

# Trade imbalances are undesirable: a note

Leon Podkaminer [The Vienna Institute for International Economic Studies, Austria]

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## Abstract

This Note provides a very simple argument suggesting that the buildup of trade imbalances may be slowing down global output growth. The observed slowdown of global economic growth (since the mid-1970s) may have been a consequence of globalization-driven emergence of large and persistent trade imbalances.

**JEL classifications** F15, E12

**Key words** economic growth, globalization, imbalanced trade

## 1. Introduction

The last 50 years not only have produced a series of revolutionary technological changes which should have accelerated global growth. These decades have also witnessed a truly revolutionary systemic change (gradual at first, accelerating later on) on the global level. The change started with stepwise internal liberalizations and deregulations in major industrialized countries. The developed countries' socio-economic models, which had sought to balance the interests of labor and business while relying on fiscal and incomes policies, were gradually replaced by the neoliberal and monetarists ones. The internal systemic changes have been synchronized with the consecutive waves of liberalization of international economic relations. Trade liberalizations (cuts in tariff levels, progressive removal of many non-tariff barriers to trade) were followed by the wholesale liberalization of capital flows, to a large degree completing the process of globalization. The phenomenal rise in international trade has been the most obvious effect of globalization. But, globalization – and the globalization-driven expansion of international trade – appears to have been associated with a *slowdown* of real growth at the global level (Podkaminer, 2014, 2016.)

According to the classical, neoclassical and contemporary theories of international trade, “more trade” (and especially more *free* trade) should bring output gains. Why are such positive effects not showing up in the available data? There may be two major reasons.<sup>1</sup>

Firstly, the expanding internationalization of production (which has been made possible by the liberalization of trade and capital flows coupled with advances in transportation technologies) seems to be generating, or at least supporting, the tendency for the global wage shares to decline – and thus for the global profit shares to rise (see e.g. Palley, 2009.) This development may be closely related to the development of inequality on the global level. While the impact of globalization on global inequality remains a controversial issue, there is also a possibility of a reverse impact: from higher inequality to slower growth. The global shift in income distribution from wages to profits can account for the weakening of global growth because such a shift raises the

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<sup>1</sup> The supply-side, or structural, developments cannot be made responsible for the secular global growth slowdown. The natural resources have become more abundant secularly (as it is evidenced by their prices trending downwards in relative – and often absolute – terms.) The weakening pace of labor productivity growth is also an unlikely cause of the slowdown of global growth. Rather, the weakening pace of productivity growth an *effect* of output growth slowdown rather than its cause (Podkaminer, 2017.)

overall saving propensity – without raising the propensity to invest. The tendency for the slowdown of growth of global output could then be an end effect of both developments: rising global profit share/profitability and falling propensity to invest.

Secondly, it may be argued that rising world trade *could* have been productive on the global scale if output growth in individual countries had been at least approximately balanced most of the time – and not only sporadically, in response to the severe debt/payments or exchange rate crises.<sup>2</sup> The negative output effects of rising trade may have emerged under the huge and persistent trade *imbalances* that have developed under progressing globalization (Figure 1.)

**Figure 1** Ratio of global trade surplus to global output, 1960-2014<sup>a</sup>



Source: Own calculations based on WDI (August 2016 edition.)

<sup>a</sup> The global trade surplus is defined as the sum of national trade *surpluses* (positive trade balances) across the world.

Such imbalances may have acted as brakes on sustained output growth in *both* the persistent deficit and the persistent surplus countries. Under a different international economic order, somehow enforcing more balanced trade among nations – with major nations not allowed to compensate deficient domestic demand with huge trade surpluses that destabilize their partners – global trade may assume the positive role assigned to it by the conventional trade theories. The classical Bretton Woods system (terminated in 1973) was an example of such international arrangements limiting persistent and large trade imbalances. It is worth remembering that the global output kept rising, in per capita terms, on average by over 3.4% per year from 1961 through 1973. The average yearly p.c. growth rate for the period 1974-2015 is 1.5%. This Note will provide a formal (but very simple) “proof” that the buildup of trade imbalances is likely to slow down global output growth.

<sup>2</sup> In the neoclassical (and derivative) trade theories countries engage in *barter* trade – very much like the individual “agents” populating the microeconomics textbooks. The barter trade is assumed to culminate in a Pareto-optimal, *balanced*, equilibrium. But in the real world nations do not engage in barter trade, but in trade involving *money*, or debt. Germany, or China, does not earn export revenues in order to spend them, immediately and completely, for paying for the imports urgently desired.

## 2. A simple “formal proof” of undesirability of trade imbalances

Let us start with the basic GDP identity:

$$\text{GDP} = C + I + B$$

where C is consumption, I is investment and B is trade balance. (All items are assumed to be “private”. The public sector is ignored, for the sake of simplicity.)

Add the (“micro-funded”) behavioral relationship linking consumption (C) to income (GDP.) The simplest such relationship is just  $C = c \cdot Y$ , with c being the propensity to consume out of income. Combining the GDP identity with the consumption function yields the immortal “multiplier” formula:

$$\text{GDP} = (I + B)/(1-c) \tag{1}$$

where (1-c) is the saving propensity denoted as s ( $0 < s < 1$ .)  $1/(1-c) = 1/s$  is the simplest version of the “multiplier” and (1) is equivalent to:

$$\text{GDP} = (I + B)/s \tag{2}$$

Now, let us consider the “global economy”. For the sake of simplicity “our” global economy will consist of two countries, indexed 1 & 2.

The formula (2) for country 1 is:  $\text{GDP}_1 = (I_1 + B_1)/s_1$

and for country 2:  $\text{GDP}_2 = (I_2 + B_2)/s_2$

In a two-country global economy  $B_1$  must equal *minus*  $B_2$  (because  $B_1 + B_2 = 0$ .) Assume country 1 runs surplus B.  $B = B_1 > 0$ . Then  $B_2 = -B$ .

The question: what is the *global* income? The answer is elementary:

$(\text{GDP}_1 + \text{GDP}_2) = (I_1 + B)/s_1 + (I_2 - B)/s_2$  or, equivalently:

$$(\text{GDP}_1 + \text{GDP}_2) = (I_1/s_1 + I_2/s_2) + B(1/s_1 - 1/s_2) \tag{3}$$

Under balanced trade ( $B=0$ ), global GDP equals the first bracketed on the right-hand side of (3.) The same obtains when  $s_1 = s_2$ . However, if  $B > 0$  the second bracketed term may be *negative*, depending on the values of  $s_1$  and  $s_2$ . Specifically, B (the country’s 1 surplus and country’s 2 deficit) *raises* the global income (from  $I_1/s_1 + I_2/s_2$ ) when  $1/s_1 > 1/s_2$  that is when  $s_1 < s_2$ , i.e. when  $(1-c_1) < (1-c_2)$ , i.e. when  $c_1 > c_2$ . Otherwise B *lowers* the global income.

Is “everything possible” then? Not quite. The condition  $c_1 > c_2$  (which is necessary for the imbalance to be “productive globally”) means that the consumption propensity in the *surplus* country is higher than in the *deficit* country. But such a constellation seems highly unlikely in practice (though perhaps imaginable “in theory”).

## Concluding remarks

It remains true that output of some countries may heavily rely on the expansion of *their* exports. Moreover, productivity growth (and growth of potential output) in many cases may critically depend on rising imports of capital goods and intermediate inputs. It is equally true that rising *net* exports may contribute substantially to overall GDP growth in some nations. But rising net exports may well be achieved at the cost of overall domestic GDP growth stagnation. This is the case in Germany where high trade surpluses (achieved through the sustained repression of wages and domestic demand) have been associated with secularly anemic GDP growth. Moreover, it must be remembered that for each country relying for GDP growth on the improvement of net exports there must be some other countries whose net exports necessarily contract – thus depressing their GDP growth. The existence of a club of countries following such “export-led” growth paths implies the existence of a club of “import-fed” countries whose GDP growth must sooner or later be held back by falling net exports. The *global* economy – being an autarchic system – cannot follow the export-led growth path based on trade surpluses.

The final “policy conclusion” could be that the basic paradigms of the international economic order need to be changed. The reformed international order should be capable of enforcing more balanced trade among nations. The major trading nations must not be allowed to compensate deficient domestic demand (and stagnant wages) with huge trade surpluses that destabilize their partners. Under the reformed world economic order the expansion of global trade could then be expected to support global growth. Of course, the basic paradigms of domestic macroeconomic policy-making in major countries would have to be overhauled too if these countries were to follow the externally balanced growth paths (Laski and Podkaminer, 2012 and Podkaminer, 2015.)

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**Author contact:** [podkaminer@wiw.ac.at](mailto:podkaminer@wiw.ac.at)

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