

Placing Nations' Sectoral Surpluses and Deficits into their Global Context

paper by

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Tension between the United States and China about which country is primarily responsible for the trade imbalance between the two has thrown the spotlight on the broader consequences for the international financial system when some countries run large and persistent current account deficits and others accumulate big surpluses.

[Atish Ghosh and Uma Ramakrishnan (2012)]

If the government is persistently running deficits, that is spending more than it earns, it will have to borrow money to meet the shortfall. Accumulating more and more debt is not sustainable, as the government can become insolvent!

[<http://nzier.org.nz/about/economics-explained/fiscal-policy/>]

Introduction

This statistical presentation builds on previous papers (Rankin 2014a, 2014b) which explore the literature of financial balances. Using current account and general government net lending, the paper analyses private sector and government sector balances for 100 selected countries, including all the major national economies and selections representing the world's regions. This enables us to take a global view of the financial circumstances of national economies, and supra-national regional economies.

For any country, domestic and foreign balances must add to zero, an accounting identity. This means that private and government balances combined equal the current account balance. For the world as a whole – a closed financial system – private and government balances add to zero, over any period of time. The world's current account balance is always zero, an accounting identity. In the long run, we would expect to see combined domestic balances in every country approach zero as short-term foreign imbalances resolve through exchange rate mechanisms.

This paper uses the period from 1995-2014 as a proxy for the 'recent' long-run, and 2010-14 as the recent post-financial-crisis short run. With governments in many economies seeking to consolidate their fiscal balances in a recent period of private-sector financial caution, accommodations must be found if fiscal targets are to be achieved. The paper investigates which groupings of national economies have provided these accommodations. It notes that, especially over the longer term, New Zealand has an unusually accommodating financial profile.

A major premise of the project that this paper is a part of is that, for the most part, private sector financial balances are autonomous, and therefore, in stable economies, public sector balances are substantially accommodating. This contravenes the 'crowding out' hypothesis which treats

privately-sourced loanable funds as scarce and borrowing as potentially unlimited, mediated through the rate of interest. In the crowding out hypothesis, increased government borrowing necessarily forces private sector accommodation by raising interest rates.

At least for the period covered here, it is clear that private sector surpluses prevail even when interest rates are very low, and that private sector balances fall at times when interest rates are rising. In line with Jan Hatzius' methods of forecasting (Rankin 2014b), it is changing private sector surpluses and deficits which presage the autonomous expenditure changes that drive macroeconomic change. Accommodating government deficits arise in part through preset fiscal stabilisers such as graduated taxation and social security. They also arise from 'fiscal stimulus' programs such as those introduced in most advanced countries in 2009, after the 2008 global financial crisis. Accommodating government surpluses arise in economies with very high levels of autonomous private sector activity (private financial deficits); this represents the expansionary flipside of the automatic stabilisation mechanism.

World and Major Country Groupings (Charts A to C)

In the 1990s, substantial private sector surpluses offset by fiscal deficits became the norm in developed economies. Economic growth driven by rising private sector borrowing, gave way to global fiscal balance in 2000, and to the United States financial crisis of 2000-02. Falling private balances drive expansions, and rising private balances likewise drive contractions.

Emerging economies show a less cyclical pattern, with private balances typically around three percent of emerging economy GDP. Noteworthy here is the partial accommodating role of emerging economies' private sectors, willing to take on increased debt when other countries' private sectors were narrowly focussed on repaying debt and increasing precautionary savings balances. Also of note is the consistent foreign deficits (ie current account surpluses) in the emerging economies. The standard economic story of development is one of capital-abundant advanced economies lending to capital-scarce emerging economies. The reality is of emerging economies' private sectors becoming important creditors of anglo-advanced-economy governments.

New Zealand (Chart D) and Australia

If ever there was a sound argument for Australasian exceptionalism, it lies in the exceptional propensities of these countries private sectors to run financial deficits. New Zealand, as an 'anglo-advanced-economy' in particular appears to have a private sector that is very comfortable with the acquisition and accumulation of debt. Thus the New Zealand private sector shows all the signs that its indebtedness has represented and continues to represent an accommodation of foreign surpluses. Further, fiscal surpluses through until 2008 represent government financial accommodation to these private deficits rather than a specific policy to run surpluses. New Zealand has a relatively low government debt to GDP ratio precisely *because* New Zealand is one of the most conspicuously indebted advanced nations in the world. Australia (Rankin 2014a), unlike New Zealand, shows recent signs of becoming debt-averse in its private sector.

Private and Public Balance Averages for 100 Countries: 1995-2014

Chart E shows the distribution of average balances for this twenty year period.

Over the long-run, an effective international monetary system should ensure a semblance of *current account* balance in all countries. Under the fixed exchange rate gold standard, this was supposed to happen through deflation in deficit countries and inflation in surplus countries. This process is known today as internal devaluation and revaluation (Medaiskytė and Klyvienė 2012, Ruparel 2012). Under floating exchange rates, current account convergence should take place through exchange-rate depreciation in deficit countries and appreciation in surplus countries. These mechanisms clearly have neither worked for the world economy as a whole (floating currencies) nor within the single-currency Euro Area. If these mechanisms were effective, then this points on this scatter-plot would cluster around the 'line of current account balance'. (Countries with long-run current account deficits appear to the left of the line of balance; surplus countries appear on the right.)

The reality of a two-sector world economy is that the public sector will always be a debtor sector, and, to maintain stable global debt to GDP ratios, we would expect average private surpluses and fiscal deficits to reflect the world economic growth rate. In Chart E, the 100-country averages revealed are labelled 'centre of gravity'. Thus more countries' balances reside in Quadrant 2 (Chart E) than in any other quadrant. They have private surpluses and government deficits. Quadrant 2 is the surplus-deficit quadrant. Asian countries in particular (shown in Chart F) are most consistently in this quadrant, with their governments' creditors being in large part their own private sectors.

Quadrant 1 is the surplus-surplus quadrant (refer Chart E). This is the natural home of oil dominant countries. Other countries there are from Asia (Korea, Singapore, Hong Kong, Uzbekistan), Africa (Algeria, Angola, Gabon), and Europe (Finland, Denmark, Luxembourg, Russia). In these countries, both private and public sectors contribute to outflows of financial capital to the rest of the world.

Quadrant 3 is the deficit-deficit quadrant. It includes a number of African economies, including South Africa. And it includes a number of Eastern European economies, including Iceland, Baltic States Latvia and Lithuania, and Euro Area members Cyprus and Portugal. In these countries, both private and public sectors receive inflows of financial capital from the rest of the world.

Quadrant 4, which includes New Zealand, is the least populated. It's the deficit-surplus quadrant; plentiful private activity generating sufficient public revenue to achieve fiscal surpluses. Most countries here lie close to Quadrant 3, meaning they have persistent current account deficits; the private deficits are larger than the government surpluses. The most rare combination of all is private deficits smaller than government surpluses. Only Paraguay and Norway achieved this, and both only just.

If the expected elliptical distribution (around the centre of gravity and the line of current account) had taken place, there would be substantially more countries near the origin, including some with fiscal and current account surpluses yet private deficits (part of Quadrant 4).

Changes from before to after the 2008 Global Financial Crisis.

By restricting the previous analysis to 1995-2008, and making a set of charts for the short period 2010-14, we can get an idea about possible trends for countries to move in autonomous or accommodating fashion either towards or away from the line of current account. And we can see the cyclical pattern of higher private surpluses (and government deficits) on average during contractionary phases of the global cycle.

For the Euro Area of the European Union, including the recently joined Baltic States, for 1995-2008 we can see in Chart G a clear division between the 'Old Europe' of the original EU (plus Finland), with the newer and smaller EU members mostly in the double-deficit Quadrant 3. Greece stands out as having the biggest average fiscal deficit, close to Portugal, Malta and Slovakia. Spain and Ireland did not have significant fiscal deficits, but did have private deficits that would have been of concern to the extent that these deficits represented debt-financed housing bubbles. The Baltic States, especially Estonia, are well out to the left, with very high private deficit balances. Estonia's financial profile was, like New Zealand's, in Quadrant 4. Iceland also features out to the left, between Latvia, Lithuania, Estonia and New Zealand.

Following the global financial crisis and ensuing world recession in 2009, there was a significant 'shift to the right', meaning substantially increased autonomous private sector balances. Ireland moved the most, from near the origin to the far corner of Quadrant 2. The move to the right was accompanied by a general move down, as accommodating fiscal deficits increased. However, the Euro Area fiscal policy, at least from 2012, has been one of fiscal consolidation throughout the Euro Area, meaning an attempt to move the Euro Area as a whole towards Quadrant 1, and away from the line of current account balance. The Baltic states have shown the most dramatic shift to the right. This dramatic switch to private sector austerity can be taken as a near-simultaneous response to the global and European financial crises, and their desires to conform more with western countries they relate to; for example, Finland.

For this attempt at an autonomous increase in Euro Area fiscal balances, to be successful, then accommodation was required elsewhere, most likely in the form of decreased private balances in some parts of the world, but also possible in the form of decreased fiscal balances outside of the Euro Area. We also note that when there are autonomous attempts to raise financial balances (eg into surpluses), and there is resistance to accommodation, then (increased) economic contraction takes place and the autonomous attempts are in large part thwarted.

One region that has accommodated in part Europe's private and public austerity is Latin America: refer Charts I and J. In Chart I, Latin American and Caribbean balances – with the exception of Panama, Costa Rica, Jamaica and Trinidad-Tobago – most closely follow the

healthy pattern clustered around the line of current account balance, and generally towards the centre of the chart rather than tending to the extreme of Quadrant 2.

In 2010-14, These countries spread to the left in an apparent accommodation of the huge and generally increasing private surpluses coming out of Europe and Asia. While this is not generally true of the African countries included here, there is evidence – uncharted at present – of significant financial flows (eg investment and land purchases) into some parts of Africa. In addition it seems likely that the conflict zones of the Middle East have also experienced significant financial inflows that will represent still unresolved components of the balances of payments.

With respect to the countries New Zealanders are most familiar with, Chart K shows Oceania (New Zealand, Australia, Fiji, Samoa) plus Japan, USA and the United Kingdom. We see USA as a significant debtor economy on both private and public balances, while Canada sits almost on the origin. United Kingdom is like a lesser version of the United States. The Oceania economies are well out to the left, but with New Zealand and Australia showing fiscal surpluses, on average, for the 1995-2008 period. Japan acts as a seemingly permanent fixture towards the extremity of Quadrant 2, with high public deficits and high private surpluses. Japan certainly renders the 'crowding out' hypothesis untenable in the contemporary global financial environment. It also challenges us to take a more benign view generally of government debt, especially when a government's private creditors are domestic and could have no interest in initiating a 'bank-run' on their own government.

In 2010-14, New Zealand migrated to Quadrant 3 (twin-deficit) close to the place previously occupied by USA. While these Oceanian countries all retain significant current account deficits, only Fiji has extended its current account deficit. Fiji's experience is most likely similar to that of some of the less developed African economies receiving significant foreign investment.

Conclusion

In general, the movement in financial balances is towards higher private surpluses, higher fiscal deficits and little resolution of current account imbalances. The general movement of developed economies appears to be towards the outlier territory currently occupied by Japan, despite the resistance of European countries, through austerity, to fiscal deficits. We also note that as the Euro nations in particular push towards Quadrant 1 (surplus-surplus), existing current account imbalances can only be accentuated. The Euro Area as a whole is moving into a mercantilist position in competition with parts of Asia (including China) and the oil-dominant economies.

Once we understand the crisis within the Euro Area as really being a crisis of unbalanced trade – a current account crisis that became a sovereign debt crisis only when the tax bases of Euro trade deficit countries shrank after these trade debts became unacceptable from 2009 – then we can envisage the imbalances of the Eurozone spreading to the world as a whole, and with more resistance to accommodation as austerity requirements befall an increasing spread of countries. Latin America and other accommodating parts of the less developed world stand to face

problems not unlike those of Greece. However, while the exchange rate mechanism clearly is not doing its principal job of preventing long-term current account imbalances, at least it does provide a mechanism through which individual countries with ongoing private external debt exposure can gain relief, especially where that exposure is in the debtor countries' currencies. It would be helpful if such relief, in future, is not accompanied by futile attempts to force debtor country governments into running fiscal surpluses that cannot be accommodated elsewhere in the global system.

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Appendix

Chart A

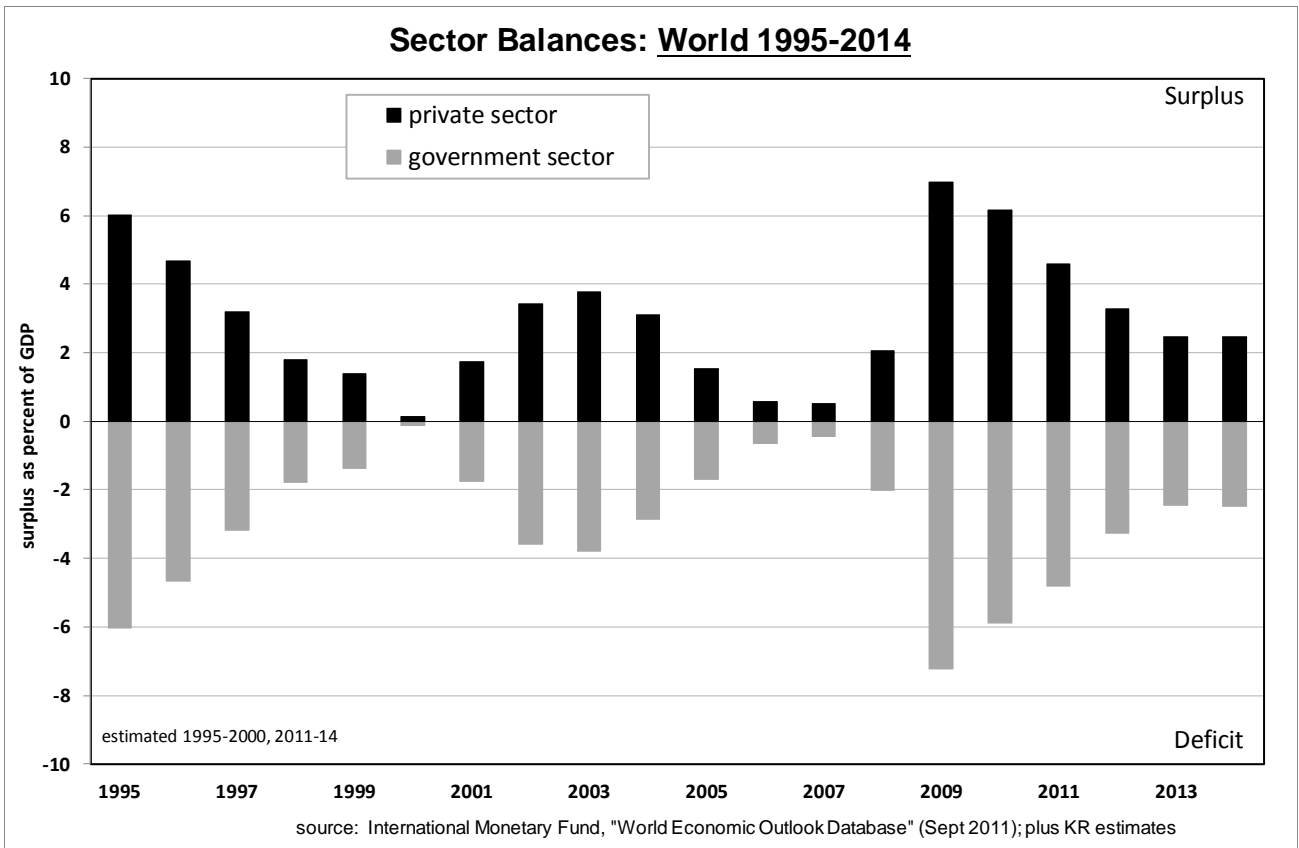


Chart B

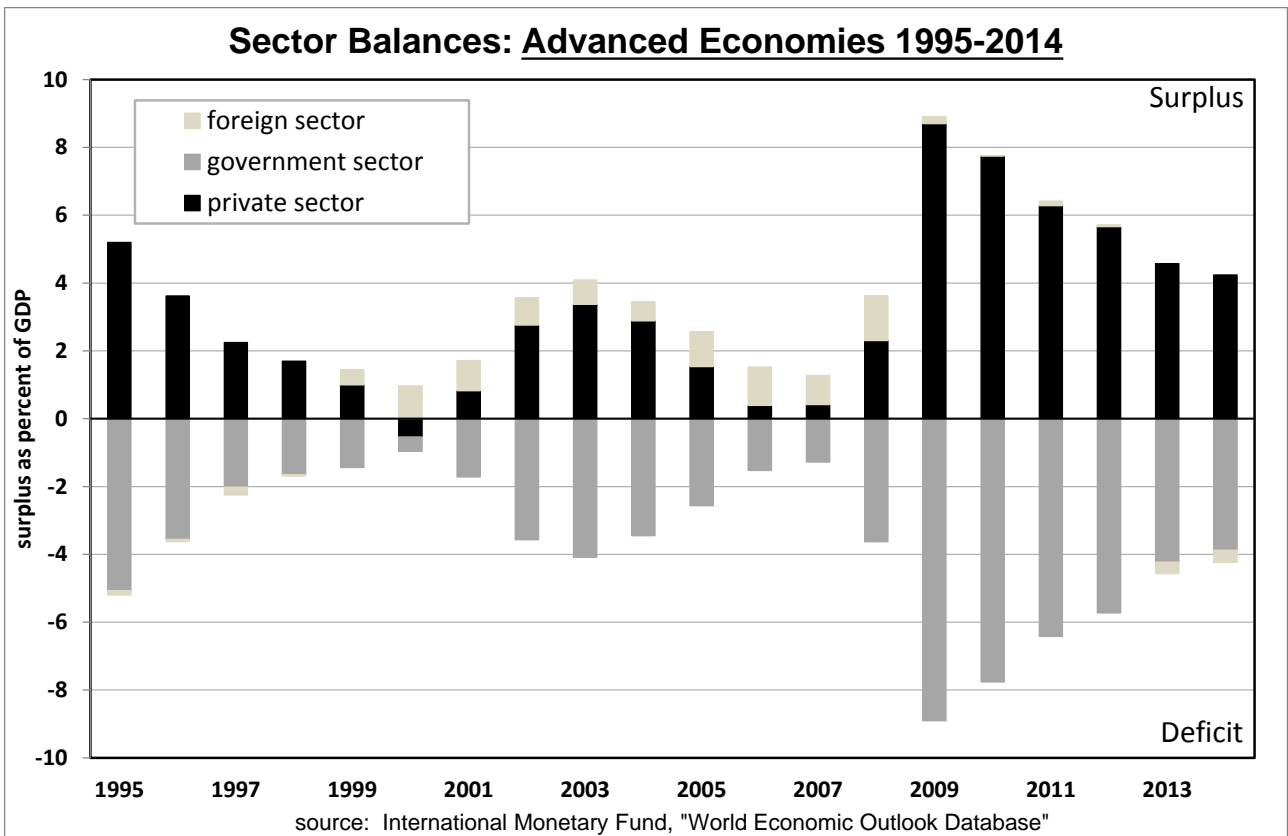


Chart C

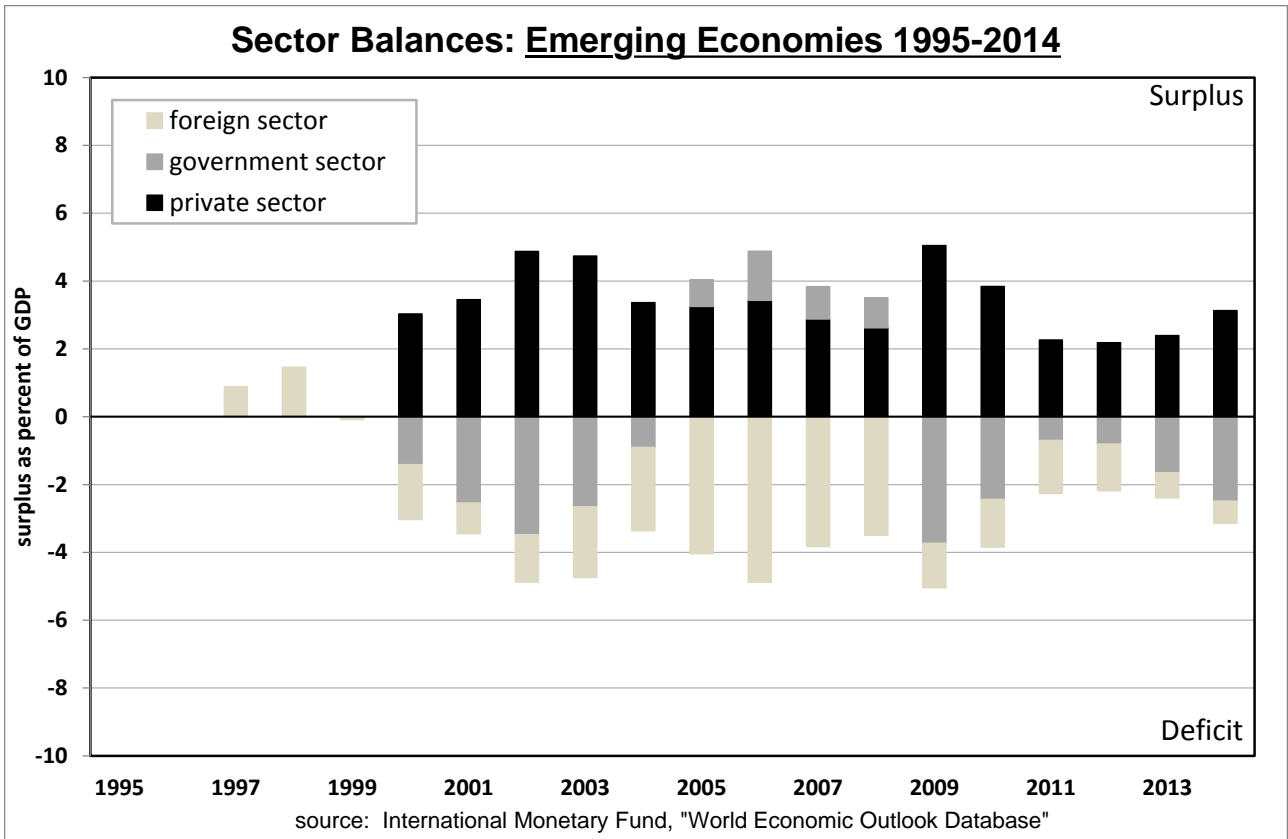


Chart D

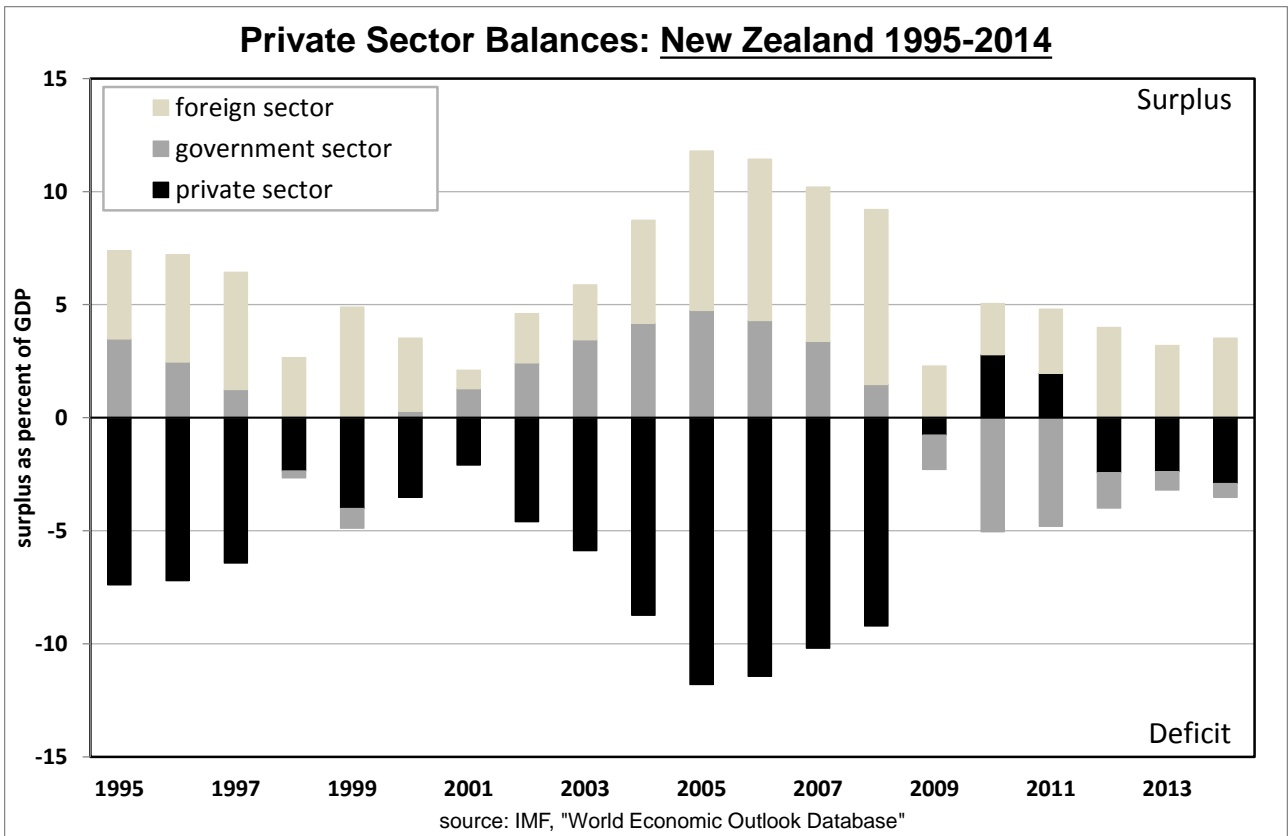


Chart E

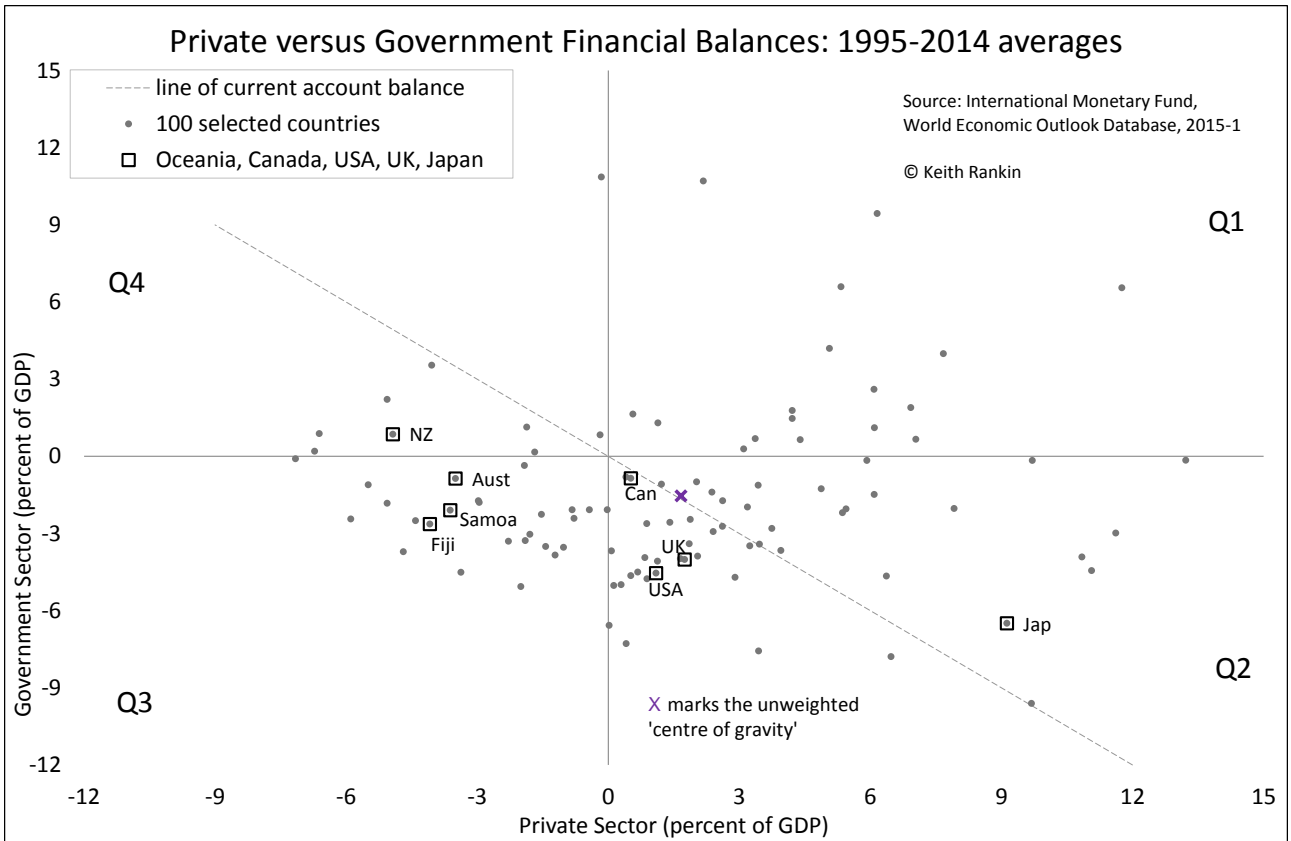


Chart F

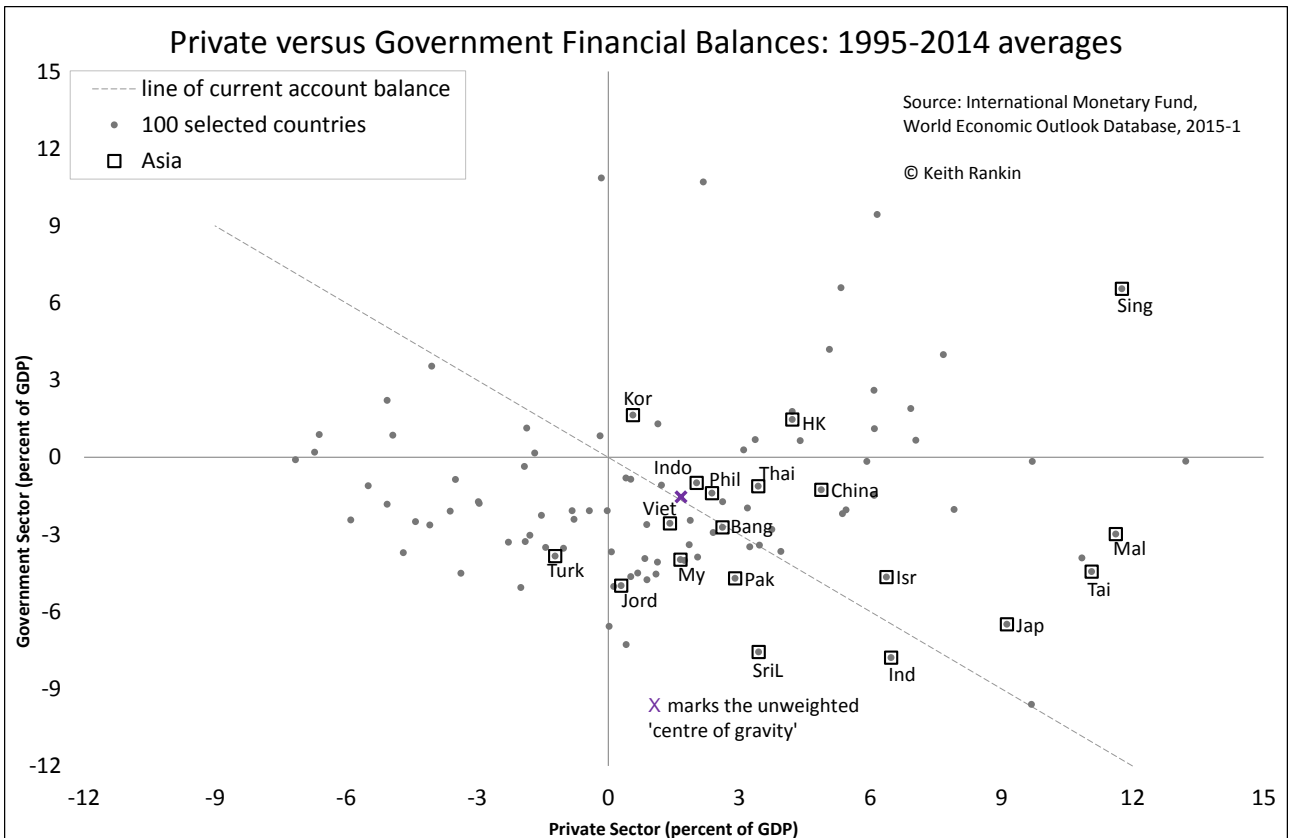


Chart G

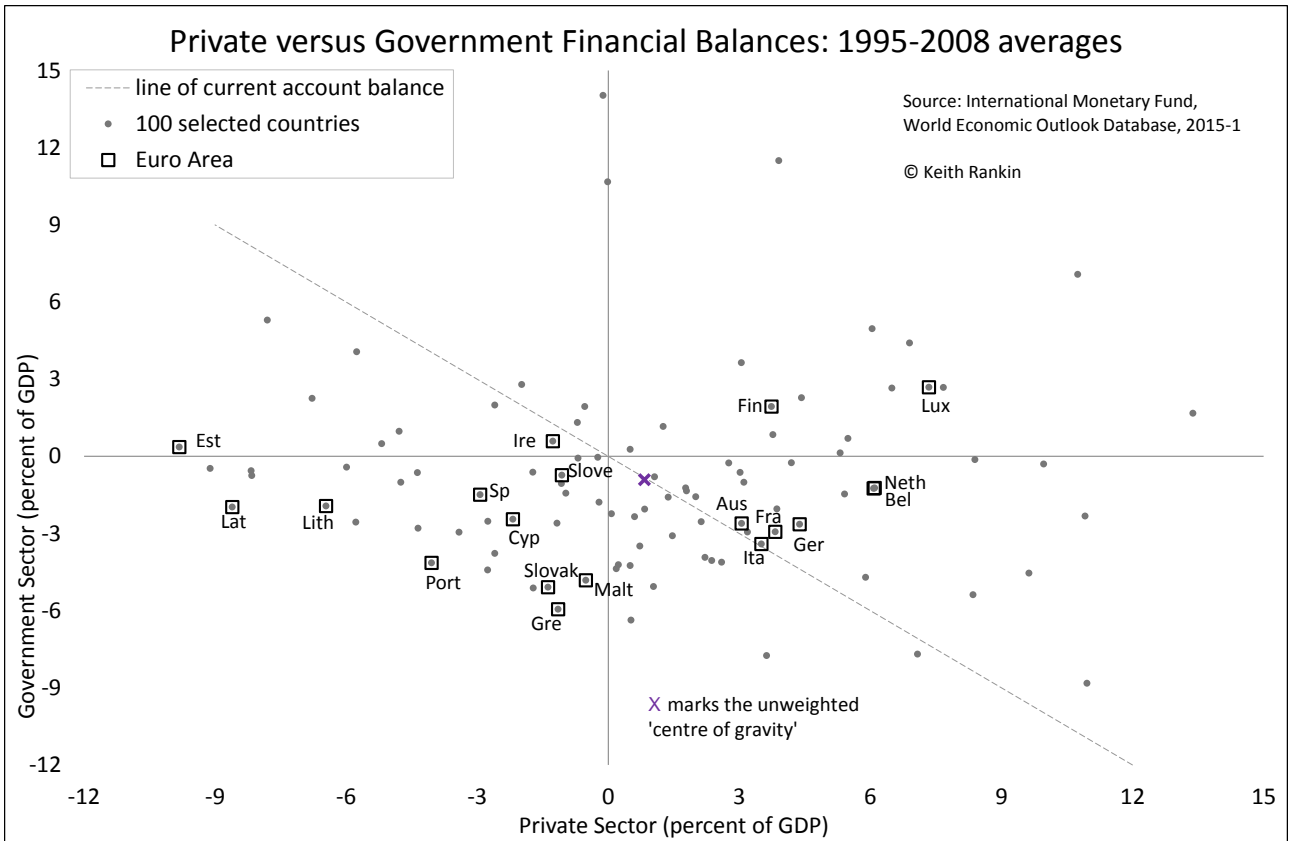


Chart H

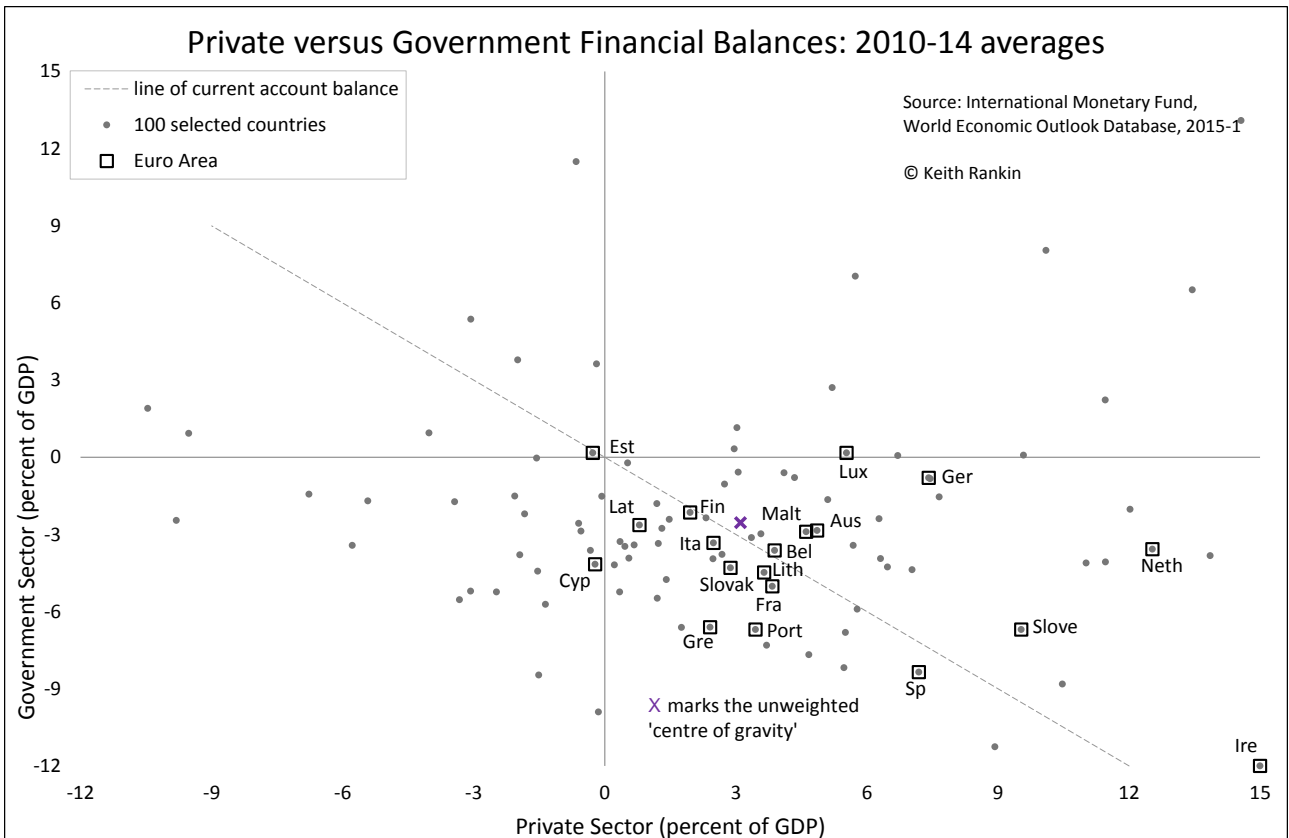


Chart I

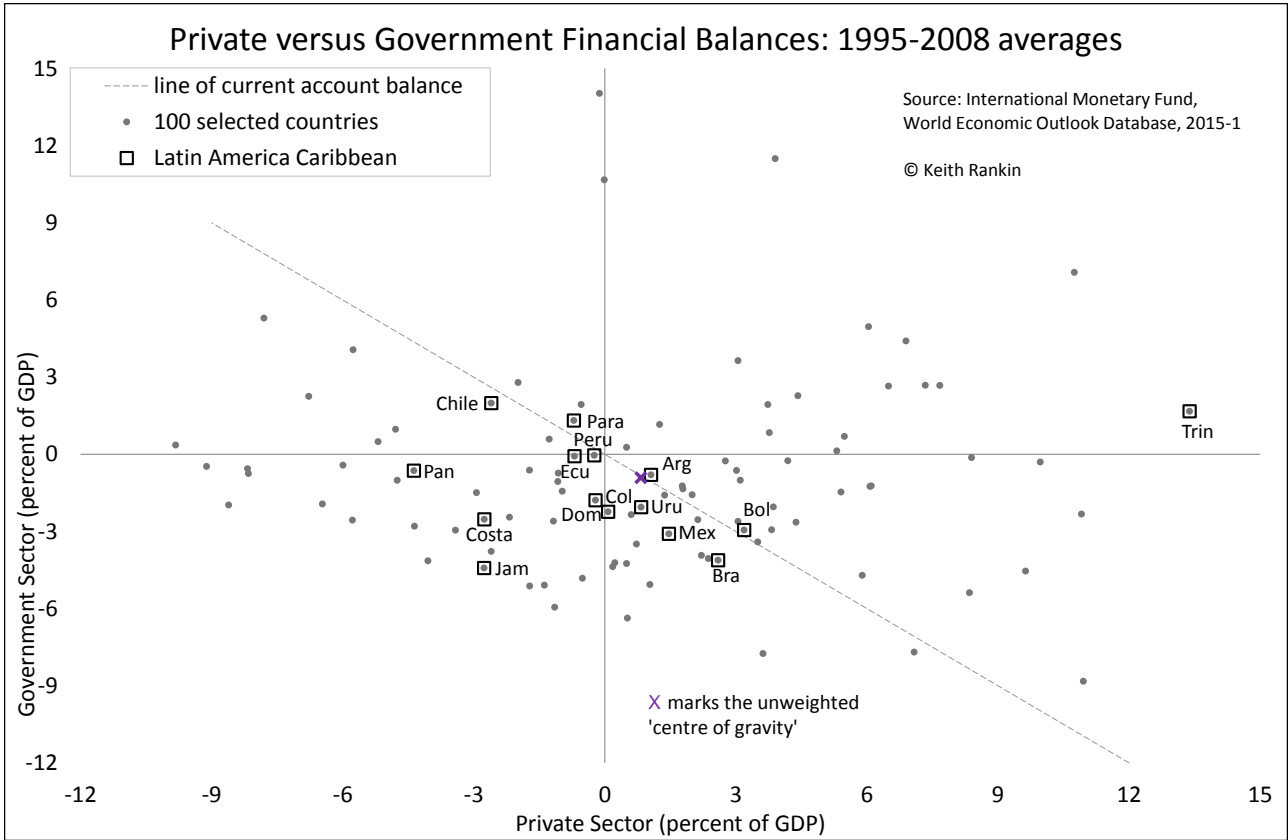


Chart J

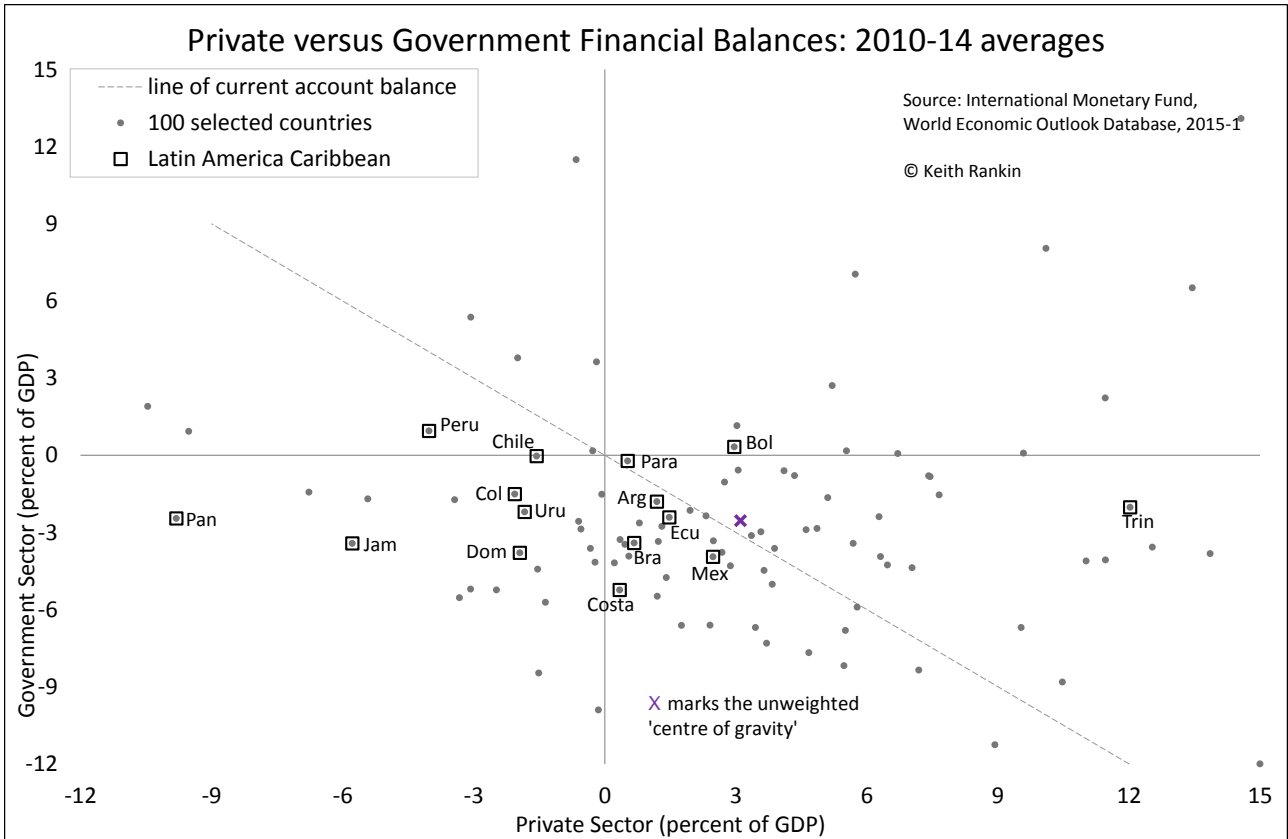


Chart K

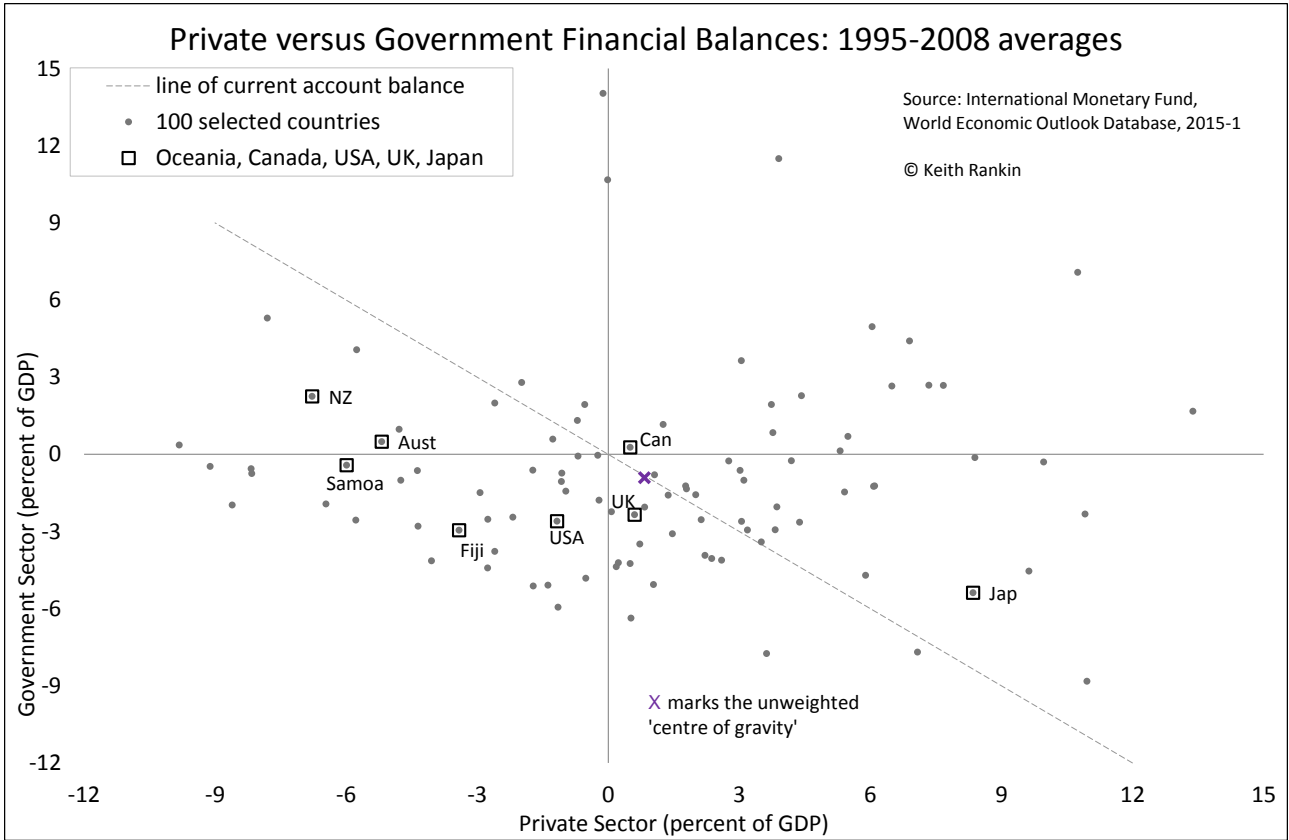


Chart L

