Chapter I

THE CURRENT GLOBAL RECOVERY AND IMBALANCES IN A LONGER-TERM PERSPECTIVE

A. Growth and imbalances

Recovery and sustained growth in the global economy has been subject to two challenges since the 1997 Asian crisis, one being on the real side and the other involving the financial sector. The first threat was the impact on developed economies of the expected sharp increase in competitiveness and exports from East Asia as the crisis-stricken economies benefited from massive currency devaluations, requiring large swings in trade balances. The second threat was that of a global collapse of financial markets as a result of the rush to liquidity following the Russian debt default in late summer 1998. Both developments gave rise to widespread forecasts of a global slowdown and concerns over a risk of recession.

In the event, neither of these threats materialized and the global economy appears to be enjoying sustained expansion. The threat from a deluge of exports from East Asian countries in that period was largely offset by the collapse of their financing systems and asset prices, as a result of which the initial adjustment was based not on increased exports but on massive cuts in imports. Even when exports increased in volume, the effect on earnings was more than offset by falling export prices, while the decline in imports of primary materials compounded a downward trend in world commodity prices that had already started in 1996. The net result was an increase in the purchasing power of consumers in developed countries that allowed demand and output to expand rapidly in conditions of price stability.

In the absence of price pressures, the United States Federal Reserve allowed the economy to grow at a rate exceeding by far what it considered to be the potentially non-inflationary level, thus enhancing the productive potential and the rate of non-inflationary growth. Growth continued at rates that were not only above forecasts but, at more than 4 per cent, double of what was considered as the maximum potential. Indeed, the potential growth rate has now been revised upward, from around 2.5 per cent to more than 3 per cent, in view of what appears to be a stable annual increase in labour productivity to rates above 2 per cent.[1]

The consequences of the fall in primary commodity prices were especially acute in the Russian Federation, where tax receipts and foreign exchange earnings had become almost totally dependent on commodity trade. The decline in export revenues led to the default on interest payments on government debt and a collapse of the rouble. Since many developed-country financial institutions were exposed either directly or indi-

rectly, the insolvency of the Russian Government threatened global financial stability; there was a loss of confidence in all but the most secure financial investments, and the funding of all but highly secure government paper dried up. United States government securities thus became the refuge of risk-averse investors and commanded a large liquidity premium.

In this instance the Federal Reserve not only refrained from raising interest rates, but also acted quickly to reduce them to counter the rising risk premium and the sale of financial assets, thereby averting the threat to global growth of the contagion implicit in the linkages between national financial markets. This monetary easing, which was extended into 2000 through efforts to counter the risks of a systemic breakdown that was feared on account of the "Y2K computer bug", did much to allow the United States economy to continue to function as the engine of world growth, in particular by providing markets for the recovering East Asian economies. In the second half of 1998 those countries had already started to benefit from accommodating domestic fiscal and monetary policies and had finally unleashed the export potential implicit in their large devaluations and excess capacity, producing record current-account surpluses.

Thus, the factors that countered the two threats to the global economy during 1998–1999 have served to accelerate growth in the United States. They also led to a sustained inflow of capital into that country in excess of its current-account deficits, as international investors sought the security of dollar assets. The attractiveness of the dollar, together with the concentration of new issues of internet technology companies in the United States, helped to produce a sustained increase in asset prices that has provided the basis for increases in both private investment and private consumption expenditures. Rapid growth and a rising dollar have resulted in a growing current-account deficit as the United States acted as "buyer of last resort" from the rest of the world. This combination of a rising current-account deficit and a strong dollar is reminiscent of the early 1980s, when it was widely considered to be unsustainable and was the source of the "hard landing" of the dollar in 1986–1987.

As in the 1980s, the Japanese surplus has been the major counterpart to the United States deficits, but now there are substantial differences that serve to reinforce the current imbalances. The first and most obvious is that the United States growth differential vis-à-vis the rest of the world is now underpinned by private spending and productivity gains due to a new Schumpeterian technological epoch, and the government is a net saver. In Japan, growth is negligible and the attempt to combat falling prices and stagnant private spending is creating rising government deficits and debt. As a result, the supply of United States government bonds that serve to satisfy the increased global preference for dollar assets is declining, while the supply of Japanese government bonds, which do not, is increasing. In such conditions the natural result is for rates on United States bonds to fall and on Japanese bonds to rise, creating expectations of gains on the former and losses on the latter. Such expectations have largely offset the recent attractiveness of Japanese equities to foreign buyers and supported the flow of funds from Japan to the United States. Since Japanese financial institutions hold a large proportion of domestic bonds, any substantial increase in domestic interest rates will lead to large capital losses, impede the process of reconstruction of the financial system and reduce lending to the private sector.[2]

The East Asian crisis and recovery have also reinforced the demand for dollar assets. The current-account surpluses generated in the region are seen as necessary not only to provide the funds to repay the short-term dollar debt, but also to satisfy the increased liquidity preferences of these countries in the form of larger international reserves as a buffer against future crises. Thus, the claims on the United States generated by its trade surpluses are willingly held as dollar assets to provide a defensive liquidity cushion. High United States interest rates favour the holding of reserves in dollars, the more so in view of the large losses sustained on holdings in the newly issued euro assets. Reserves are further supplemented as countries intervene to sell their currencies against the dollar to prevent unwanted real appreciations which might choke off the recovery process.

Thus the East Asian region, which has the world's largest export surplus, through its tendency to hold those surpluses in dollar assets, has provided support for the dollar but made it difficult for the United States to reduce its deficits. As the recovery continues, imports will rise and current-account surpluses will shrink, but capital flows to the region are likely to increase. Since

the volatility of capital flows was the major reason for the earlier crisis, it is likely that these countries will continue to hold larger proportions of their capital inflows as reserves, maintaining the increased demand for dollar assets as risk and liquidity hedges.[3]

Europe is the other major region with a current-account surplus. Growth in EU has in general not been sufficient to bring about reductions in unemployment, although there are some important exceptions. Europe has lagged behind the United States in the exploitation of new technologies in communications and computing to increase productivity. Consequently, there are now substantial differences between labour productivity growth in Europe and the United States, constituting a reversal of the post-war trend for European productivity to dominate. One way to overcome this lag has been to acquire United States companies or to start up operations in the United States; indeed, the United States has become a net recipient of FDI. While European FDI flows to that country more than tripled from 1995 to 1998, reaching more than $160 billion, the flow in the opposite direction rose from $50 billion to $70 billion.[4] Since many United States firms are now truly global corporations, they are considered as global investments, and European portfolios have increased their holdings of United States equities. This process was given a further boost by the introduction of the euro, which eliminated the benefits from diversification of assets denominated in other EU currencies.

Neither the strength of the dollar vis-à-vis the euro nor higher United States interest rates has done much to reduce current imbalances in trade, growth and capital flows between Europe and United States. Since the strong dollar is due to foreign demand for dollar assets, it supports consumption in the United States by feeding through to household wealth, given the relatively high share of equity in household portfolios, as well as by increasing purchasing power. Thus, high interest rates are not very effective in preventing overheating through their effect on domestic demand and the dollar. On the other hand, since in EU trade with the rest of the world is a small proportion of GDP, one can expect little expenditure switching from the United States to Europe as a result of the weakness of the euro. By contrast, to the extent that the strong dollar induces the European Central Bank (ECB) to raise interest rates, domestic sources of growth may be dampened and the restructuring of the EU slowed. It thus appears that the strength of the dollar exacerbates the differential in demand growth between EU and the United States.

Persistence of similar imbalances between the United States and Europe in the 1960s contributed to the breakdown of the Bretton Woods system. At that time the dollar was weak in the presence of large outflows from the United States on account of non-commercial transfers linked to political and military objectives. These flows were accompanied by a persistent budget deficit, a positive growth differential and a negative interest differential with Europe. The United States wished to avoid using higher interest rates in support of the dollar in order not to slow growth, and the weakness of the dollar made little contribution to the correction of external imbalances. There was no agreement on whether the appropriate policy was the reduction of the United States' budget deficit and growth or an increase in European demand and growth. Unwilling and unable to act on exchange rates, the United States introduced a wide variety of capital controls. The impasse was eventually resolved by abandoning the Bretton Woods system and taking the dollar off gold.

In the current situation, the equivalent fiscal measure to reduce United States trade deficits would be an increase in its budget surplus. While this might have been the policy response in the era of Keynesian fine-tuning of the 1950s and 1960s, it is no longer considered desirable; nor is the use of expansionary fiscal policy considered desirable by EU in the light of the Stability and Growth Pact. Thus, the entire burden of adjustment is placed on monetary policy, i.e. a rise in interest rates in the United States relative to those in EU. But, if such adjustment simply increases the attractiveness of dollar assets and further feeds the bubble in equity prices, it may become self-defeating. The increased role of the dollar as a reserve currency and the closer integration of global capital markets thus constrain the effectiveness of United States monetary policy in cooling the economy and reducing its trade deficits. What might be required in the present context is a reverse interest equalization tax to reduce the return to non-residents on their holdings of United States assets.[5]

In any case, adjustment in global imbalances through a relative rise in United States interest rates is unlikely since most emerging markets need

to follow suit in order to retain capital inflows. More fundamentally, ECB has started to increase interest rates in an attempt to ward off anticipated inflationary pressure, even though growth in EU is barely 3 per cent and the decline of the euro has hardly affected prices. It is clearly unwilling to follow the Federal Reserve lead in attempting to discover if potential growth rates could be raised by a more accommodating policy.

A parallel increase in both United States and European interest rates (and an eventual increase in Japanese rates to convince corporations to restructure rather than carry losses at zero interest rates) would have little impact on exchange rates of the currencies of the countries concerned or on trade imbalances, but it would sharply increase the carrying costs of debt in developing countries. Increasingly, developing country economic fundamentals, such as fiscal and current-account balances and the inflation rate, are dependent on foreign interest rates. In some economies (e.g. Argentina and Hong Kong, China) this link is more direct, whereas in others (e.g. Brazil and many East Asian countries) it operates through the external debt burden and capital flows. In all cases, however, higher international interest rates would pose a serious threat to the recovery in emerging markets. In East Asia, where recovery has taken place without any substantial corporate and financial restructuring, higher interest rates will simply make this process more onerous, and the recovery may eventually be stalled by the failure of the domestic financial system to provide finance.

A strong European recovery, which has been expected since 1993, has been repeatedly retarded by rising United States rates because increased integration of financial markets and attempts by ECB to establish credibility have resulted in rising interest rates in Europe also. It is unlikely that growth could accelerate in Europe in the face of a United States downturn accompanied by a slowdown in Latin America and East Asia. Thus, the risks that were identified in the aftermath of the Asian crisis continue to be present.

As noted above, similar unsustainable imbalances were present in the global economy for substantial periods in both the 1960s and the 1980s, before creating serious disruptions in global growth and dampening the prospects of developing countries. In the past, excess savings of the rest of the world were balanced by excess spending by the United States Government, and the demand for United States assets was met by the issue of government securities. Today, it is the United States private sector that is sustaining global spending. Since the government is running a fiscal surplus, the demand for dollar assets due to increased uncertainty over global asset values cannot be met by increasing the supply of risk-free United States government securities but would require the issue of assets by the private sector. The basic question is whether foreign investors seeking liquidity and safety will be equally willing to hold private assets. As long as internet stocks dominate investor attention, large expected gains can offset their risk spread over government securities, and the dollar can become the transaction currency for international equity trading. This tendency will be reinforced by the fact that the integration of Europe’s largest equity markets is taking place between London and Frankfurt, thus providing little support to the euro. Further, the movement towards listing many developing-country companies in New York financial markets to ensure sufficient liquidity simply reinforces the tendency for the dollar to become the vehicle currency in the global equity market. Nonetheless, since private debt is not a perfect substitute for Treasury debt, the increasing United States budget surplus can add to the fragility of the current situation and raise the possibility of a “hard landing” for the dollar. In such an event global prospects will depend very much on how monetary policy is conducted and coordinated among the United States, Europe and Japan.

B. Eliminating global imbalances and sustaining growth

Whenever large global imbalances are built up by self-sustaining processes, such as those currently prevailing, uncertainty increases. Current uncertainties, however, are not over the nature of future events, but rather over their timing and implications. There can be little doubt that growth in the United States economy will slow, either of its own accord or induced by continued action on interest rates by the Federal Reserve. By the same token it is certain that the trade deficit will in time be reduced.

It is also likely that the European recovery will be choked off because of a fall in exports as the United States economy slows autonomously, or because the Federal Reserve increases interest rates and ECB mirrors those increases. Consequently, although its economy is equivalent in size to that of the United States, EU is unlikely to take over the role of the United States in supporting global demand. Growth in EU is unlikely to be much above 3 per cent on the basis of domestic demand, and even if it did manage to replicate United States growth rates, it would not generate an external deficit similar in size to that of the United States. Thus, EU cannot replace the United States as the global "buyer of last resort" for the recovering Asian and Latin American economies.

Now that imports in East Asia have recovered to more normal levels, any slowdown in the world economy would once again worsen the external accounts in those countries and render them more dependent on capital inflows. Most countries in the region have built up massive dollar reserves to meet this contingency and they may soon have to use them. Tighter balance-of-payments constraints will bring growth rates back to lower levels. Before the Asian crisis, the region accounted for roughly one half of the annual growth in global demand, and it is unlikely to return to this position, at least in the foreseeable future.

Just as in Europe, Japan has been unable to generate growth based on private domestic expenditure, on the model of the United States, and growth remains dependent on exports. The East Asian recovery has provided a beneficial complement to its fiscal expenditure programmes, but now that growth in East Asia is constrained, recovery in Japan will not be particularly robust, and at any rate too weak to offset the slowdown in the rest of the world, particularly in the United States.

Latin America also depends on global markets. Indeed, outward-looking development strategies in many of these countries depend for their success on mutually reinforcing regional and global growth. A slowdown in United States growth would consequently adversely affect the Latin America economies also.

It is thus evident that optimistic forecasts of a return to global growth at rates above 3 per cent make an implicit assumption about how the decline in United States demand will be compensated for internationally. Obviously, the optimal scenario would be that of a natural decline in United States growth without any further increases in interest rates in either the United States or Europe. If tight monetary policy has to be used to quell the United States' expansion and is also applied in Europe, eventually accompanied by Japan's abandonment of its zero interest rate policy, then indebted developing countries will be doubly burdened by falling export receipts and higher financing costs. If higher interest rates produce financial market turmoil, such as occurred in the global bond market in 1994, which produced losses in net wealth far in excess of the 1987 stock market crash or the Asian crisis, then developing countries could also find themselves severely restricted in their access to private finance. Clearly, a collapse in bond prices would quickly be transmitted to equity prices, which could substantially reduce United States growth as consumers cut

back on their expenditures to meet rising interest and margin payments or adjust to their lower wealth levels. In 1994 high interest rates were accompanied by a decline in the dollar. Normally, such a decline would be beneficial to developing countries. However, if a global financial market turmoil produced a massive shift to liquid assets, it is likely that, as in 1998, the dollar would become the currency of refuge, producing a combination of high interest rates and a strong dollar that was so detrimental to indebted developing countries in the 1980s. While the distribution of financial indebtedness in the present situation is different, and fewer liabilities are held in variable rate form linked to the United States interest rate, a number of countries have direct linkages, either through currency boards or through indexing of debt, allowing a quick and direct transmission of deflationary forces to their economies.

Thus, the prospects for the world economy are not as optimistic as the surprising recovery in 1999 has led many to believe. This much is clear: the remnants of the wreckage of the Asian crisis of 1997 cannot be swept away by another East Asian "miracle" or by the new technologies that appear to be shifting the United States onto a higher potential growth path. An increasingly interdependent global financial and trading system can scarcely function efficiently with only one policy tool, monetary policy, especially without appropriate coordination. The restoration of fiscal policy to the armoury of defensive measures, as well as increased international cooperation, will be required if the full potential of new technologies is to be realized and set the world economy on a higher growth path, thereby enabling developing countries also to achieve sustained increases in per capita income. ■

Notes

1 Already in 1995 the UNCTAD secretariat argued that low estimates of potential growth and high estimates of natural rates of unemployment were due to hysteresis, and that industrial economies could grow much faster without an acceleration in inflation and could reduce unemployment to levels below the estimates of natural rates if appropriate policies were pursued (*TDR 1995*, Part Three, chap. III). See also *Newsweek*, 18 Sept. 1995: 38–39.

2 Around 40 per cent of the existing stock of government bonds is held by government agencies such as the Trust Fund Bureau. About a quarter is in bank portfolios. It has been estimated that a 100 basis point rise in interest rates on long bonds in February 1999 would have produced a capital loss of 1.5 trillion yen for bank holders alone. See IBJ Securities, Economic analysis report: The dual managed system of the moratorium period, *IBJS Research & Reports*, April/May 1999 (www.ibjs.co.jp).

3 On the increased tendency to accumulate excess reserves in emerging markets see *TDR 1999*, chap. V.

4 UNCTAD, FDI/TNC database.

5 Similar measures were used in the past, for instance by Switzerland in the early 1970s, when negative interest was paid on deposits by non-residents to slow capital inflows.