

## **Economic Interdependence and Instability in the Global Economy**

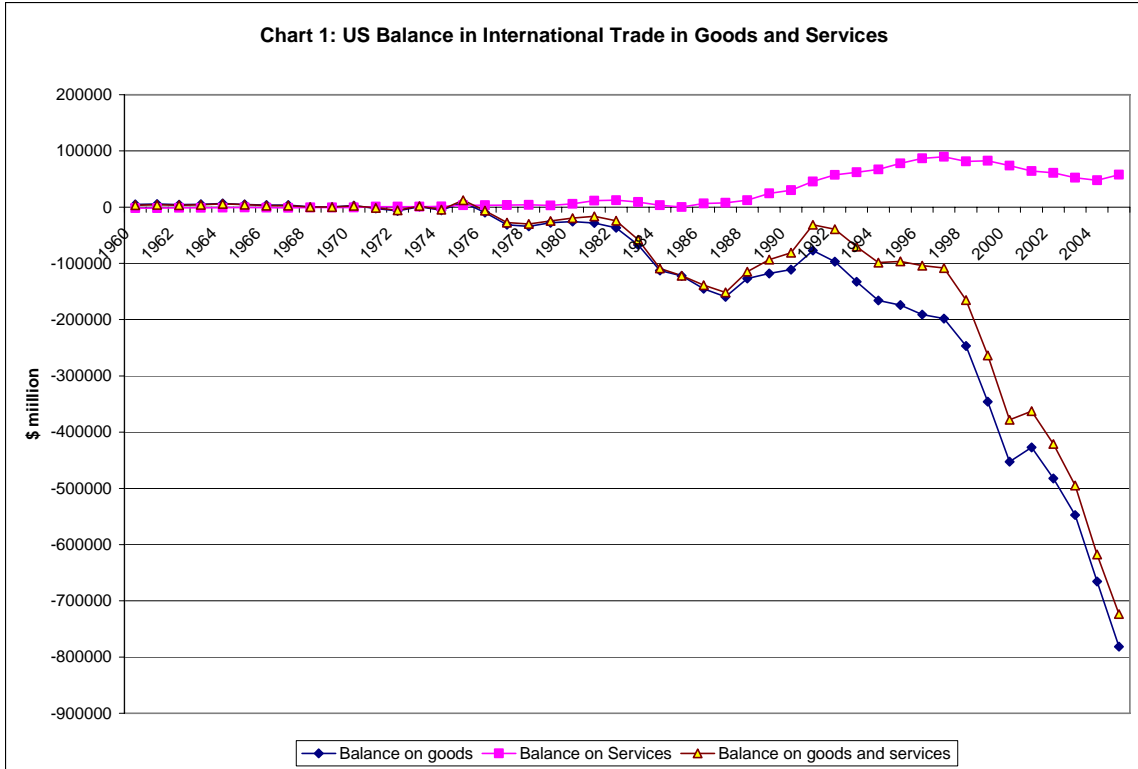
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There is little disagreement among economists that economic integration and enhanced interdependence have been the inevitable consequences of trade and financial liberalization since the late 1970s. However, there remains substantial divergence of opinion on the nature and consequences of increased integration. For example, there is no agreement on whether the process merely reflects an intensification of tendencies already underway prior to the 1970s and since World War II or is accompanied by a change in the nature of global interdependence itself. Nor is there agreement on whether the consequences of this process in terms of global growth, global economic stability and global inequality have been positive, benign or adverse.

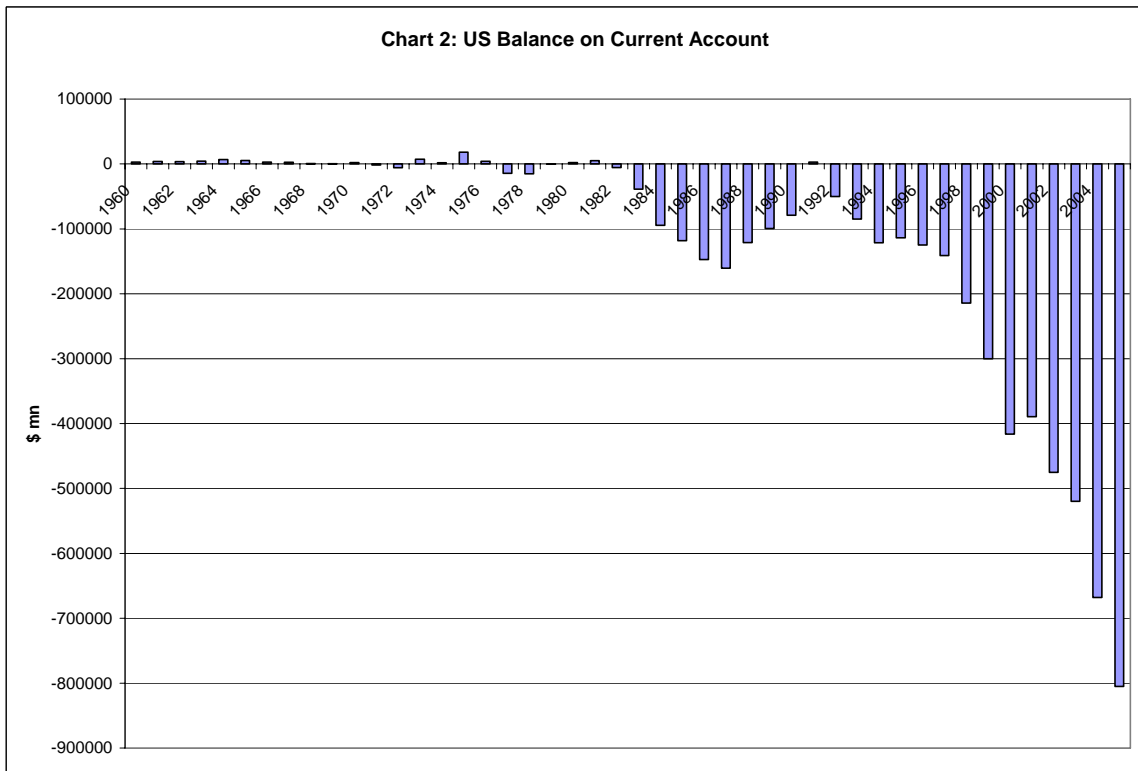
It hardly bears stating that there is one very important sense in which there is a strong similarity between the years prior to and during what is routinely identified as the era of globalization. During both these phases the US has been the global hegemon and its dominance both before and after the late 1970s is reflected in the fact that the dollar was and is the world's only reserve currency. There have no doubt been changes in terms of the break down of the Bretton Woods system and the short-lived Smithsonian agreement that resulted in the transition from a world of fixed to floating exchange rates in the early 1970s, the emergence and strengthening of the Euro much later and periods in which the dollar depreciated significantly against other national currencies. But, through all this, the dollar has remained the world's leading currency and only reserve.

This persistence of the dollar as the world's reserve is surprising given the dramatic changes in the position of the US within the world system. To start with, from around the mid-1970s the US has lost its competitiveness in commodity production, which has resulted in an increasing deficit in its balance of trade in goods. As a result, despite a growing surplus till quite recently in its trade in services, the overall balance of trade in goods and services has been negative (Chart 1). That is, the dollar has remained the world's reserve currency not because the US is the world's most competitive economy, but despite the growing loss of competitiveness of the US.

A concomitant of the loss of competitiveness has been the fact that the US has increasingly been a net recipient of capital flows. The current account deficit of the US which has to be financed with capital flows, barring for adjustments in reserves, was in balance or reflected small surpluses between 1960 and 1982. Subsequently, partly as a result of the second oil shock the deficit widened, only to fall again in the period after 1987 and turn into a surplus in 1991. Since 1991, however, that deficit has continued to widen to touch \$668 billion in 2004 and exceeded \$800 billion in 2005.



Source: US Department of Commerce, Bureau of Economic Analysis, <http://www.bea.gov/bea/di1/tab11.xls> accessed 21 March 2005.



Source: Same as Chart 1

This massive increase in the current account deficit implies that despite its loss of competitiveness the US has been able to keep domestic demand rising. GDP growth which was down from 3.7 per cent in 2000 to 0.8 in 2001, rose to 1.6 per cent in 2002, 2.7 per cent in 2003, 4.2 per cent in 2004 and 3.5 per cent in 2005 (Seskin et al 2005). In February 2006, unemployment stood at 4.8 per cent, the lowest rate since September 2001.<sup>1</sup> It is now widely accepted that this buoyancy in domestic demand and the consequent growth in output and employment has been the result of a combination of deficit financed spending by the US government and debt financed spending by American residents. From a high of 6 per cent of GDP in 1992, the US fiscal deficit had declined continuously and turned into a budget surplus in 1998. The budget surplus rose to touch 1.3 per cent of GDP in 2000. However, after the recession of 2001, the deficit climbed again to 4.6 per cent of GDP in 2003 and 4.3 per cent in 2004, which helped the recovery and the recent buoyancy.

But it was not merely government spending that was responsible for the revival, which was triggered by consumption spending by households as well. In the mid-1980s, American households saved, on a net basis, around 9 per cent of their disposable income. Americans now save less than 1 per cent of their disposable income.<sup>2</sup> This obviously keeps retail sales going. Households save less and consume more, because the value of their wealth accumulated in the past has been rising. This is because of a speculative surge, involving purchases of homes for investment purposes. A National Association of Realtors study, based on 2003 census data, found that there were 43.8 million second homes in the U.S. While 6.6 million of these are vacation homes, far more, 37.2 million, are investment units. This compares with 72.1 million owner-occupied homes (Ackman 2005). In the event, since 2001, the median price of an investment home has risen 25.4 per cent, from \$118,000 to \$146,900, with average prices ruling higher than median prices in most markets. The pushes up housing prices and, through the wealth effect, triggers consumption spending. Further, debt financed investment purchases have resulted in the fact that housing construction is at a long term high. This triggers demand for construction material and labour and has its multiplier effects.

The wealth effect is not new to the US. During the years of the stock market boom of the second half of the 1990s, the relatively wider dispersion of direct and indirect stock ownership in the US implied a substantial increase in the wealth of American citizens. The consequent “wealth-effect”, which encouraged individuals to spend because they saw their “accumulated” wealth as being adequate to finance their retirement plans, was seen as a major factor underlying the consumer boom and the fall in household savings.

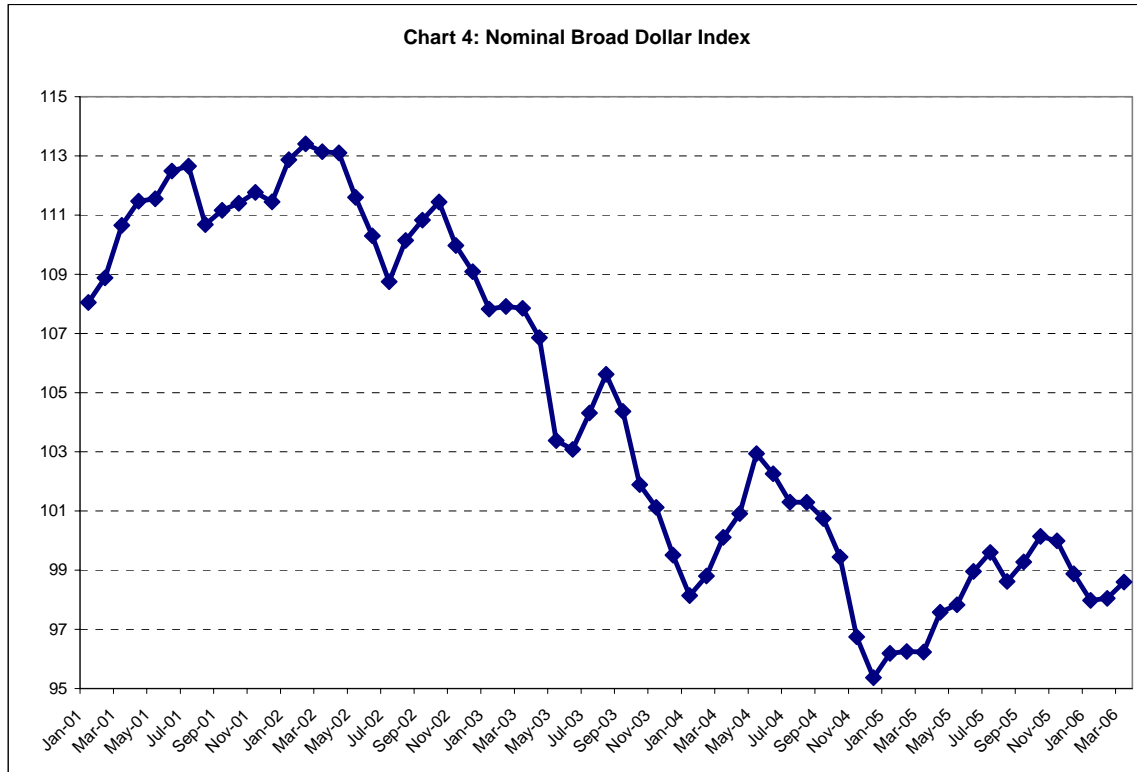
A major factor responsible for the stock boom was the massive inflow of capital into the US during that period. Higher US interest rates, confidence in the dollar because of creditable growth and the “flight to safety” explained that flow of capital into the US. The same is not true today. The deficit on the balance of payments has created a fear that the dollar may collapse and all efforts of the G-8 are geared to ensuring a softlanding. Though the trade-weighted index of the dollar stabilised during early 2005 and even appreciated somewhat thereafter, it has once again been sliding and is currently still close

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<sup>1</sup> From US Bureau of Labour Statistics at <http://www.bls.gov/news.release/empsit.nr0.htm>.

<sup>2</sup> *The Economist*, “The hare and the tortoise”, available at [http://www.economist.com/displaystory.cfm?story\\_id=4399377](http://www.economist.com/displaystory.cfm?story_id=4399377).

to the low it reached at the end of 2004 (Chart 4). Further, US interest rates can hardly be considered high. Bond yields in the US are not only low by the standards prevailing since the early 1980s, but are far less than the rate of economic growth that they are expected to roughly reflect. Put all this together, and the US would not be considered a favoured and safe haven.



Source: Board of governors of the Federal Reserve System available at [http://www.federalreserve.gov/RELEASES/H10/Summary/indexbc\\_m.txt](http://www.federalreserve.gov/RELEASES/H10/Summary/indexbc_m.txt) accessed March 23, 2006-03-23

Yet capital has indeed been flowing into the US. According to the IMF's *International Financial Statistics*, the current account deficit of the US in 2003 and 2004 stood at \$531 and \$666 billion respectively, or about 4.8 and 5.7 percent of the U.S. gross domestic product (GDP) (Table 1). Clearly, in order to finance that deficit, U.S. citizens, businesses, and governments had to raise net capital of around that sum. This must come from countries that were registering a surplus on their current account.

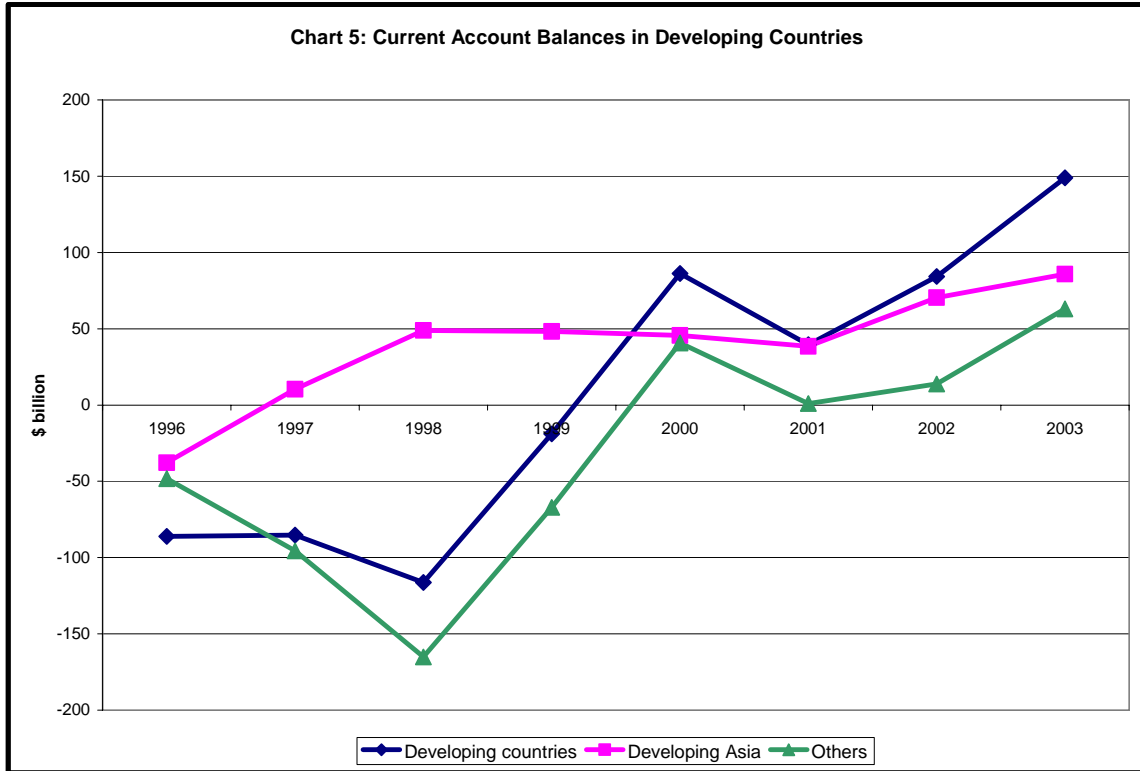
Consider for example 2003, for which current account data is available for a larger group of countries and which was a year in which the average monthly price of West Texas Intermediate crude oil was only \$31 a barrel, as compared with \$26 in 2002, \$41 in 2004 and \$51 during the first six months of 2005. In that year, 52 out of the 126 countries for which data was available recorded surpluses on their current account, while 74 recorded deficits, with the US recording the largest deficit of \$531 billion and Japan the largest surplus of \$136 billion. From the data it emerges that the surpluses of the top 17 surplus earning countries would have been necessary to cover the United States deficit. The surpluses of these 17 countries accounted for as much as 86 per cent of the surpluses

earned by the countries that recorded a surplus. On the other hand, the US alone accounted for 72 per cent of the total deficit recorded by the 74 deficit countries.

Thus there is indeed a fundamental imbalance in the global balance of payments. But this imbalance does not just lie in the concentration of deficits and surpluses. It is also reflected in the fact that the US deficit was not being financed largely by the surpluses of other developed countries or, prior to the current spike in oil prices, by surpluses in the oil exporting countries. While Japan and Germany are the two largest surplus earners, the surpluses of these two countries accounted only for 30 per of the aggregate surplus of all surplus earners and 35 per cent of the US deficit. Even among these two, Japan accounts for \$136 billion of their combined 188 billion surplus. Further, Germany's surplus of over \$51 billion is implicitly being absorbed by deficits in other countries of the Euro area, with the surplus of the Euro area as a whole estimated at only \$23.5 billion.

The net result of all this is that developing countries and countries in transition have become important sources of surpluses to finance the US deficit. If we take the top ten developing and transition economies in terms of the size of their surpluses, their aggregate surplus accounts for 39 per cent of the US deficit. If we leave out oil exporters and take the top 10 among the remaining developing countries, their surpluses account for 28 per cent of the US deficit. China's surplus alone accounts for 8.6 per cent of the US deficit., whereas net surpluses from the Euro area amount to only 4.4 per cent of that deficit.

Taking developing countries as a group, we find that the period since the mid-1990s has seen a transformation of their current account deficits into surpluses (Chart 5). While this was true initially of a set of countries in Asia, they have since been joined by countries in West Asia, the Commonwealth of Independent States (included by the IMF in the developing countries and emerging markets group) and Latin America, though not Africa and Central and Eastern Europe. However, developing and emerging market countries outside Developing Asia have also been recording a surplus as a group.

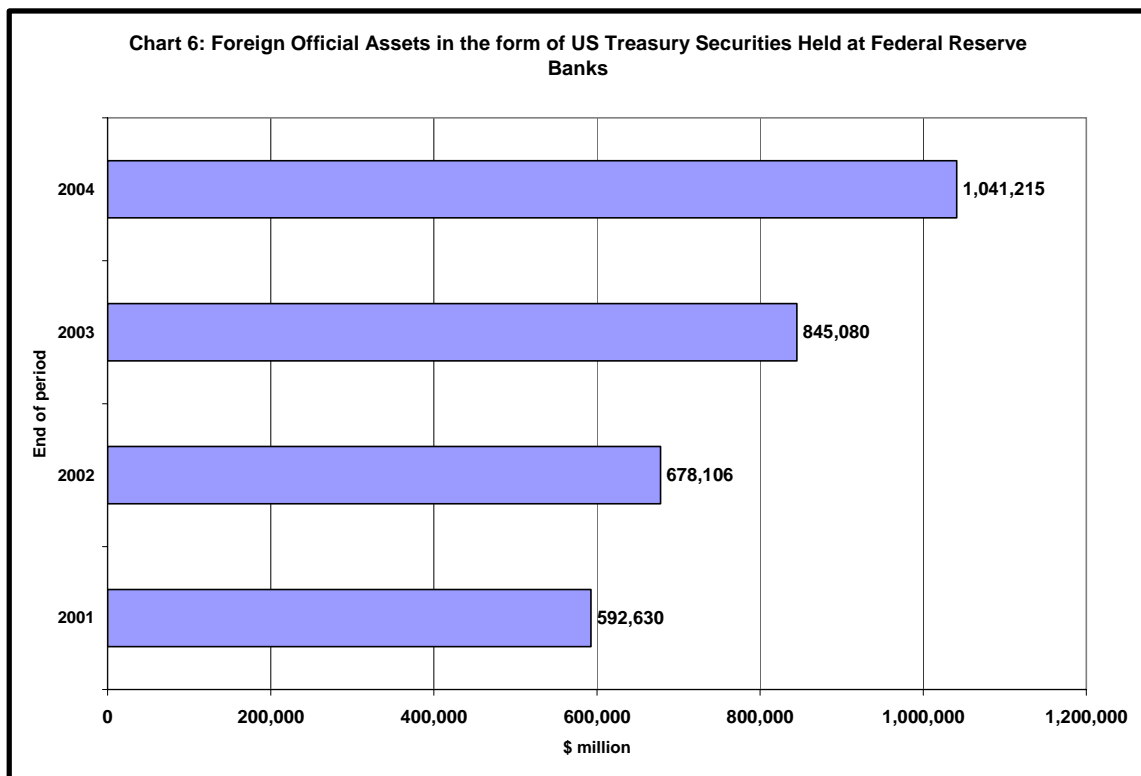


Source: *IMF Financial Statistics Database*

In fact, these developing countries have been even more important from the point of view of financing recent increases in the US deficit. As Federal Reserve Governor Ben S. Bernanke (2005) pointed out, the inflow of capital into the US has not been the result of flows from the developed countries but from the developing world. The \$410 billion increase in the U.S. current account deficit between 1996 and 2003 was not matched by surpluses in the other industrial countries as a whole, although some individual industrial countries did record increased surpluses. The collective current account of the industrial countries declined by \$441 billion between 1996 and 2004, implying that, of the \$548 billion increase in the U.S. current account deficit, only about \$106 billion was offset by increased surpluses in other industrial countries. The bulk of the increase in the U.S. current account deficit was balanced by changes in the current account positions of developing countries, which moved from a collective deficit of \$90 billion to a surplus of \$326 billion--a net change of \$416 billion-- between 1996 and 2004.

It is interesting to note the manner in which these surpluses were being recycled to the US. Data from the Federal Reserve relating to the Fed's holdings of assets for official institutions – which is a proxy for foreign central bank holdings - rose by \$85 billion in 2002, \$167 billion in 2003 and \$196 billion in 2004. Needless to say, not all of these investments are from developing countries, since Japan is a major investor. The Japanese government spent a record \$180 billion in 2003 on intervention in foreign exchange markets and much of that money found its way into the US Treasury market. During that period, Japan's foreign exchange reserves rose by \$203.8 billion to \$673.5 billion. While developing countries may not be playing a similar role, their contribution is still important.

It is because the surpluses of the rest of the world including the developing countries was being “voluntarily” recycled to the US that interest rates there did not have to rise to attract capital to finance that country’s rising current account deficit. Low interest rates in turn have helped finance the housing boom which according to Alan Greenspan is not a speculative bubble but just “froth”. Whether bubble or froth, most economists agree that the easy money that has financed it has been crucial to the economic recovery since 2001. According to one estimate, housing has contributed over 40 per cent of employment growth since then. And housing expansion plus real estate inflation have accounted for 70 per cent of the increase in household wealth over this period. And this as noted earlier has triggered an expansion in consumer spending. Thus, capital inflows have once again helped finance growth in the US, even if mediated this time by the real estate rather than the stock market.



There are three questions that arise in this context. First, what explains the fact that developing countries are recording current account surpluses? Second, how much of their balance of payments surpluses are explained by the current account? And, when they do record surpluses how do they use them?

There are clearly three kinds of factors explaining developing country current account surpluses. First, there is the Chinese case, where the current account surplus arises because the country’s competitive position in the international market for goods yields a trade balance that more than covers the deficit in services and that in income. Second, there are countries like India which ensure a current account surplus because the trade

deficit is not widened very much further by the services deficit because of large service income inflows, and where the aggregate deficit in trade in goods and services is more than covered by a surplus on the current transfers account because of large remittances from migrant workers residing abroad. Finally, there are countries like Bangladesh which record significant deficits in their trade in goods and services but are able to make up the difference because of remittances that ensure a surplus in the current account.

Thus in a majority of developing countries it is not a surplus in merchandise trade but surpluses from the sale of services through physical migration and/or digital migration (India) that deliver a current account surplus. In terms of accounting identities a current account surplus implies that savings in these countries does exceed investment. This does mean that despite the low level of per capita income in these countries, the opportunity offered by current account surpluses is not being used to step up investments in order to raise the rate of aggregate and per capita income growth. What is more, in the case of a number of such countries, they are net recipients of capital on the capital account, even of substantial magnitude as in the case of India. This implies that total savings (domestic and foreign) exceeds investment by an even larger margin.

Part of the reason why developing countries record a surplus on their current account is the deflationary fiscal stance adopted by their governments. Growth is curtailed through deflation so that, even with a higher import-to-GDP ratio resulting from trade liberalisation, imports are kept at levels that imply a trade surplus. Consider the flows that deliver current account surpluses for developing countries? As Table 2 shows, for developing countries as a group, two factors account for these surpluses: first, the transformation of the trade deficit (goods and services) in these countries into surpluses, and a substantial inflow of current transfers, mainly in the form of remittances.

	1997	1998	1999	2000	2001	2002	2003
Current account balance	-85.3	-116.3	-18.9	86.3	39.5	84.2	148.9
Balance on goods and services	-45.6	-66.1	42.2	147.9	93.5	128.6	183.4
Income, net	-91.8	-99.5	-114.3	-118.3	-116.9	-124.5	-137.3
Current transfers, net	52.1	49.2	53.2	56.7	63	80	102.7

This does imply that these countries are in deflationary mode, which precludes maximising the benefits of their access to foreign exchange. What accounts for this deflationary stance? It is related to the fundamental transformation in the global balance of payments situation during the three decades of globalisation. Prior to the oil shocks, which were important triggers for the major changes in the quantum and nature of international capital flows, the international payments scenario reflected differences in the global economic strength of individual nations. The scenario was one where the developed countries recorded large surpluses, the oil-exporting developing countries much smaller surpluses and the oil-importing developing countries were burdened with significant deficits. The process of restoring global balance involved adjusting growth in the oil-importing developing countries so as to tailor their deficits to correspond to the extent to which surpluses from the developed countries could be recycled to finance those deficits.

Though for a short period after the oil shocks of the 1970s this situation changed with surpluses in developed countries falling, those earned by the oil exporters rising sharply and deficits in the oil-importing developing countries exploding, the picture returned to its pre-oil shock form by the 1980s. Even when oil exporters were earning large surpluses, the fact that these surpluses were being deposited within the banking system in the developed world made the process of recycling surpluses one of transfers from the developed to the oil-importing developing countries. The real change was that private rather than official flows through the bilateral and multilateral development network came to dominate capital flows.

Associated with this shift was a transformation of capitalism in the developed countries which witnessed the rise to dominance of finance capital. To start with, oil surpluses deposited with the international banking system resulted in a massive increase in credit provision, both within the developed countries and in the so-called emerging markets. Second, the breakdown of the system of fixed exchange rates, triggered by the US decision to delink the dollar from gold, resulted in a sharp increase in foreign exchange trading. Third, growing exposure of financial agents in domestic and international debt markets and in foreign exchange markets resulted in the burgeoning of derivatives that allowed financial institutions to hedge their bets by transferring credit risk. And, finally, the liberalisation of financial markets in developing countries aimed at exploiting the benefits of a global financial system awash with liquidity provided an opportunity for banks, pension funds and other financial firms to increase their investments in developing countries in search of lucrative returns.

One consequence of these developments was that the flow of capital to developing countries, particularly the “emerging markets” among them had nothing to do with their financing requirements. Capital in the form of debt and equity investments began to flow into these countries, especially those that were quick to liberalize rules relating to cross-border capital flows and regulations governing the conversion of domestic into foreign currency. The point to note is that these inflows did not spur substantial productive investment in these countries. Even foreign direct investment, defined as investment in firms where the foreign investor holds 10 per cent or more of equity, had “portfolio” characteristics, and often took the form of acquisitions rather than greenfield investment.

What is important from the point of view of global balances is that the inflow of such capital imposed a deflationary environment on developing countries because one requirement for keeping financial investors happy was to substantially reduce the deficit of the government or its expenditures financed with borrowing. Financial interests are against deficit-financed spending by the State for a number of reasons. To start with, deficit financing is seen to increase the liquidity overhang in the system, and therefore as being potentially inflationary. Inflation is anathema to finance since it erodes the real value of financial assets. Second, since government spending is “autonomous” in character, the use of debt to finance such autonomous spending is seen as introducing into financial markets an arbitrary player not driven by the profit motive, whose activities can render interest rate differentials that determine financial profits more unpredictable. Finally, if deficit spending leads to a substantial build-up of the state’s debt and interest burden, it may intervene in financial markets to lower interest rates with implications for financial returns. Financial interests wanting to guard against that possibility tend to

oppose deficit spending. Given the consequent dislike of expansionary fiscal policy on the part of financial investors, countries seeking to attract financial flows or satisfy existing financial investors are forced to adopt a deflationary fiscal stance, which limits their policy option.

In sum, while the inflow of remittances is reflective of one aspect of the process of globalisation that has benefited developing countries, the rise of current account surpluses reflect the deflation imposed by financial flows and the financial crises they engineer in some countries. As a result, developing countries as a group did not require capital inflows to finance their balance of payments. But such inflows did occur, in the form of private foreign direct and portfolio investment. Hence, if a country is successful in attracting financial flows, the consequent tendency for its currency to appreciate, forces the central bank to intervene in currency markets to purchase foreign currency and prevent excessive appreciation.

The net result is that most Asian countries – some that fell victim to the late 1990s financial crises, like Korea, and those that did not, like China and India – have accumulated large foreign exchange reserves. According to the IMF, the share in global reserves (excluding gold) of developing Asia and Japan together rose from 15 per cent in 1980, 30 per cent in 1990, 52 per cent in 2000 and 63 per cent in 2004 (Table 3). The share of Asian developing countries in the total reserves of developing countries similarly increased from 22 per cent in 1980 to 60 per cent in 1990, stayed at that level in 2000 and rose to 65 per cent in 2004.

	1980	1990	2000	2003	2004
All Countries	321274.	655815.	1556070	2124010	2483400
Industrial Countries	186037.	414092.	656131.	820185.	904284.
Japan	19316.5	55178.7	272392.	446368.	536952.
Developing Countries	135237.	241722.	899935.	1303820	1579120
Africa	14956.	11768.	42153.	61802.	82119.7
Asia *	29702.	144643.	548242.	840366.	1033630
China, P.R.: Mainland	1996	20796.	129155.	274670.	395683.
China, P.R.: Hong Kong	n.a.	17269.	82540.	79652.	79549.
India	5444.	1069.	29091.	66581.	81515.
Indonesia	4227.	5243.	21876.	23528.	22506.
Korea	2293.	10398.	73781.	104500.	128136.
Taiwan Province of China	1729.	50919.	81926.	139055.	n.a.

Source: *IMF Financial Statistics Database*

For long, this episode of rising reserves in till-recently-poor countries appeared almost conspiratorial, because these reserves were being invested in dollar denominated assets, especially government securities in the US. The choice of assets was, of course, determined by the facts that the dollar was the world's reserve currency and the US the world's sole superpower, both of which engendered confidence in American, dollar-denominated assets. Such confidence was crucial since governments were interested in ensuring the liquidity and safety of their reserve assets, which may need to be recalled at short notice in case of a loss of investor confidence leading to an outflow of financial

investments. The direct benefit of this situation for the US was obvious. With America afflicted by a loss of competitiveness, any growth in the country was accompanied by a widening of the trade and current account deficits on its balance of payments. Capital inflows into the US helped finance those deficits, without much difficulty. And central banks, mostly from Asia, are estimated to have financed more than half that capital flow in recent times.

This implies that growth could not have occurred without capital flows into the US. What is more those flows were responsible for the long period of buoyancy over the last decade in the US. That buoyancy came not because the US was the world's most competitive nation in economic terms. Rather, as noted earlier, till the turn of the last decade growth was accounted for by a private consumption and investment spending boom, spurred by the bubble in US stock and bond markets that substantially increased the value of the savings accumulated by US households. The money market boom was encouraged by the flight of capital from across the world to the safe haven that dollar denominated assets were seen as providing. Investment of reserves accumulated by the Asian countries was one important component of that capital inflow. With the value of their savings invested in stocks and securities inflated by the boom, consumers found confidence to spend.

To be sure, when the speculative boom came to end in 2000, triggered in part by revelations of corporate fraud, accounting scandals and conflicts of interest, this spur to growth was substantially moderated. But capital inflows into the US did not dry up but increased, resulting in a low interest rate regime that still encouraged debt-financed consumer spending and a housing and real estate boom. Together with the return to deficit-financed spending by the American state, justified by its nebulously defined war on terror, America is once again witnessing buoyant output.

The only threat to US buoyancy throughout this period was the possible unsustainability of the widening current account deficit in its balance of payments. But the boom was not aborted, because the rest of the world appeared only too willing to finance those deficits, even if at falling interest rates in some periods.

Unfortunately, few other countries benefited directly from this chain of events. They did not because they did not have the military power to create the required confidence in their currencies, even if sheer competitiveness warranted a decline in the dollar. A few countries benefited indirectly: China, for example, because of the export boom to the US; the UK because, among other things, of a boom in services, including financial services. But overall, to use a phrase popularized by former US Treasury secretary Lawrence Summers, the world economy was flying on one engine.

### **Developing country exchange rates: Under- or Overvalued?**

Recently, however, a number of efforts have been made to window dress this iniquitous outcome. The first of these is to argue that the reason why the US is unable to correct its "twin deficit" problem is the undervaluation of exchange rates in some developing countries that limits export from the US and increases imports into the US. That is the US trade and current account deficit is not the result of its own debt- and deficit-financed profligacy and lack of competitiveness, but the distorted exchange rate policies in developing countries.

As far back as mid-July 2003, Alan Greenspan, chairman of the US Federal Reserve, while deposing before a congressional committee, warned the Chinese authorities that they could not continue to peg the renminbi to the US dollar, without adversely affecting the functioning of their monetary system. This touching concern for and gratuitous advice to the Chinese had, however, some background. Greenspan was merely echoing the sentiment expressed by a wide circle of conservative economists that the Chinese must float their currency, allow it to appreciate and, hopefully, help remove what is being seen as the principal bottleneck to the smooth adjustment of the unsustainable US balance of payments deficit.

China was, of course, only the front for a wide range of countries in Asia, who were all seen as using managed and “undervalued” currencies to boost their exports. Around the same time that Greenspan was making his case before the congressional committee, *The Economist* published an article on the global economic strains being created by Asian governments clinging to the dollar either by pegging their currencies or intervening in markets to shore them up. That article reported the following: “UBS reckons that all Asian currencies, except Indonesia’s are undervalued against the dollar ... The most undervalued are the yuan, yen, the Indian rupee and the Taiwan and Singapore dollars; the least undervalued are the ringgit, the Hong Kong dollar and the South Korean won.”

To anyone who has been following the debate on exchange rate regimes and exchange rate levels in developing countries, this perception would appear to be a dramatic reversal of the mainstream, conservative argument that had dominated the development dialogue for the last three to four decades. Till recently, many of these countries were being accused of pursuing inward looking policies, of being too interventionist in their trade, exchange rate and financial sector policies, and, therefore, of being characterized by “overvalued” exchange rates that concealed their balance of payments weaknesses. An “overvalued” rate, by setting the domestic currency equivalent of, say, a dollar at less than what would have been the case in an equilibrium with free trade, was seen as making imports cheaper and exports more expensive. In the medium term, such restrictions were seen as encouraging investments in areas that do not exploit the comparative advantages of the country concerned, leading to an inefficient and internationally uncompetitive economic structure.

What was required, it was argued, was substantial liberalization of trade, a shift to a more liberalized exchange rate regime, less intervention all-round, and a greater degree of financial sector openness. Partly under pressure from developed country governments and the international institutions representing their interests, many of these countries have since put in place such a regime.

Seen in this light, consistency and correctness are not requirements it appears when defending the world’s only superpower. Nothing illustrates this more than the effort on the part of leading economists, the IMF, developed country governments and the international financial media to hold the exchange rate policy in Asian countries, responsible for stalling the “smooth adjustment” of external imbalances in the world system.

The adoption of a liberalized economic regime in which output growth had to be adjusted downwards to prevent current account difficulties and attract foreign capital had its

implications. It required governments to borrow less to finance deficit spending, which often led to lower growth, lower inflation and lower import demand. Combined with or independent of higher export growth, these effects showed up in the form of reduced deficits or surpluses on their external trade and current accounts. And that, combined with capital flows resulted, in turn, in the peculiar distribution of global current account deficits and surpluses and global foreign reserves seen in the world today.

The imbalance in the distribution of reserves was the inevitable consequence of wanting to prevent autonomous capital flows that came in after liberalization of foreign direct and portfolio investment rules from increasing exchange rate volatility and threatening currency disruption due to a loss of investor confidence. These reserves are indeed a drain on these systems, since they involve substantial costs in the form of interest, dividend and repatriated capital gains but had to be invested in secure and relatively liquid assets which offered low returns. But that cost was the inevitable consequence of opting for the deflation and the capital inflow that resulted from the stabilization and adjustment strategies so assiduously promoted by the US, the G-7, the IMF and the World Bank in developing countries the world over. Unfortunately, the current account surpluses and the large reserves that this sequence of events resulted in have now become the “tell-tale” signs for arguing that the currencies in these countries are “under-“ not “overvalued” and therefore need to be revalued upwards.

### **Inventing a global “saving glut”**

Overvaluation of currencies in competing countries is not the only argument used by those who want to absolve the US of the responsibility for global imbalances. Recently, Federal Reserve Governor Ben Bernanke took issue “with the common view that the recent deterioration in the U.S. current account primarily reflects economic policies and other economic developments within the United States itself.” In his view, though domestic developments have certainly played a role, a satisfactory explanation of the rapid rise of the U.S. current account deficit requires a global perspective that takes account of the fact that “over the past decade a combination of diverse forces has created a significant increase in the global supply of saving--a global saving glut--which helps to explain both the increase in the U.S. current account deficit and the relatively low level of long-term real interest rates in the world today.”

What accounts for this so-called global saving glut? One factor is, supposedly, a rise in the desired savings rate in developed countries (other than the United States) at a time when investment opportunities are constrained by supplied-side factors. Desired savings is seen to be high because of the expected dramatic increases in the ratio of retirees to workers in a number of major industrial economies. On the other hand prospective returns from investment are seen as low because of slowly growing or declining workforces, as well as high capital-labour ratios, in many of these countries. Why these features must necessarily result in low prospective earnings and an apparent dearth of domestic investment opportunities is by no means clear. But, according to Bernanke, as a consequence of these factors the mature industrial economies as a group “seek to run current account surpluses and thus to lend abroad”. However, this potential source of excess saving cannot be the principal explanation of the saving glut, because in a number of these countries--Japan being one example--household saving has been declining.

Hence, according to Bernanke (2005), “a possibly more important source of the rise in the global supply of saving is the recent metamorphosis of the developing world from a net user to a net supplier of funds to international capital markets.” The shift, in his view, occurred because of developments in the developing countries themselves, especially the financial crises many of them faced since the mid-1990s. These crises are seen to have occurred because net capital imports into the developing countries in the early and mid-1990s were not always productively used but absorbed for the wrong reasons. In some developing countries, governments borrowed to finance budgetary deficits and avoid necessary fiscal consolidation. In other countries, these funds were not allocated to projects promising the highest returns because of “opaque and poorly governed banking systems”. The resulting loss of lender confidence, together with other factors such as overvalued fixed exchange rates and reliance on short-term debt denominated in foreign currencies resulted in financial crises, that led to capital outflows, currency depreciation, sharp declines in domestic asset prices, weakened banking systems, and recession. Such was the experience, according to Bernanke, in Mexico in 1994, in a number of East Asian countries in 1997-98, in Russia in 1998, in Brazil in 1999, and in Argentina in 2002

Thus the transformation of developing countries from net importers to net exporters of capital is seen as a voluntary or enforced response to these crises, created by wrong policies or institutional inadequacies in the developing countries. In the wake of the crises these countries either chose or were forced into strategies that implied a current account surplus. There are two reasons why this could have occurred: crisis-induced deflation that restricted imports and generated a current account surplus or conscious efforts to engineer a current account surplus in pursuit of a policy of reserve accumulation to deal with likely future capital outflows. Going against the evidence, Bernanke opts for the latter explanation, and argues that the shift to a surplus in the current account of East Asian countries, such as Korea and Thailand, was because they began to build up large quantities of foreign-exchange reserves and continued to do so even after capital inflows that had dried up after the crises were restored. In financial terms, governments have essentially acted as financial intermediaries, channelling domestic saving away from local uses and into international capital markets by issuing debt to their citizens to mobilize domestic saving, and then using the proceeds to buy U.S. Treasury securities and other assets.

Even countries that had escaped the worst effects of the crisis such as China and India are seen to have built up reserves to serve as "war chests". Further, reserve accumulation occurred because of resort to foreign exchange interventions intended to promote export-led growth by preventing exchange-rate appreciation. Countries typically pursue export-led growth because domestic demand is thought to be insufficient to employ fully domestic resources. Following the 1997-98 financial crisis, many of the East Asian countries seeking to stimulate their exports had high domestic rates of saving and, relative to historical norms, depressed levels of domestic capital investment--also consistent, of course, with strengthened current accounts.

In sum the transformation of developing countries from borrowers on international capital markets to large net lenders is a result of developments internal to these countries. However, the reasons for the reversal has been misread because it obviously implies that the gap resulting from the low level of national saving in the US, which is considerably

short of U.S. capital investment, is being made up by net foreign borrowing or the use of foreign saving to finance part of domestic investment.

This has been the basis on which the low savings rate in the US has been identified as an important factor underlying global balance of payments imbalance. As Li Ruogu, the deputy governor of the People's Bank of China, put it in an interview with the Financial Times, in the context of the controversy over the “undervaluation” of the Renminbi (RMB): "The savings rate in China is more than 40 per cent. In the US it is less than 2 per cent. So the problem is that they spend too much and save too little."

However, according to Bernanke, this "made in the USA." perspective is misplaced, because it is partly based on the “popular argument” that focuses on the burgeoning U.S. federal budget deficit when explaining the decline in national saving and the rise in the current account deficit in the US. But that argument, in his view, cannot be sustained for two reasons: first, the US was recording a rise current account deficit even during 1996 to 2000 when it was recording budgetary surpluses; second, there is no necessary relationship between a budget deficit and a current account deficit—countries such as Germany and Japan continue to run large current account surpluses despite government budget deficits that are similar in size (as a share of GDP) to that of the United States.

What that ignores is that, the reason why a budgetary deficit leads to current account deficit is that the excess of government investment over government savings it implies is not matched by an excess of private saving over private investment or is accompanied by an excess of private investment over private saving that aggravates the deficit. Yet, using his “conclusion” Bernanke builds a two-step argument to explain the US current account deficit. First, while there is a necessary correspondence between the excess of investment over saving and the current account deficit, the causation really runs from the latter to the former. That is because there is a global savings glut, the US can sustain an excess of investment over saving. Second, the excess of investment over savings arises because of the effect that the savings glut has on asset prices and exchange rates, although the pattern of asset-price changes was somewhat different before and after 2000.

Thus the real argument is that the global savings glut *creates* the excess of investment over savings in the US. Between around 1996 and early 2000, it did this by affecting equity prices. The US was well placed to mediate these effects because of the development and adoption of new technologies that delivered increases in productivity, which together with low political risk, strong property rights, and a good regulatory environment, made the country exceptionally attractive to international investors during that period. As a result “excess savings” flowed into the US and ensured buoyant stock and foreign exchange values.

As noted earlier this encouraged U.S. consumers to spend on goods and services, which affected domestic production but also ensured large increases in imports. Further, the appreciation of the dollar rendered imported goods cheaper in terms of dollars while making exports expensive, which worsened the trade imbalance. On the other hand, the savings which were flowing into the US and resulted in a rise in a current account deficit was absorbed into the capital investment triggered by the profit opportunities the process generated.

When the picture is painted thus, the fact that both the inflow of capital into US stock markets and the rise in stock prices was fuelled by speculative fever is ignored, leaving the reasons for the collapse of the stock market starting in 2000 unspecified. Rather the argument jumps to explaining why the current account deficit persisted even after the stock market collapse. It did, according to Bernanke, because of the effects of the global savings glut on US interest rates. Global excess saving lowered interest rates, making it, rather than high equity prices, the principal cause of lower US saving. Low mortgage rates have supported record levels of home construction and strong gains in housing prices. The asset price effects of this housing boom has once again encouraged consumption spending as the increase in housing wealth not only reduces the desire to save but provides access to credit to finance consumption. Here again the speculative element in the housing bubble is ignored. As we shall see later, that speculative element does create the possibility that when expectations of further increases in housing prices do not materialise or when interest rates are expected to rise the boom can come to an end and even turn into collapse.

Thus, events outside the US, especially the internally induced financial crises in emerging-market countries have, through their effects on equity values, house prices, real interest rates, and the exchange value of the dollar, widened the current account deficit in the US. This implies that “specific trade-related factors cannot explain either the magnitude of the U.S. current account imbalance or its recent sharp rise. Rather, the U.S. trade balance is the tail of the dog; for the most part, it has been passively determined by foreign and domestic incomes, asset prices, interest rates, and exchange rates, which are themselves the products of more fundamental driving forces.”

There, of course, remains the question as to why the current-account effects of the increase in desired global saving were felt disproportionately in the United States relative to other industrial countries. Given his argument, Bernanke cannot but point to the technology boom in the US and the ostensible “depth and sophistication” of its financial markets as factors that make it an attractive investment destination. But he too cannot ignore the role played by the status of the US dollar as the leading international reserve currency to explain why the saving flowing out of the developing world has been directed relatively more into dollar-denominated assets such as U.S. Treasury securities. However, what the first of the arguments manages to achieve is to obfuscate the puzzle as to why the dollar remains the reserve currency despite the loss of US competitiveness.

If not obfuscated, the only way to unravel that puzzle would be to refer: (i) to the crucial role played by US markets in the growth process of many countries, including China, India and much of East Asia; and (ii) to the strategic and military dominance of the US and its aggressive expansionism. The first allows the US to demand a quid pro quo for access to its markets. The second provides the basis for the confidence that despite the widening current account deficit the US economy and the dollar are unlikely to experience a cumulative downward descent into recession. In the event, the US returns to robust growth with a widening deficit, even when many other developed industrial economies are faced with slow growth or recession.

The problem of markets delivering unexpected outcomes, however, does not go away, since the possibility that the low interest rates that underlie the present situation may not continue. Interest rates can rise for two reasons. First, foreign investors may fear that the

dollar cannot continue to be sustained at anywhere near current levels and thus reduce their holding of Treasury bonds and other dollar-denominated assets. The consequent decline in the prices of those assets would imply a rise in interest rates. Second, any decline in the value of the dollar would trigger price increases because of the 16 per cent share of imports in US GDP. To deal with that price increase the Fed may have to raise interest rates. A rise in interest rates because of either of or both these causes can bring the housing boom to an end, lead to a sharp fall in consumption and precipitate a recession.

Within the imperial order always fearful of a “hard landing”, this has created two imperatives. First, in the medium term, the world needs other supportive engines, which must be from within the developed economies. Second, till that time, and even thereafter, US growth must be sustained. The new discovery that Asian currencies, particularly the Chinese renminbi, is under- and not overvalued, stems from the second of these two concerns. A revaluation of these currencies is seen as necessary to limit and reverse the US current account deficit and prevent a collapse of the dollar.

The perception clearly is that the current account correction cannot be ensured by curtailing US growth and therefore the growth of US imports. It is necessary to boost exports, so that growth can coexist with a reducing trade and current account surplus. This is where China and the fact that it notches up large trade surpluses with the US comes in. Ignoring the fact that simultaneously China had recorded a trade deficit with the rest of the world, the surplus with the US is seen as a direct consequence of China’s undervalued exchange rate, which had been pegged to the dollar since 1995 despite rising capital flows and reserves. Thus, the story goes, if China revalues its currency vis-à-vis the dollar by anywhere between 15 and 40 per cent, depending on the advocate, China would absorb more imports from and be able to export less to the US, correcting the trade imbalance between the two countries.

The flaws in these arguments are obvious. A revaluation of the renminbi may reduce China’s trade surplus with the US, but it is unlikely to trigger either export or output growth in the US. Rather, the space vacated by the Chinese in US markets would be occupied by some other trading country such as India, Vietnam, Korea or the Philippines. Further, those Asian countries that expect to gain from the renminbi’s revaluation would soon find that their current account surpluses and reserves are seen as grounds for identifying their currencies as undervalued and provide the basis for a revaluation demand. India, with \$140 billion of foreign exchange reserves is already being targeted. Whatever gains would occur from China’s revaluation would be shortlived.

Further, if China and other countries, like India, with rising reserves are deprived of those reserves on these grounds, the capital required to finance the current account and budget deficits accompanying US growth would soon dry up. This would drive up interest rates in the US, cut consumption and investment spending, make the current account deficit unsustainable, and ensure the collapse of US growth and the dollar that the revaluation is expected to stall.

What is ignored in all this is that the specific form of integration that the current process of globalization has generated has delivered not just uneven growth but the prospect of increased instability. In the process the desperation to protect the current imperial order is

yielding a number of scatter-brained proposals. Economics has been reduced to deformed ideology, devoid of consistency and rationality.

<b>Table 1: Global Current Account Deficits/Surpluses</b>		
<b>COUNTRY</b>	<b>2003</b>	<b>2004</b>
UNITED STATES	-530,664,000,000.00	-665,939,000,000.00
UNITED KINGDOM	-30,758,400,000.00	-46,878,700,000.00
AUSTRALIA	<i>-30,353,600,000.00</i>	<i>-40,024,900,000.00</i>
SPAIN	-23,676,000,000.00	-49,224,800,000.00
ITALY	-20,555,900,000.00	n.a.
GREECE	-11,225,000,000.00	n.a.
PORTUGAL	-7,937,010,000.00	-12,681,700,000.00
TURKEY	-7,905,000,000.00	-15,451,000,000.00
HUNGARY	-7,210,760,000.00	-8,819,050,000.00
MEXICO	<i>-6,479,450,000.00</i>	<i>-7,409,170,000.00</i>
CZECH REPUBLIC	-5,660,680,000.00	n.a.
POLAND	-4,599,000,000.00	-3,585,000,000.00
NEW ZEALAND	-3,356,670,000.00	-6,232,030,000.00
ROMANIA	-3,311,000,000.00	n.a.
SOUTH AFRICA	-2,604,640,000.00	-6,982,060,000.00
IRELAND	-2,104,790,000.00	-748,422,000.00
CROATIA	-2,066,360,000.00	-1,668,260,000.00
AZERBAIJAN, REP. OF	-2,020,860,000.00	<i>-2,589,210,000.00</i>
BOSNIA & HERZEGOVINA	-1,745,400,000.00	-1,917,020,000.00
BULGARIA	-1,675,830,000.00	-1,813,230,000.00
AUSTRIA	-1,363,250,000.00	987,577,000.00
LITHUANIA	-1,278,350,000.00	-1,589,740,000.00
ESTONIA	<i>-1,116,290,000.00</i>	<i>-1,431,700,000.00</i>
CHILE	-1,102,110,000.00	1,389,690,000.00
PERU	-1,060,650,000.00	-71,679,400.00
GUATEMALA	<i>-1,039,150,000.00</i>	<i>-1,188,340,000.00</i>
COLOMBIA	-1,021,070,000.00	-1,109,990,000.00
COSTA RICA	-967,011,000.00	n.a.
SUDAN	-955,410,000.00	-870,880,000.00
LATVIA	-916,694,000.00	-1,673,300,000.00
NICARAGUA	-779,500,000.00	n.a.
EL SALVADOR	-763,580,000.00	-611,520,000.00
JAMAICA	-761,400,000.00	n.a.
TUNISIA	-730,330,000.00	<i>-554,812,000.00</i>
ICELAND	<i>-533,750,000.00</i>	<i>-1,055,120,000.00</i>
MOZAMBIQUE	-515,640,000.00	n.a.
ECUADOR	-455,424,000.00	n.a.
CYPRUS	-441,761,000.00	-914,773,000.00
MADAGASCAR	-438,809,000.00	n.a.
PANAMA	-437,200,000.00	-1,104,280,000.00
BELARUS	-423,511,000.00	-1,042,900,000.00
BAHAMAS, THE	-418,480,000.00	n.a.
ALBANIA	-406,815,000.00	n.a.

UGANDA	-388,773,000.00	-253,897,000.00
GEORGIA	-374,754,000.00	-425,643,000.00
HONDURAS	-314,317,000.00	-412,860,000.00
SLOVAK REPUBLIC	-281,938,000.00	n.a.
MACEDONIA, FYR	-278,513,000.00	n.a.
MALTA	-274,633,000.00	-549,963,000.00
MALI	-270,974,000.00	n.a.
KAZAKHSTAN	-270,114,000.00	532,894,000.00
ETHIOPIA	-198,959,000.00	n.a.
ARMENIA	-190,584,000.00	-166,962,000.00
GUINEA	-187,528,000.00	-174,784,000.00
BELIZE	-180,945,000.00	n.a.
BARBADOS	-169,350,000.00	n.a.
SRI LANKA	-159,820,000.00	n.a.
SURINAME	-159,000,000.00	n.a.
CAMBODIA	-155,204,000.00	n.a.
ARUBA	-140,335,000.00	n.a.
MOLDOVA	-132,300,000.00	n.a.
SLOVENIA	-98,900,800.00	-274,755,000.00
KYRGYZ REPUBLIC	-94,616,700.00	n.a.
GUYANA	-90,600,000.00	n.a.
SIERRA LEONE	-80,024,400.00	n.a.
CAPE VERDE	-77,245,700.00	n.a.
VANUATU	-41,252,300.00	n.a.
BURUNDI	-37,290,800.00	n.a.
MALDIVES	-30,434,400.00	n.a.
HAITI	-13,110,000.00	n.a.
GUINEA-BISSAU	-5,870,610.00	n.a.
TAJIKISTAN	-4,822,800.00	-57,044,700.00
CONGO, REPUBLIC OF	-2,600,000.00	n.a.
NETHERLANDS ANTILLES	6,810,060.00	n.a.
BOLIVIA	35,574,800.00	n.a.
MYANMAR	49,631,200.00	n.a.
URUGUAY	52,100,000.00	n.a.
KENYA	67,740,700.00	n.a.
NEPAL	110,342,000.00	n.a.
MAURITIUS	121,699,000.00	n.a.
BANGLADESH	131,638,000.00	n.a.
PARAGUAY	146,019,000.00	n.a.
YEMEN, REPUBLIC OF	148,727,000.00	n.a.
BAHRAIN, KINGDOM OF	200,922,000.00	415,251,000.00
GHANA	255,160,000.00	-235,656,000.00
NAMIBIA	270,586,000.00	n.a.
COTE D IVOIRE	352,843,000.00	n.a.
ISRAEL	577,500,000.00	504,000,000.00
SYRIAN ARAB REPUBLIC	728,000,000.00	360,300,000.00
DOMINICAN REPUBLIC	867,100,000.00	n.a.
JORDAN	962,870,000.00	n.a.

PHILIPPINES	1,396,000,000.00	2,080,000,000.00
OMAN	1,445,900,000.00	n.a.
MOROCCO	1,552,160,000.00	1,062,840,000.00
LUXEMBOURG	2,229,580,000.00	2,828,400,000.00
UKRAINE	2,891,000,000.00	6,804,000,000.00
CHINA,P.R.:MACAO	3,061,440,000.00	n.a.
PAKISTAN	3,573,000,000.00	-807,840,000.00
LIBYA	3,642,000,000.00	n.a.
EGYPT	3,743,300,000.00	n.a.
BRAZIL	4,177,290,000.00	11,668,900,000.00
FINLAND	6,497,250,000.00	7,528,770,000.00
INDIA	6,718,000,000.00	n.a.
DENMARK	6,963,070,000.00	n.a.
INDONESIA	7,251,800,000.00	n.a.
ARGENTINA	7,370,010,000.00	3,029,320,000.00
THAILAND	7,952,820,000.00	7,079,570,000.00
KUWAIT	9,415,740,000.00	18,883,600,000.00
VENEZUELA, REP. BOL.	11,448,000,000.00	13,830,000,000.00
FRANCE	11,803,300,000.00	-4,832,730,000.00
KOREA	12,320,700,000.00	27,612,800,000.00
MALAYSIA	13,381,200,000.00	n.a.
BELGIUM	13,780,100,000.00	12,045,700,000.00
NETHERLANDS	16,403,300,000.00	n.a.
CHINA,P.R.:HONG KONG	16,469,900,000.00	16,357,300,000.00
CANADA	17,268,000,000.00	25,870,100,000.00
SWEDEN	22,844,200,000.00	n.a.
EURO AREA	23,499,500,000.00	56,716,300,000.00
SAUDI ARABIA	28,047,900,000.00	51,487,700,000.00
SINGAPORE	28,183,500,000.00	n.a.
NORWAY	28,326,200,000.00	34,444,900,000.00
RUSSIA	35,410,000,000.00	60,108,800,000.00
SWITZERLAND	43,618,500,000.00	50,567,600,000.00
CHINA,P.R.: MAINLAND	45,874,800,000.00	n.a.
GERMANY	51,446,500,000.00	104,301,000,000.00
JAPAN	136,215,000,000.00	172,059,000,000.00

Source: IMF, *International Financial Statistics Database*

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