last decade, collectively, six countries accounted for 66% or two-thirds of the cumulated trade surplus.

Germany, China, Japan, the Netherlands, Switzerland and South Korea concentrate most of the trade surplus.

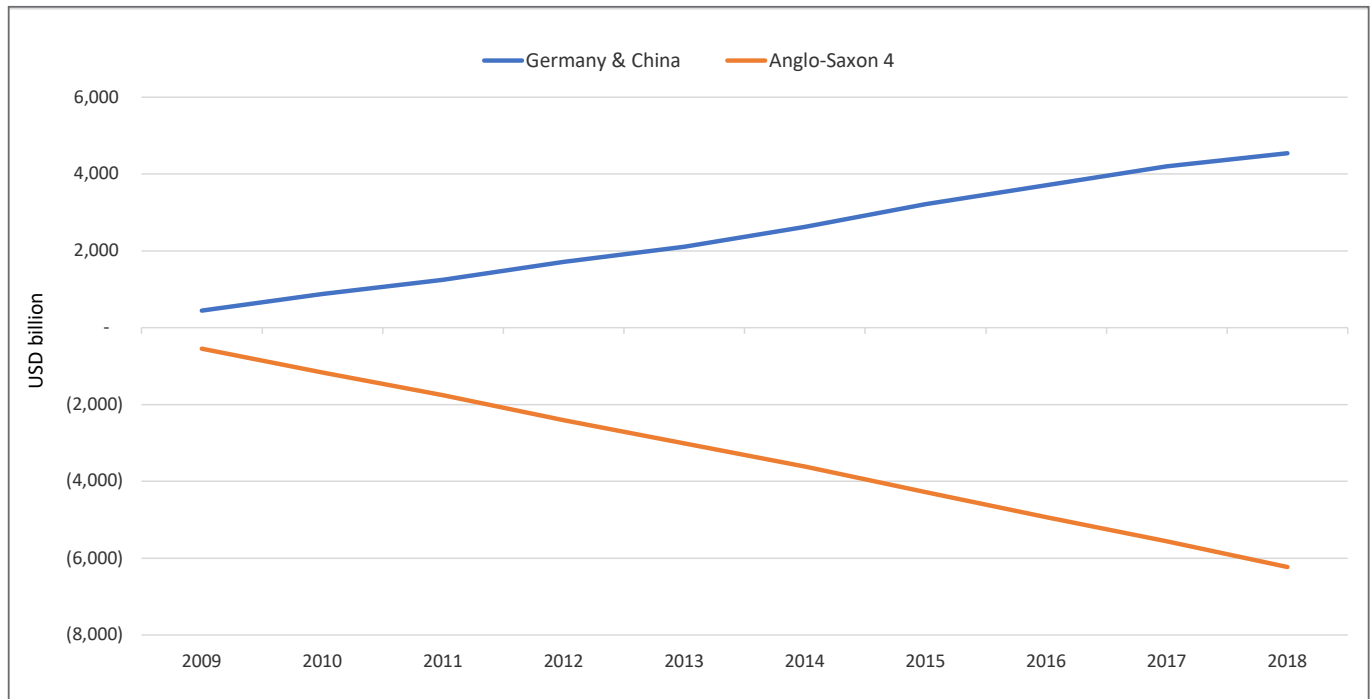
Germany has been the largest producer of current account surpluses in the last decade, accumulating USD 2.57 trillion of surplus (21%) against China's USD 1.97 trillion (16%), accounting for 21% and 16% of the total respectively, despite the fact that Germany's economy is about one-third the size of China's.

These two are joined by Japan, Netherlands, Switzerland and South Korea in making up a group of six (three north European and three East Asian) industrialized net exporters that collectively have accounted for 66% or two-thirds (just under USD 8 trillion) of the surpluses that have been run in the past decade.

**6 countries account for 2/3rd (just under USD 8 trillion) of the past decade's trade deficit.**

**Among the surplus countries, Germany has been the largest, accounting for 21% of the cumulated deficit or nearly USD2.6 trillion, with China accounting for another 16%.**

Chart 1: Cumulative surpluses and deficits of Anglo-Saxon 4 vs. China & Germany 2009-2018 in USD bn



Source: World Bank Open Database

*The exchange rates of the six countries that have accumulated the biggest surplus are not market-based*

Among this group of six, all of them have an exchange rate arrangement that is in some way not market based. The Germans and the Dutch share a currency with their European counterparts in the Eurozone. The Swiss have intervened heavily in the exchange rate to fight appreciation pressure as have the Japanese, Koreans and Chinese over the past decade.

**The six largest surplus countries all have an exchange rate arrangement that is in some way not market based.**

In short, all six pay careful attention to their exchange rates which form part of their macroeconomic policy mix. Secondly, all six countries have or have had a strong tradition of state-led industrial policy.

**How has the single European currency been preventing real exchange rate adjustments and current account balance?**

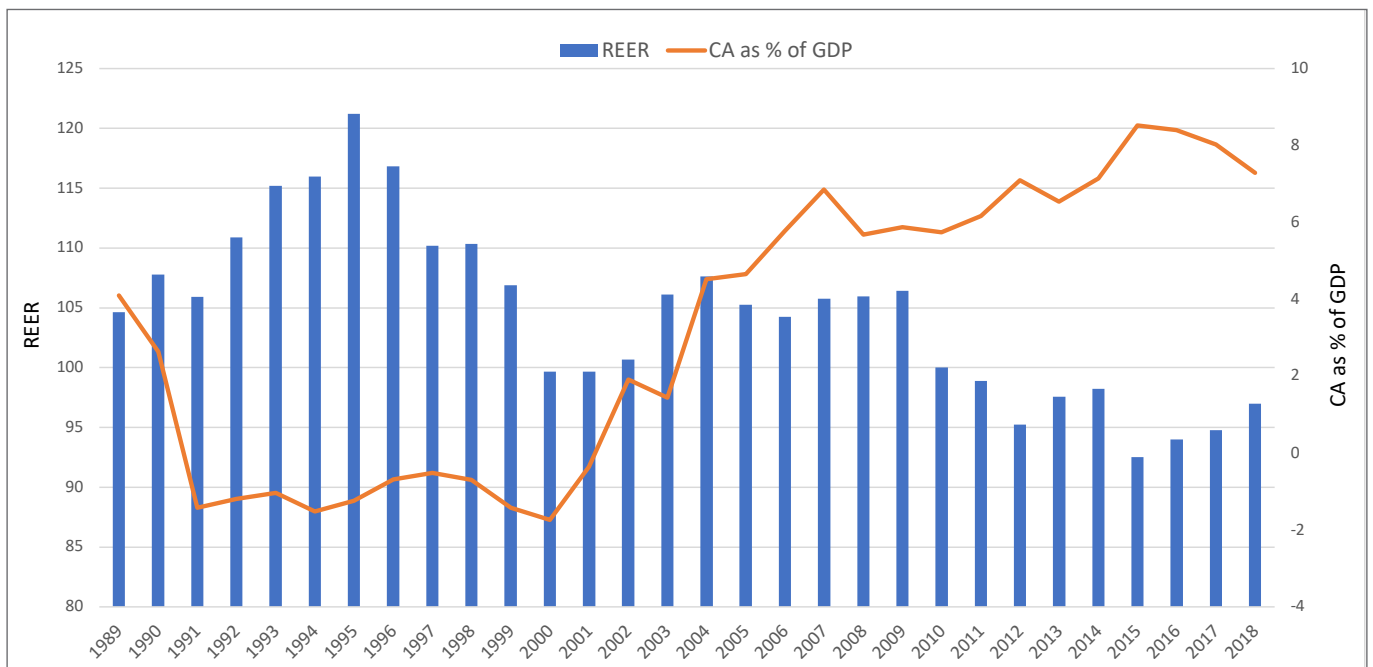
As Germany surpasses China as the biggest current account country, its real effective exchange rate should be appreciating rapidly. It has now run a current account surplus every year since 2002, and recently the surplus has consistently exceeded 7% of GDP. Given that Germany is operating at full employment, one would expect Germany's current account to be flirting with deficit if rebalancing mechanisms were working.

Yet, using the Bank of International Settlement's broad real effective exchange rate (REER), Germany's currency is now 6% cheaper than it was at the outset of the Euro in 1999 and has been in a declining trend between 2005 and 2016, although it is slightly off its lows now.

The single European currency has therefore prevented the exchange rate flexibility which is a prerequisite for a more sustainable trading system.

Germany's REER has depreciated while its current account surplus has ballooned in size.

**Chart 2: Germany's real effective exchange rate vs. current account as a % of GDP**



Source: World Bank Open Database

*The second most important group of surplus countries are the hydrocarbon exporters*

Russia, Saudi Arabia, Norway and Kuwait have run a cumulative current account surplus of just over USD 2 trillion in the past ten years. However, as compared to the first group of countries, these economies will not sustain their trade surpluses once their natural gas and oil resources become depleted, or the marginal cost of production rises.

**Table 2: Top 10 countries that ran a surplus between 2009-2018**

#	Country	Total accumulated current account surplus in the past decade (USD)	% relative to the world's total surplus
1	Germany	2.57 trillion	21%
2	China	1.97 trillion	16%
3	Japan	1.35 trillion	11%
4	Netherlands	741.4 billion	6%
5	Switzerland	649.4 billion	5%
6	South Korea	641.4 billion	5%
7	Saudi Arabia	622.4 billion	5%
8	Russia	616.5 billion	5%
9	Singapore	526.6 billion	4%
10	Norway	437.3 billion	4%
11	Kuwait	375.1 billion	3%
12	Sweden	238.8 billion	2%
13	Denmark	229.9 billion	2%
14	Thailand	217.4 billion	2%
15	Iraq	142.5 billion	1%

Source: World Bank Open Database

### Little tendency towards balance

The analysis of current accounts in nominal US dollar terms over the past decade not only tells us that imbalances are highly concentrated in a few countries, it also suggests that there is little tendency towards balance.

Of the deficit countries, all four Anglo-Saxon economies have run a deficit in each of the past ten years, although Canada managed a surplus during the 2006-2008 commodity boom. The four emerging markets have also run perennial deficits.

Similarly, among the surplus countries only Saudi Arabia ran a deficit in two of the ten years, the remaining countries have run a surplus in each and every year.

Longer time series data, where available, supports this thesis. The last time China ran a current account deficit for example was in 1993. In the case of Korea, it was 1997.

**The analysis of current accounts in nominal US dollar terms over the past decade tells us that deficits and surpluses in key countries have endured year after year.**



Switzerland had a current account deficit in 1980. The United States just managed a tiny surplus in the recession year of 1991 but that was the last time it did so. The dataset from the World Bank for Japan starts in 1996 and it has not run a deficit since then. So, the point that surplus countries have been running them irrespective of the cycle, and deficit countries, likewise, is born out by longer term data.

Looking at the data for individual country current accounts relative to their own GDP is also revealing of a system that is not tending towards balance. For example, over a ten-year period only 16 countries, out of 96, have had an average current account position of +1% or -1% of GDP or less (i.e. more or less balanced). In contrast, 41 have run an average annual deficit of more than 3% of GDP while 19 have run an average annual surplus of more than 3% of GDP. In other words, nearly two-thirds of countries have been running average annual current account positions that are severely out of balance. In fact, on average the mean current account deviation from balance among 96 countries over the past 10 years has been 6.7% of GDP.

### Signs of improvement?

There is a modicum of hope. The annual average deviation from balance has been contracting lately, although 2018 saw a modest rise. From a post-crisis peak of 7.7% in 2011, the mean deviation from average fell consistently to a low of 4.6% in 2017 before ticking up in 2018 to 5.4%.

Among the 18 countries identified as being in a near perennial state of dis-equilibrium, and that account for the lion's share of the trade imbalance in dollar terms, the magnitude of dis-equilibrium has also declined in recent years. From a post-GFC high of 8.7% in 2012, the unweighted average has fallen to a low of 3.9% in 2016 and 2017 before rising again in 2018 to 5.5%.

Weighting the numbers by GDP produces a more encouraging picture, with a deviation from balance peaking in 2012 at 4.8% and falling to below 3% in 2016 although, like the unweighted number, it rose again in 2018.

In spite of this, both the unweighted and weighted numbers are meaningfully higher now, even after the recent improvement, than they were before the three events that have contributed in major way to the disequilibrium: the Asian financial crisis (with the subsequent focus of certain emerging markets with foreign exchange reserve accumulation); the formation of the Euro; and Chinese accession to the WTO.

**Surplus countries run surpluses irrespective of the cycle. China last ran a deficit in 1993, the USA last ran a small surplus in 1991.**

**Two-thirds of countries are severely and consistently out of balance.**

**Some rebalancing starting to happen, but not fast enough to mitigate the risks the imbalances pose and mostly driven by falling oil prices.**

Indeed, the biggest driver of the recent fall in the weighted average imbalance has been Kuwait and Saudi Arabia, which account for more than half the improvement and is due to lower oil prices. China has contributed to the decline but it only accounts for about 15% of the improvement.

### Improvements have come at the cost of slower growth

Improvements in trade imbalances in the past seven years or so, have come at the cost of slower growth. This raises the question of whether the very modest trend towards equilibrium has been achieved efficiently, or whether it is because deficit countries are running large output gaps, thus diminishing demand for imports but operating well below their potential production frontiers.

Such improvement as there has been has come at the cost of slower growth, a sub-optimal outcome.

In other words, has it actually been a sub-optimal improvement in trade imbalances? An economy in equilibrium has a balanced current account at full employment. The sub-optimal scenario certainly appears to be the case in the Eurozone, where formerly large deficit countries such as Greece, Portugal, Italy and Spain have moved towards balance or small surplus, but at the expense of high unemployment rates.

#### The case of Greece

Greece is a relevant example. In the five-year period 2014 to 2018 inclusive, its current account has averaged a deficit of 1.7% of GDP, relatively close to balance in a global context. In the five years from 2006-2010, its current account deficit averaged 12% of GDP. Greece is therefore a stand-out as part of the detrimental trend in global imbalances.

Unemployment on the other hand, the best single indicator of how close the country is operating to its potential, averaged about 8% while the deficits were high (low by Greek standards and perhaps, given the microeconomics of the labor market, a level that constitutes “full-employment”) and then sky-rocketed to average about 22% in the last five years.

Even that level of demand contraction was unable to move the country to a current account surplus. Why? It has had the wrong real effective exchange rate for the past 20 years and real effective exchange rates are very slow to adjust if the nominal exchange rate is fixed.

Further reading: ["Is the Euro the Biggest Threat to the Global Trading System?"](#)

## Reasons for the imbalances

A sustainable global trading system should show a tendency towards balance. This is, of course, not to say that every country should balance every bilateral trade relationship every year, nor even that every participant should balance its overall current account every year. Some economic shocks that drive the system away from equilibrium also take longer than others to be dissipated. Oil shocks, the formation of the European single currency and China's accession to the WTO are good examples.

**For the system to be equitable and sustainable, there should be at least a general tendency for current accounts to trend towards balance over the course of the economic cycle.**

However, if the system is robust and crucially, the path to equilibrium is not being obstructed, then these shocks should not knock the system permanently off-balance.

The picture that emerges from this analysis of country level and aggregate current accounts is one of constant disequilibrium with a large number of countries running severely out-of-balance current account positions, a situation that pre-dates the global financial crisis and has continued in its aftermath.

Even with the recent diminution in trade imbalances relative to GDP, the global trading system is still very far from equilibrium both in absolute terms and relative to the period prior to China's accession to the WTO, the Asian financial crisis and the formation of the European single currency in 1999.

Fixed exchange rates have prevented current account re-balancing. Real effective exchange rates should have been allowed to move to prevent long-lived and large imbalances from building up in the system with potentially destabilizing consequences. Exchange rates were fixed and current accounts did not re-balance.

## Impacts of the imbalances

### Threats to the financial system

Prolonged and sizable trade imbalances also pose a real threat to the financial system, which becomes overly reliant on fickle short-term capital flows to fund the deficits. Financial history is riddled with examples of external debt defaults, causing banking crises, that lead to lost output and sub-optimal economic outcomes. These crises undo the efficiency gains that come from trade.

**Persistent trade imbalances require short-term cross border capital flows to fund the deficits and pose a real threat to the financial system.**

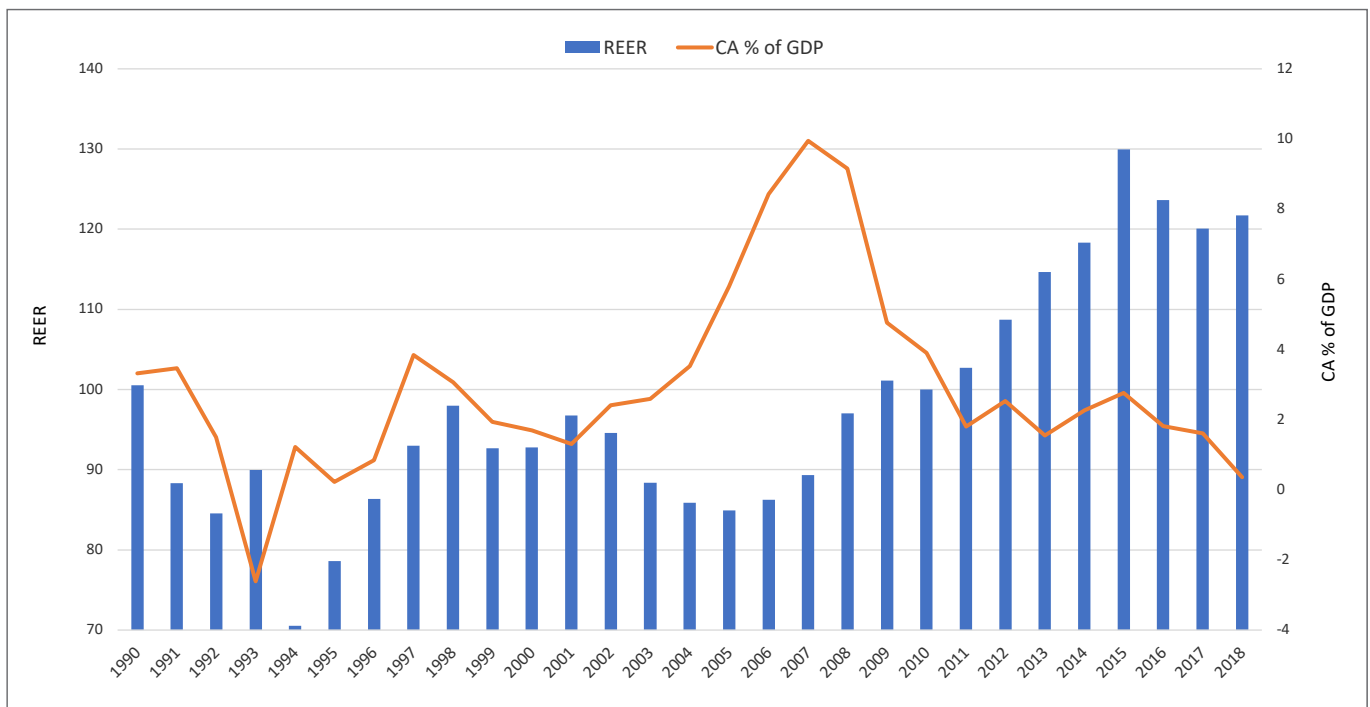
### Geopolitical tensions

The current spate of protectionist measures, of which the Trump tariffs are the most high profile but by no means the only example, and aimed in an ad hoc way at addressing public concerns about the economy, are a direct result of the prolonged and large trade imbalances that have been allowed to persist.

**Nominal exchange rate flexibility is required to prevent long periods of trade imbalances developing.**

To the high deficit Anglo-Saxon bloc countries, whose genuinely free-floating exchange rates is not subject to policy interference, the global trade playing field looks decidedly uneven. A large proportion of their potential export markets (within which China and the Eurozone each represent 16% of global GDP) operate under a system where nominal exchange rates are not floating and therefore movements in real effective exchange rates, relying on relative changes in prices and productivity growth, take too long to be effective.

**Chart 3:** China's real effective exchange rate vs. current account as a % of GDP



Source: World Bank Open Database

Take the situation with China, which entered the WTO in 2001, with a fixed exchange rate that was continuously undervalued. Its current account surplus grew from 1.3% to 9.7% of GDP between 2001 in 2007. During that period, which should have been one of rapid currency appreciation, its real effective exchange rate actually declined because productivity growth outstripped inflation differentials against the backdrop of a fixed nominal exchange rate.

**In the absence of a free-floating Yuan, it has taken 25 years for China's real effective exchange rate to appreciate sufficiently to bring the current account close to balance.**

The growth of Chinese foreign exchange reserves stands testimony of the degree to which the central bank had to intervene to circumvent the market's natural equilibrium and keep the exchange rate down. The last time China ran a current account deficit was in 1993 prior to the devaluation of 1994.

It has taken 25 years for the real effective exchange rate to move sufficiently to bring China's current account down towards balance (in 2018 it was just 0.36% of GDP), but over that time frame much damage has been done, not least to global public opinion.

#### **Why was China not labelled a currency "manipulator" in 1994?**

Corrective policy action requires building public opinion support, which takes time. This is the reason why the US officially named China a "currency manipulator" in August 2019. The prescient time to do so would have been in 1994 when China implemented an exchange rate "re-alignment" to turn a current account deficit into a surplus. Paradoxically, this is when the designation was actually removed.

Perhaps another time to call China out might have been in the run up to WTO accession in 2001 in the eighth year of successive surpluses, despite being a country in deep need of foreign capital investment and therefore more likely to run a deficit on the current account to absorb foreign investment, through the capital account. Or, for that matter, at any point in time over the subsequent seven years during which China quintupled its exports, driving its current account surplus to 9% of GDP and forcing its central banks to accumulate an additional USD 2 trillion of foreign exchange reserves to keep the exchange rate down.

But by the time the political climate was judged right for action, the problem, in this case specifically the undervaluation of the RMB (there were plenty of other issues involved), had passed and the damage had already been done.

## Key takeaways and recommendations

Global trade imbalances have persisted within the context of the multilateral trading system, prompting the general public and therefore politicians to call into question the validity of a set of rules and institutions that have allowed such damaging lopsidedness in trade to exist for so long.

These persistent imbalances should therefore give cause to concern for those who wish to see the multilateral trading system recover and continue to deliver growth and prosperity.

Moving forward, mechanisms that restore balance need to be allowed to work. Real effective exchange rates cannot do their work in the absence of nominal exchange rate flexibility.

This analysis strongly supports the idea that nominal exchange rate flexibility, at the national level, is a prerequisite for a trading system that has a tendency towards balance and therefore minimizes balance of payments-induced risks to the financial system and global growth.

promoting sustainable global trade

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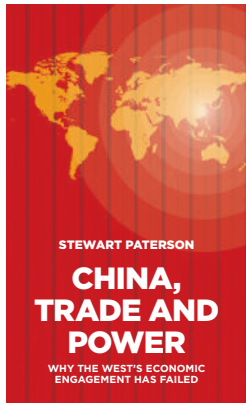
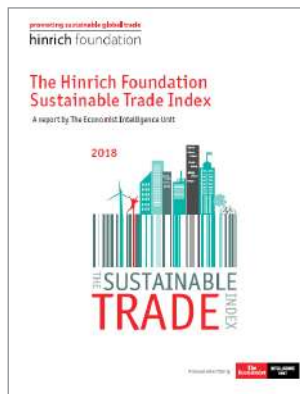
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