

Creditors can huff but they need debtors

By Martin Wolf

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Blessed are the creditors, for they shall inherit the earth.

Blessed are the creditors, for they shall inherit the earth. This is not in the Sermon on the Mount. Yet creditors believe it: if everybody were a creditor, we would have no unpaid debts and financial crises. That, creditors believe, is the way to behave. They are mistaken. Since the world cannot trade with Mars, creditors are joined at the hip to the debtors. The former must accumulate claims on the latter. This puts them in a trap of their own making.

Three of the world's four largest economies – China, Germany and Japan – are creditors: they run current account surpluses, in good and in bad times (see charts). They believe they are entitled to lecture debtors on their follies. China, an ascendant superpower, enjoys berating the US for its imprudence. Japan, a US ally, is more discreet. Germany's ambitions are closer to home. It wishes to turn its eurozone partners into good Germans, instead.

More

Yet creditors are vulnerable. Their economies have a capacity to supply goods and services that borrowers desire far larger than their own residents will ever buy. Deficit economies are mirror images: their capacity to supply such goods and services falls short of their demand. These surpluses and deficits are embedded in both kinds of economy.

Within creditor countries, the producers of tradeable goods and services are a powerful lobby for the supply of credit to debtors. Private funding will halt once financiers realise how bad their lending has been. Policymakers are then caught between throwing good money after bad or tolerating brutal adjustment, as their markets disappear. In punishing profligate borrowers, they also damage their own citizens.

This story lies behind what is happening to the world. It is behind the agenda of the [European summit](#) of last week and that [of the Group of 20 leading economies](#) this weekend. As Mervyn King, governor of the Bank of England, [stated](#) in a recent speech, it is the story behind all the crises since 2007: “Persistent trade surpluses in some countries and deficits in others did not reflect a flow of capital to countries with profitable investment opportunities, but to countries that borrowed to finance consumption or had lost competitiveness. The result was unsustainably high levels of consumption

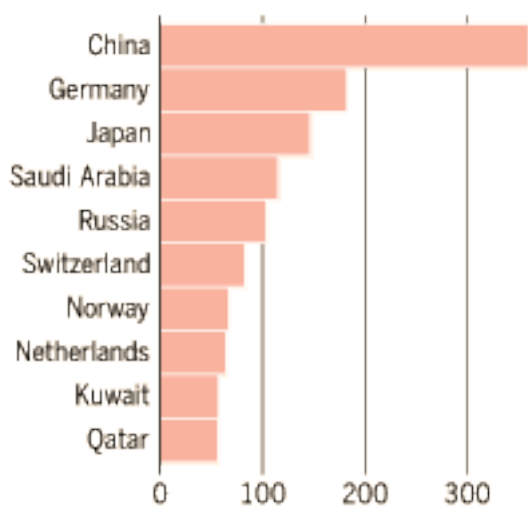
(whether public or private) in the US, UK and a range of other advanced economies and unsustainably low levels of consumption in China and other economies in Asia, and some advanced economies with persistent trade surpluses, such as Germany and Japan.” In brief: everybody helped make a mess and everybody has to play their part in fixing it.

As the poet A.E. Housman wrote: “To think that two and two are four/And neither five nor three/The heart of man has long been sore/And long ’tis like to be.” You cannot keep your surpluses and fail to finance others’ deficits, one way or the other. Yet this is what Germany is trying to do. Germany effectively controls the European Central Bank. It also has the strongest credit rating. So it can decide how the rescue facilities will work. Not well, alas, as Willem Buiter of Citigroup has [argued](#) in the FT. Yet even France cannot do much more than moan about the outcome.

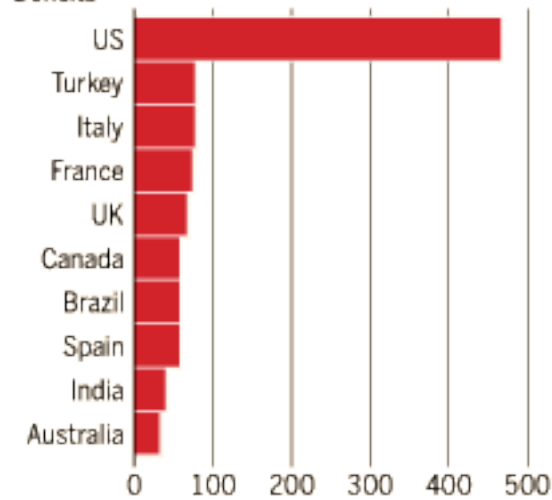
The country with the credit sets the rules. Debtors have to beg, particularly in a fixed currency arrangement, whenever finance is needed to cushion an adjustment imposed via deflation. Creditors can also insist on their interpretation of the causes of a crisis. Germany states that it is all the fault of bad fiscal policies: correct those and bind fiscal policy for all time; the virtuous will then inherit the earth.

Global imbalances Largest current account surpluses and deficits, 2011 (\$bn)

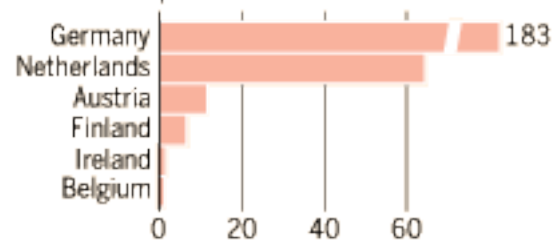
Surpluses



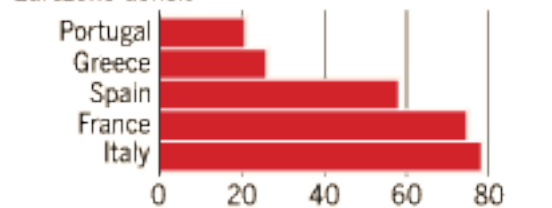
Deficits



Eurozone surplus*



Eurozone deficit



Source: IMF

* Selected countries

This view of the world suffers from three drawbacks: it is wrong; it is self-defeating; and it is destabilising. It is wrong because far from all crisis-hit countries suffered from irresponsible fiscal policies. In important cases, they suffered far more from irresponsible private lending and borrowing. It is self-defeating, because attempts by every member country to tighten fiscal policy at once will impoverish all, including creditors. The view is also destabilising, because the way out of this trap would be via a shift of the eurozone into external surplus. Resolving the internal imbalances by worsening global ones is a bad idea.

Germany wants both to minimise the financing and continue to run huge external surpluses. This cannot work. Some will argue that Germany adjusted into surplus in the 2000s. Why can't its partners do so now? Germany moved into surplus with countries that willingly ran deficits. But Germany does not want to run deficits. Given that, its partners cannot run surpluses, unless they do so with the world. That would be possible only after a huge weakening of the euro or depressions in weaker countries. The latter would ensure waves of sovereign and bank defaults and the end of the eurozone. Such one-sided adjustment will surely fail.

Meanwhile, the eurozone seems to have decided that it needs Chinese help. Why its members think so is incomprehensible. Money is available inside the eurozone. What is missing is a willingness to take on risks of loss. But, as [the Chinese economist](#) Yu Yongding [wrote](#) in the FT, China will not take that risk. It is folly to imagine it would, at less than a prohibitive economic or political cost.

After all, China already runs its own risk of massive losses on the currency reserves – now worth \$3,200bn – it has accumulated. That was a public capital outflow aimed at supporting its trade surpluses. But, in its attempts at managing the currency relationship with the US, it is the latter that controls the central bank. China can huff and puff. But it must either buy the money the US creates, to preserve competitiveness, or stop doing so. If it buys, it throws good money after bad. If it stops buying, it imposes a shock on itself. Do creditors rule the world? Not really. In the short run, they can threaten to turn off the credit. But their surpluses depend on the willingness and ability of others to run deficits. It would be more sensible to admit that there has been too much borrowing by the profligate because there was too much lending by the supposedly prudent. Once it is understood that both are at fault, both must adjust. Imposing one-sided adjustment on erstwhile debtors will not work. As little Greece seems about to prove, debtors are able to inflict a great deal of damage on everybody – as the US discovered in the Great Depression. It would be a good idea to rediscover that reciprocal interest urgently, right now. Creditors do not sell to Mars. We are all on the same planet. Agree to fix its messes, right now.

