The New Structure of Global Balances

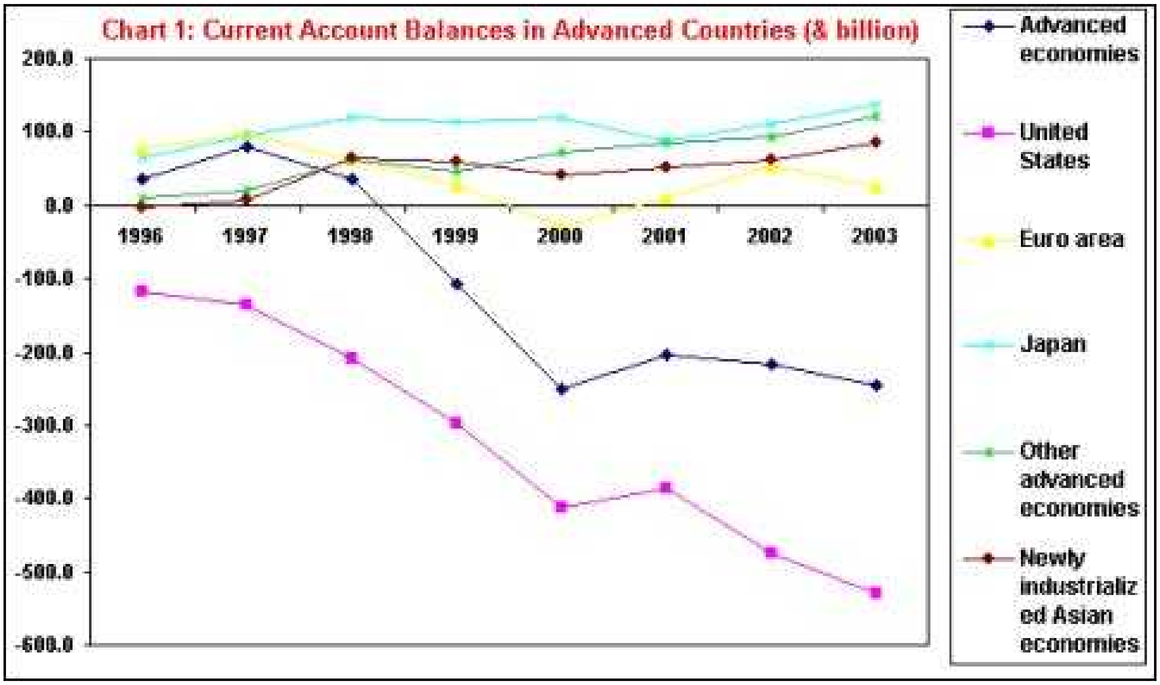
C.P. Chandrasekhar and Jayati Ghosh

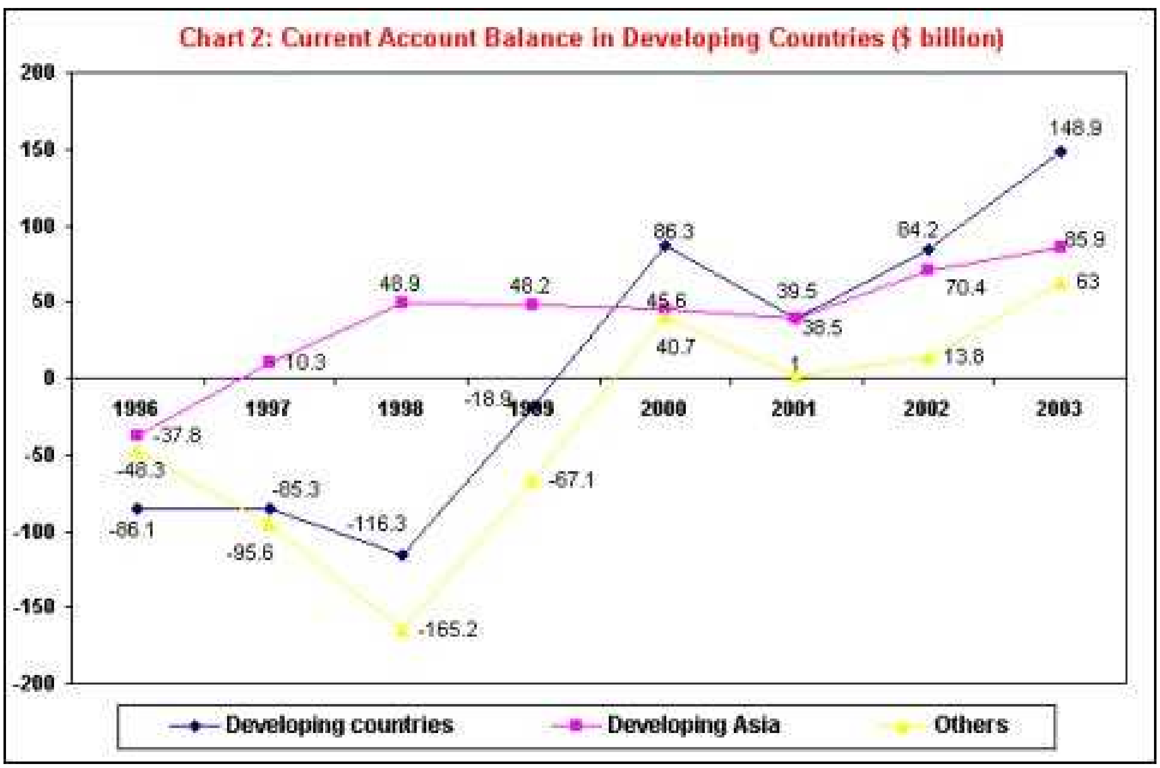
An unusual and striking feature of the current global balance of payments situation is the huge deficit on the current account of the world's dominant country, the United States, which is partly being financed with surpluses in the current and capital account of developing countries, especially those in developing Asia. At the end of the second quarter of 2004, the annual current account deficit in the US balance of payments stood at $572 billion and was forecast to touch 5.5 per cent of GDP in 2004. At around the same time, 9 developing countries in Asia and Latin America (Brazil, China, Hong Kong, India, Indonesia, Malaysia, Singapore, South Korea, Taiwan, and Venezuela) were recording an annual surplus of around $190 billion on their current account.

To boot, many of these developing countries were recipients of large capital inflows - in the form of foreign direct investment, portfolio capital and debt - resulting in surpluses on the capital account. Together these current and capital account surpluses were adding to their reserves, which in turn were being invested in dollar denominated financial assets, thereby financing in part the US deficit.

Weekly data from the Federal Reserve relating to November 3, 2004 showed the Fed's holdings of assets for official institutions - which is a proxy for foreign central bank holdings - rose over the previous year by $253.6 billion to $1,053 billion. This compares with a rise of $217 billion during the whole of 2003. 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. In the first two months of this year, those reserves rose a further 15 per cent to $776.9 billion. While developing countries may not be playing a similar role, their contribution is still important.

As Chart 1 shows, the current account deficit in the US has widened continuously since the mid-1990s, resulting in an overall deficit for all advanced economies, despite the fact that every one of them has shown surpluses in almost all those years. On the other hand, during this period developing countries as a group have seen a transformation of their current account deficits into surpluses (Chart 2). 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.





This implies that three decades of globalisation have fundamentally transformed the international balance of payments situation. 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.

The long term effects of these developments are there to see. Available figures point to galloping growth in the global operations of financial firms. In the early 1980s, the volume of transactions of bonds and securities between domestic and foreign residents accounted for about 10 per cent of GDP in the US, Germany and Japan. By 1993, the figure had risen to 135 per cent for the US, 170 per cent for Germany and 80 per cent for Japan. Much of these transactions were of bonds of relatively short maturities.

Since then, not only have these transactions increased in volume, but a range of less traditional transactions have come to play an even more important role. Traditional bank claims, though important, are by no means dominant. Banks reporting to the Bank of International Settlements (BIS) recorded foreign claims on residents of all countries at $15.7 trillion at the end of 2003. This compares with the annual global GDP of $36400 trillion in that year.

Non-bank transactions have been far more important. In 1992, the daily volume of foreign exchange transactions in international financial markets stood at $820 billion, compared to the annual world merchandise exports of $3.8 trillion or a daily value of world merchandise trade of $10.3 billion. According to the recently released Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity, in April 2004, the average **daily** turnover (adjusted for double-counting) in foreign exchange markets stood at $1.9 trillion. With the average GDP generated globally in a day standing at close to $100 trillion in 2003, this appears to be a small 2 per cent relative to real economic activity across the globe. But the sum involved is huge relative the daily value of world trade. In 2003, the value of world merchandise exports touched $7.3 trillion, while that of commercial services trade rose to $1.8 trillion. Thus, the daily volume of transactions in foreign exchange markets exceeded the annual value of trade in commercial services and was in excess of one quarter of the annual merchandise trade.

The trade in derivatives is also large and significant. The Triennial Survey indicates that the average daily volume of exchange traded derivatives amounted to $4.5 trillion in 2004. In the OTC derivatives market, average daily turnover amounted to $1.2 trillion at current exchange rates. The OTC market section consists of "non-traditional" foreign exchange derivatives – such as cross-currency swaps and options – and all interest rate derivatives contracts. Thus total derivatives trading stood at $5.7 trillion a day, which together with the $1.9 million daily turnover in foreign exchange markets adds up to $7.6 trillion. This exceeds the annual value of global merchandise exports in 2003.

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 imposes a deflationary environment on developing countries, because one requirement for keeping financial investors happy is 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.

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 1 shows, 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. So, unless exports of goods and services and/or remittances are large and growing, deflation must be the factor influencing the current account.

Table 1: The Current Account of Developing and Emerging Market Countries ($ billion)

	1996	1997	1998	1999	2000	2001	2002	2003
Current account balance	-86.1	-85.3	-116.3	-18.9	86.3	39.5	84.21	148.9
Balance on goods and services	-46.6	-45.6	-66.1	42.2	147.9	93.5	128.6	183.4
Income, net	-83.7	-91.8	-99.5	-114.3	-188.3	-116.9	-124.5	-137.3
Current transfers, net	44.2	52.1	49.2	53.2	56.7	63	80	102.7

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 trade 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, particularly in the form of private foreign investment. Such capital inflows then either went out as other net investment or were accumulated as reserves that were invested in large measure in US Treasury bills. That is, private capital flowed into developing countries to earn lucrative returns, and this capital then flowed out as investment in low interest Treasury bills in order to finance the US balance of trade deficit.

What is more, 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 consequent build-up of foreign currency assets, while initially sterilized through sale of domestic assets, especially government securities, soon reduces the monetary policy flexibility of the central bank. Governments in Asia, especially India, faced with these conditions are increasingly resorting to trade and capital account liberalization to expend foreign currency and reduce the compulsion on the central bank to keep building foreign reserves. That is, if financial liberalisation is successful, in the first instance, in attracting capital flows, it inevitably triggers further liberalization, including of capital outflows, leading to an increase in financial fragility.

Thus, financial liberalisation that successfully attracts capital flows increases vulnerability and limits the policy space of the government. Unfortunately, the dominance of finance globally has meant that such debilitating flows occur even when individual developing countries or developing countries as a group have no need for such flows to finance their balance of payments or augment their savings. The real benefit of such flows is derived by the US government, which, being the home of the reserve currency can resort to large scale deficit financing which it opposes in developing countries. The resulting balance of trade and current account deficits are not a problem because they are financed with capital flows from the rest of the world including "emerging market" developing countries. The problem now is that the willingness of private investors and governments to hold more dollar denominated assets is waning. If that continues a crisis at the metropolitan centre of global capitalism is a possibility.