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U.S. DEBT AND GLOBAL IMBALANCES¹

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Introduction

Concern about global imbalances has been building since the 1990s and analysts from a variety of disciplines have called attention to aspects of the problem ranging from the unsustainability of the US current account position to the role of “under” and “over” saving rates in deficit and surplus countries.² There are, however, some critical issues relating to the buildup in US debt and other global imbalances that have yet to be fully explored. Many analysts assume, for example, that imbalances arise as a result of developments and policies within national economies. This paper argues that imbalances – including “under” and “over” saving – also result from interactions at the global level and are at least partially shaped by pressures generated by the current international monetary and payments systems on the direction and volume of international capital flows.

The paper begins with a discussion of the ways in which a fiat currency and privatized payments system under the guardianship of a few wealthy developed countries and their private multinational financial institutions have contributed to the problem. This is followed by an examination of U.S. debt and global imbalances that focuses on the U.S. international investment position, the link between foreign exchange reserves held in the U.S. and liquidity creation and the link between net capital flows and credit expansion. Part II analyses the risks in failing to address the U.S. foreign debt problem and Part III offers proposals needed to address the monetary aspects of global imbalances.

Part I. The Role of International Monetary Arrangements in Creating U.S. Debt and Global Imbalances

Monetary Arrangements and Global Economic Responses

Since the collapse of the Bretton Woods international monetary system, most cross-border payments are denominated in the national currencies of relatively few so-called strong currency countries. Other countries - those whose currencies are not widely used in international transactions or held as external savings - “earn” the means of payment by exporting goods and services to strong currency countries or borrow strong currencies on the expectation that exports to the countries that issue them will provide the external savings needed to service their debts. While this underlying bias toward export-led growth was not initiated by the shift in global monetary arrangements in the 1970s,

¹ This paper is a revised and updated version of the author/s contribution to a joint paper with Stephany Griffith-Jones presented at the FONDAD conference on Global Imbalances and the US Debt Problem in 2006.

² For earlier analyses of the problem, see Blecker (1999), D'Arista (1999), Godley (1999), Greider (2000) and Plender (2000).

that shift (and the pricing of oil in dollars) augmented support for such policies in many developed countries while moving export capacity to the center of development policy. The International Monetary Fund (IMF) prescribed export-led-growth policies for all developing and emerging economies after the financial crises of the 1980s and 1990s, despite little evidence that strong currency countries other than the US were willing to accept the current account deficits needed to ensure their success.

Meanwhile, the role of key currencies as means of payment ensures that a few strong currencies also have become stores of value in the global economy in holdings of both private investors and official institutions. The rapid growth in key currencies as stores of value since the 1970s is recorded in the international investment positions of countries and the Bank for International Settlements' (BIS) reports of holdings in external markets.³ The US international investment position is arguably the most important record of the growing importance of the stock of holdings of external savings but, while many analysts focus on the evidence it provides of the rising external debt of the US, the impact of that debt on the US domestic and global economies is less widely discussed. The following examination of the US international investment position sets the stage for our analysis of its impact on the US and global economies.

The US International Investment Position

The status of the US as the world's dominant importer of both goods and capital is relatively recent. When Wall Street crashed in October 1987, US residents still owned more assets abroad than the amount of US assets owned by foreigners. In other words, the US international investment position was still positive, as it had been since World War I. But the increased borrowing required to finance growing trade deficits had already taken a toll on that once-strong creditor position. By 1989, the US became a net debtor nation and its external (i.e., foreign) liabilities continued to mount throughout the 1990s. At year-end 1996, the net debt reached a record \$548 billion (with assets at market values). One year later, it crossed the \$1 trillion threshold – equivalent to 13 percent of gross domestic product – and by the end of 1998 rose to \$1.5 trillion or 18 percent of GDP.

The volume of capital flows to and from the US increased after 1998 and, in 2004, set new records despite concerns about the willingness of foreigners to continue financing the nation's ongoing current account deficits. But, at the end of that year, the magnitude of the gap between a record inflow of new investment in US assets by foreigners (\$1,450.2 billion) and an equally unprecedented outflow for new foreign investment by US residents (\$867.8 billion) was masked by valuation adjustments.⁴ The result was a relatively modest increase in the net value of US liabilities to foreigners between 2003 and 2004

³ Many third party transactions in key currencies take place in external ("Euro") markets and external savings in those currencies are held there as well. One result is that the value of key currencies can be determined by transactions that do not finance the current accounts of the countries that issue them and do not change these countries' international investment positions.

⁴ Dollar depreciation in this period pushed up the value (measured in appreciating foreign currencies) of outstanding US assets abroad by \$811.8 billion while price changes contributed only \$406.0 billion to the rise in the much larger stock of US assets held by foreigners.

In 2005, net foreign inflows (\$1,212.2 billion) were slightly smaller than in 2004 but US net investment abroad (\$426.8 billion) dropped to half the amount of the previous year.⁵ As in 2004, however, valuation adjustments – primarily greater price appreciation of US held foreign stocks than of foreign-held US stocks – pushed up the value of US-owned assets abroad by an amount (\$577.1 billion) larger than the financial outflow while the value of foreign-owned assets in the US dropped by \$110.9 billion. Once again, valuation changes dampened the increase in the US international investment position; the net value of US liabilities to foreigners increased by only -\$97.5 billion to -\$2,546.2 billion and fell from 20.5 to 20.1 percent of GDP (see Tables 1 and 2).

The net inflow of foreign investment in both 2004 and 2005 was much larger than the amounts needed to finance US current account deficits and the excessive inflow of foreign savings sloshed back into the global economy as US residents recycled the surplus capital they could not use profitably at home.⁶ Nevertheless – even as dollar devaluation in 2004 and price appreciation of US-owned foreign assets in 2005 moderated the increase in the net negative investment position – the dollar value of foreign-held assets as a share of US GDP rose more rapidly than the rate of US growth. In 2005, foreign-held assets climbed to 107.4 percent of US GDP, up from 97.0 percent at year-end 2003.

There are important asymmetries in the composition of American residents' foreign holdings versus foreign residents' holdings in the US. One is the fact that a larger share of US holdings abroad (32 percent at year-end 2005) are direct investments in plant and equipment while only 20.5 percent of US liabilities to foreigners are direct investments. Foreign investors have tended to purchase marketable financial assets (stocks, bonds, government securities and bank liabilities) that can be liquidated more easily than direct investments. Another is the difference in the holdings of US and foreign public sectors. The central bank and other US government agencies own relatively few foreign assets while foreign official institutions owned some \$2.2 trillion of US financial assets or about 16.3 percent of the \$13.5 trillion total stock of foreign investment at year-end 2005. As these asymmetries suggest, the US pool of liquid foreign assets might be too small to prevent substantial market disruptions if there were a decline or abrupt withdrawal of foreign funding that required sales of foreign holdings, while their already large holdings of US assets might limit other countries' ability or willingness to cushion withdrawals with loans or further purchases.

⁵ Of particular note was the decline in US direct investment abroad to \$9.1 billion from \$244.1 billion in 2004, largely due to tax incentives under the American Jobs Creation Act that encouraged foreign affiliates to pay dividends to their US parent companies.

⁶ It is often argued that the inflow of foreign savings in excess of the amount required to finance the US current account deficit was triggered by the large outflow of US investment abroad in 2004. However, the size and composition of private capital flows suggests that, as former Federal Reserve Board Chairman Alan Greenspan noted (2003), over-financing has been a chronic development due to rising rates of return on US assets. Thus, we argue, excess inflows financed US residents' capital outflows in this and other years rather than the reverse.

In 2004, the net inflow of foreign official funds (\$387.8 billion) broke the previous year's record (\$278.3 billion) and focused attention on these investors as a major source of capital flows to the US. But their contribution to the total inflow was only 27.4 percent and dropped to 16.5 percent in 2005. The much larger stocks and flows of private foreign investment better illustrate the context and incentives for the record volume of flows in these and other years. One incentive was the rapid expansion in global liquidity that, the BIS argued, was created by stimulative monetary policies in industrial countries in response to the recession of 2001-2002 (BIS 2004a). Ample liquidity and historically low interest rates had sparked a search for yield that, as the Federal Reserve began its measured increases in policy rates, shifted borrowing in dollars for carry trade transactions to borrowing in yen and renewed speculative interest in US financial assets.⁷

The role of carry trades in driving international capital flows appears to have intensified in the fourth quarter of 2005. The BIS notes anecdotal reports of a surge in such transactions by hedge funds using short positions in yen and other low interest rate currencies to fund long dollar positions. But even as US interest rates rose, the search for yield continued to push up equity markets in emerging economies and lowered their sovereign bond spreads. In the third quarter of 2005, foreign portfolio investment in emerging economies hit near-record levels and rebounded in November after a short sell-off in October (BIS 2005c).

As the build-up in liquidity in the US, Japan and many emerging economies intensified in 2005, it appears to have perpetuated the round-robin, procyclical pattern of international capital flows. For example, the BIS noted that Japan's bull market in equities had become the favorite destination for foreign investors (BIS 2005c). But the currency appreciation that might have been associated with foreign investment in equities was offset by lending in yen for carry trade investments in dollar assets. Thus with flows into one or more segments of a national market spilling out and into other national markets – even returning, in some cases, to the markets from which flows had originated – excess liquidity was distributed throughout the global economy, exerting ongoing, downward pressure on interest rates.

These developments call into question the assumption that, as former Federal Reserve Board Chairman Alan Greenspan asserted, capital flows are “exact mirror images of current account balances”. But Greenspan also acknowledged that rising rates of return on US assets “resulted in private capital investments from abroad that chronically exceeded the current account deficit” (Greenspan 2003, p.3). What he failed to add is that these excessive investments from abroad expand the supply of credit and have, as their mirror image, rising levels of debt owed by domestic sectors.⁸ The link

⁷ Cross-border carry trades involve borrowing in a low-yielding currency and investing in assets denominated in a higher yielding currency. Beginning in the mid-1990s, significant increases in carry trade transactions have helped drive up activity in both credit and foreign exchange markets and have played a major role in the depreciation of funding currencies and appreciation of investment currencies.

⁸ Foreign savings have supplied between 10 and 20 percent of total lending in US credit markets in every year since 1994. In 2004 and 2005, foreign private and official investment accounted for 26.8 and 25.7

between them is critical in determining whether or not current levels of either external or domestic debt are sustainable because both have the potential to constrain global as well as US domestic demand.

Foreign Exchange Reserves and Liquidity Creation

Clearly, the private sector has been and remains the driving force in international capital flows and a major source of funding for US credit expansion.⁹ Nevertheless, the excessive scale of foreign private inflows and the outflows of US investment they financed increased incentives for larger inflows of foreign official investment as well. Sizable spillovers of investment into emerging economies – again, in response to the search for yield - prompted monetary authorities in these countries to step up the level of intervention to curb currency appreciation and moderate the growth of money and credit in their domestic economies. But the dollars they purchased found their way back into US financial markets in the form of foreign official purchases of US Treasury and agency securities – investments that contributed to further increases in liquidity in US and global markets and additional downward pressure on interest rates.¹⁰ As a result, these institutions and their reserve holdings play a critical role in the expansion – and potential contraction – of global liquidity.

A key element of the currency-based international monetary system that superseded Bretton Woods is that, unlike gold, foreign exchange reserves are interest-bearing assets denominated in a strong currency.¹¹ Dollar reserves held in the US are invested in US Treasury securities and are liabilities of the Treasury. They are not included in stocks and flows of the US central banks' liabilities, are outside its direct influence and, thus, constitute a system for parallel open market operations with the same liquidity-creating powers as those of the Fed. Moreover, changes in reserve holdings respond procyclically to Federal Reserve initiatives, amplifying the impact of a given policy objective.

For example, when the dollar depreciates because the Federal Reserve has taken policy actions to lower US interest rates by buying Treasuries in the open market, foreign official institutions buy dollars with their own currencies in their own or in external

percent of total lending respectively and helped push the debt of domestic nonfinancial sectors from 189.8 percent of GDP in 2001 to 211.4 percent at year-end 2005 (FRS, *Flow of Funds*).

⁹ As the 2005 BIS *Annual Report* noted, dollar holdings of foreign official institutions in the US and in offshore deposits accounted for only about a third of the long-dollar position of non-US residents.

¹⁰ The level of activity in external markets in 2004 also reflects the extraordinary buildup in global liquidity in this period. Cross-border and foreign currency claims of BIS reporting banks grew by \$2.28 trillion – more than twice the change in 2003 and substantially larger than the previous record increase of \$1.33 trillion in 1997 (BIS 2005b).

¹¹ Central banks also held foreign exchange assets as international reserves in the late 19th and early 20th centuries and their use expanded after 1922 as a means of augmenting limited gold supplies. The fact that returns on these assets increase reserve holdings was seen then (as now) as an attractive feature.

markets to prevent their currencies' appreciation and to push up the value of the dollar.¹² The dollars are then invested – usually in US Treasuries - and increase foreign holdings of dollar reserves. The repatriation of dollars amplifies the direction and impact of the Fed's policy initiative by increasing downward pressure on interest rates and supplying additional liquidity. Conversely, when the Fed tightens by selling government securities, foreign central banks may be motivated to sell from their holdings and use the proceeds to buy their own currencies to moderate dollar appreciation and downward pressure on their own exchange rates – again, amplifying the impact of the Fed's actions.¹³

If the objective is to counter the impact of Fed policy on exchange rates, the outcome in both cases is likely to be the opposite of that intended. Foreign central banks' attempts to change exchange rates by buying and selling their own and other currencies usually fail because the resources available for intervention are dwarfed by the size of global market flows. But in the context of the US market, foreign official purchases and sales of US Treasuries are comparable to or larger than those of the Fed and can significantly change conditions in US domestic credit markets. Since the 1970s, foreign official purchases have exceeded Federal Reserve purchases in many quarters and years and, in time, their holdings grew larger than the Fed's. Thus the fact that intervention culminates in investment decisions that reinforce (rather than counter) Fed policy initiatives is an equally potent factor in undercutting the effectiveness of intervention in exchange markets.

Recent reserve accumulations by emerging economies differ from earlier intervention initiatives by advanced economies in that dollars are acquired as payments for goods and services and are exchanged for the home currency in domestic rather than external markets. Their reinvestment in US financial assets adds liquidity to US credit markets and may even counter Fed initiatives to raise interest rates and constrain credit growth. Given that one objective of reserve accumulation is to raise the value of the dollar, the reinvestment of dollars in US assets can be counterproductive since it amplifies the easier market conditions that foster depreciation while impeding the shift to tighter conditions that would attract additional private foreign investment and raise the dollar's value. However, by bolstering the availability of credit and thus contributing to conditions that support import purchases, these investments help maintain access to the US market – a major objective of countries that favor export-led growth.

Monetary analysts and the Fed itself have tended to ignore the implications of these developments, but the size of the additions to dollar reserves in the years 2002 through 2005 make clear the need for concern about the central bank's ability to offset their impact on US interest rates and credit expansion. And, given their size, pressures and incentives to re-export that liquidity are inevitable. Thus, intervention and reserve accumulation have played a substantial role in reinforcing the round-robin pattern of

¹² Because the Federal Reserve discourages holdings of foreign currency assets in the US, the exchange of foreign currencies for dollars must take place offshore. Thus, intervention involves a repatriation of dollars held outside the US.

¹³ Foreign official sales of US Treasuries in the early 1980s contributed significantly to the overshooting of dollar interest and exchange rates.

international capital flows in recent years. Moreover, it is likely that foreign currency reserves' highly procyclical role in amplifying the expansion and contraction of liquidity in the market for the reserve currency would persist even if the euro, yen or other currencies replaced the dollar.

How a Currency-based International Monetary System Exacerbates “Under” and “Over” Saving

As we have argued, using national currencies as an international store of value generates debt in key currency countries. The investment of external savings in the credit instruments of that country tends to lower the cost and expand the availability of credit as residents sell assets from their portfolios to foreign investors and seek to replace those assets with comparable investments. If flows are not large, they can be sterilized by issuing central bank liabilities to resident investors to mop up excess liquidity. The US, however, has never used that tool and, in any event, flows had grown too large by the end of the 1970s to be effectively sterilized by using traditional bank-centered quantity controls such as increases in reserve requirements.¹⁴ In addition, the rapid pace of financial liberalization and restructuring in the 1980s - and the ongoing relaxation of prudential lending standards – exacerbated conditions for the build-up in debt.

The household sector incurred the largest increase in debt in the period 1995 - 2005 and this increase was associated with a fall in the saving rate and a rise in consumption as a share of total aggregate demand.¹⁵ Given its availability and favorable terms, many consumers viewed the cushion provided by access to credit as a substitute for savings – particularly after 2002 when borrowing was used both to purchase appreciating residential property and extract equity for spending. But businesses, too, took advantage of low rates in bond markets to borrow for stock buy-backs that tended to strengthen the bottom lines of managers rather than those of the firms they managed.

US monetary policy was complicit in these developments: maintaining interest rate differentials favorable to the dollar to attract capital inflows in the latter half of the 1990s, allowing foreign savings to pump up credit growth and create asset booms¹⁶ and failing to moderate imbalances in credit flows with existing quantitative tools where possible or insistence on prudential norms. Nowhere in the public pronouncements of the central bank was there mention of concern about credit expansion or the effectiveness of the existing means to control it. Suggestions that financial institutions follow prudential norms were offered only after credit-fueled bubbles had already reached unsustainable levels.

¹⁴ Moreover, foreign inflows were increasingly used to purchase financial assets in secondary markets rather than invested in bank deposits, further weakening the Fed's ability to sterilize them with existing, bank-centered monetary tools.

¹⁵ Debt of the US household sector rose from 65.7 percent of GDP in 1995 to 92.1 percent at year-end 2005. The debt of the federal government fell over the same period from 49.2 percent of GDP to 37.7 percent, while that of nonfinancial businesses rose from 55.6 percent to 66.8 percent (FRS *Flow of Funds*).

¹⁶ For a discussion of the link between credit growth and asset booms, see Borio and Lowe (2002).

Emerging economies, too, have experienced high levels of credit growth and spending since the 2002 recovery. In some of these countries, the buildup in global liquidity has resulted in rising consumption. In others - China, for example – credit expansion has bolstered spending on fixed investment.¹⁷ For many emerging economies, high saving rates and lagging consumption were re-enforced by the inability to pay or receive their own currencies in external transactions. Given this constraint, they adopted policies that channeled savings into the production of exports. Moreover, faced with the need to maintain low prices and prevent exchange rate appreciation to remain competitive in the global economy, they encouraged households to save as an alternative to higher wages and government-provided safety nets. Imbalances arose as smaller shares of households' income and of the pools of credit they generated were channeled to these savers.

Equally important, their inability to use domestic savings in external transactions increased the vulnerability of soft-currency countries to external shocks. The extraordinary build-up in reserves by emerging economies over the past decade is indicative of the pressures to use surplus earnings from trade to construct a cushion against those shocks. But to do so, they were required to lend their savings to strong currency countries rather than invest them in their own economies. This imperative is a further constraint on demand in these “high saving” countries as they amass idle resources to cover needed imports and debt service in the event of future financial crises.¹⁸

The profit-seeking strategies of the large private financial institutions that dominate the international payments system intensified emerging economies' vulnerability to financial crises. As more developed and developing countries adopted capital account liberalization in the 1990s, the valuation of currencies increasingly came to depend on the arbitrage transactions of these institutions between different financial instruments and markets rather than on trade (Cornford 2005). Changes in interest rate differentials on assets denominated in different currencies now play a disproportionate role in driving shifts in capital flows and currency values, exacerbating the problems of monetary control on a global scale. Exposed to this dynamic, emerging economies lost the ability to influence the buildup of external debt in their own economies and, again, were forced to respond by amassing offsetting assets in the form of foreign exchange reserves to cover their exposure. The growth in their foreign exchange reserves in the 1990s forged a link between “oversaving” at the international level and widening global imbalances even as – on the positive side – they appear to have decreased developing countries' vulnerability to crises.

¹⁷ Spending for fixed investment in China accounted for 50 percent of total aggregate demand in 2005 (White, 2006).

¹⁸ While foreign exchange reserves held on the books of central banks provide support for expansions of money and credit in the domestic economy, monetary authorities in these countries must sterilize some or all of the buildup in reserves by selling holdings of domestic assets or issuing central bank liabilities to prevent overexpansion. Both of these sterilization techniques inhibit the growth and stability of domestic capital markets by constraining the central banks' ability to support those markets.

Part II Risks and Potential Consequences of Imbalances for the US and Global Economies

While many agree that US deficits are unsustainable, there is no consensus view on what set of circumstances or particular scenario might trigger a shift in the buildup of US indebtedness. As former Chairman Greenspan (2003) noted, the sustainability of US trade deficits depends on whether and for how long foreigners will be willing to increase their holdings of dollars. In the case of the foreign private sector, some part of the answer will depend on interest rate differentials favorable to the dollar and opportunities for leveraged investment strategies such as carry trades that will continue to make investments in short-term dollar assets attractive. For official investors with a longer-term outlook, the issue is more complicated. Concern about the buildup of huge imbalances in reserve ownership became widespread when the holdings of Japan and emerging Asia reached \$2,444.7 billion or 64 percent of the global total at the end of February 2005. The size of their holdings prompted worries that one or more of these countries might decide to change the currency composition of their portfolios of reserves and that this could precipitate a sell-off by other official and private investors (IMF 2004).

It is always possible that political developments could prompt sales of dollar reserves, but depreciation is thought to be the most likely trigger for diversification. Yields apparently do influence portfolio choices of official investors. In fact, after strong growth in the 1990s, the dollar share of global reserves fell after 2000 and slipped below 65 percent at the end of 2004, down from 69.2 percent at year-end 2003. While depreciation of existing holdings was certainly a factor in lowering the dollar's share, the increase in euro deposits of OPEC countries suggests that euro appreciation had also begun to influence decisions about new reserve investments (BIS 2004a, 2004b),

Sales of foreign exchange assets denominated in one of the major currencies have tended to be reinvested in assets denominated in another. But it is possible that – like some Asian private investors who have withdrawn foreign currency deposits in international banks for reinvestment in their own currencies at higher interest rates – foreign central banks might simply liquidate some portion of their reserve holdings for such purposes as reducing domestic and external government debt, financing development projects or nationalizing foreign-owned companies and financial institutions.

Meanwhile, some of the risks that might cause a shift in the buildup of US debt could originate in the home economy rather than externally. In the aftermath of the recent run-up in domestic debt, stagnant or falling home prices could push US households to the limits of their capacity to borrow – the more so since increases in disposable income lagged both GDP growth and net borrowing during the recent recovery. If borrowing slows, spending is likely to slow as well and that, in turn, will trigger a slow-down in imports – an outcome that some might view as a soft landing in terms of reducing the current account deficit.

But slower import growth would also shrink the inflow of foreign capital. Losing inflows of funding from foreign current account surpluses would contract the supply of new credit to US consumers and businesses and that, in turn, would tend to push up interest rates to levels that would attract an offsetting supply of domestic savings. The shift in the availability and terms of credit would provide incentives to save but at the cost of an additional constraint on spending and an even sharper drop in imports.¹⁹

Should these or other developments trigger a shift in the buildup of US indebtedness, one of several unwelcome scenarios might follow. For example, a scenario in which declining housing prices halt or shrink credit growth and imports suggests a period of stagnation in both the US and global economies like the long slowdown in growth that Japan experienced in the 1990s.²⁰ A slowdown in overall foreign investment would contribute to that ongoing stagnation but could also result in significant deflationary pressures.

Given the extraordinary level of support foreign savings have provided for the buildup in debt by the US government and private sectors since the 1980s, any significant withdrawal of that support would not only constrict US credit availability but lower prices of US financial assets as well. The enormous share of dollar assets held by both private and official foreign investors would ensure that losses would be shared by both borrowers and lenders, rapidly spilling over into markets for goods, services and financial assets in virtually every other country in the world. Of particular concern would be the deflationary impact of a contraction of global reserves as dollar reserves held by central banks as backing for domestic credit fell in value.

The worst case scenario would be an actual draw-down of the stock of foreign investment in US financial assets. Asset sales by foreigners could drive down prices to levels that would shrink the net worth of households in the US and other countries, erode the capital of financial institutions and precipitate a more rapid slide into deflation. If such a scenario were to develop, the extent of damage to economies and financial systems would depend on the size and rapidity of the rush to exit and/or the nature and effectiveness of countercyclical responses. Again, the size of foreign private and official dollar holdings suggests that an effective countercyclical response would require the coordinated participation of many countries and, in particular, that of Japan and China.

Part III Efforts and Proposals to Address National and Global Imbalances

Many advanced and emerging economies have also experienced distortions in their domestic markets similar to those that plagued the US economy. Associated with

¹⁹ Rising US interest rates might attract speculative private foreign inflows but their effect on asset prices would quickly deflate in the context of waning aggregate demand.

²⁰ The potential for a significant drop in US housing prices to precipitate a slowdown in spending is exacerbated by the fact that residential mortgages account for over 30 percent of credit market debt of all US nonfinancial sectors and almost all types of financial institutions hold mortgage loans (FRS, *Flow of Funds*). Falling prices for homes would lower households' net worth directly and through the feedback effect of downward pressure on prices of mortgage paper held by the institutions in which households' savings are invested.

surges of capital inflows and reserve accumulation, growth in household debt and overheated real estate markets became notable problems in central and eastern European countries, Russia, Korea and Thailand by the middle of the current decade. Faced with rising housing prices in the aftermath of the collapse of its credit card bubble, Korea's efforts in tackling the problem by imposing a range of fiscal and monetary restrictions were particularly aggressive.²¹ China has not been troubled by rising household debt but its central bank began to tackle the problem of excessive lending to State Owned Enterprises (SOEs) by adopting quantitative controls such as changes in reserve requirements, increased interest rates on discounting and lending facilities and "window guidance"(BIS 2004a).

The BIS gave guarded approval to these initiatives in 2004 and, subsequently proposed a macrofinancial stabilization framework that would use countercyclical techniques in implementing both regulatory and monetary policies (2005a; White 2006) This new framework would reintroduce quantitative measures such as liquidity requirements and loan-to-value ratios, set prudential norms relating to the growth in credit or asset prices and "use monetary and credit data as a basis for resisting financial excesses in general, rather than inflationary pressures in particular" (BIS 2005a, p.148).

These are all welcome and sensible responses to the problem of widening imbalances in domestic economies and a notable retreat from prescriptions for deregulation and inflation targeting put in place in the two decades following the ascendancy of free market ideology. The proposed BIS framework is not only desirable but necessary and should be supported and adopted by US monetary and regulatory authorities, as well as those in other advanced and emerging economies.

Nevertheless, few prescriptions have emerged to address the underlying problem – the surges of capital flows that fuel credit expansion and the dangerous side effects associated with the protection that reserve accumulation has provided for emerging economies. The following section offers proposals that we believe would contribute to crisis prevention by addressing the flaw in an increasingly unworkable international reserve and payments system.

Dealing with International Monetary Issues

It is one of the ironies of the current international reserve system that the current account surpluses of emerging economies are either loaned to a strong currency country to assist in increasing its rate of growth or are recycled back to the emerging economies in the form of private foreign acquisition and ownership of their financial assets and productive facilities. One of the more pressing issues in dealing with global imbalances is to find ways to recycle these countries' savings back into their own economies in support of development strategies that increase income and demand more equitably across their

²¹ These restrictions included higher capital gains taxes on sales of multiple residential properties; ceilings on loan-to-value ratios for mortgage loans; limits on or penalties for aggressive credit card marketing; credit ceilings based on the borrower's income; increased loan provisioning by credit card issuers, and requirements that borrowers repay a mandatory portion of their credit card debt (BIS 2004a).

household and business sectors and reduce dependence on exports for growth. The following is one proposal directed toward accomplishing those objectives.

Creating a Public International Investment Fund for Emerging Economies.

With the phenomenal growth of institutional investors' assets over the last two decades, foreign portfolio capital has become an important component of inflows into the evolving securities markets of emerging economies. In most cases, however, these inflows tend to change prices and exacerbate volatility in secondary markets rather than provide long-term financing for economic expansion, while outflows often trigger or intensify currency crises. Moreover, many developing countries that need long-term financing for infrastructure and other basic components of development strategies do not have markets that can absorb foreign portfolio investment flows nor the credit standing to attract them. What is needed is a new channel for portfolio investment to provide flows that are stable, in amounts appropriate to the size of a country's economy and directed toward the goals of development rather than solely toward the short-term profits of investors.

Such a channel could be constructed by creating one or more closed-end funds for emerging market investment as a separate institution under the Bretton Woods umbrella.²² These funds would issue their own liabilities to private and official investors and use the proceeds to buy stocks and bonds of private enterprises and public agencies in a wide spectrum of developing countries. While marketed primarily to institutional investors in advanced economies, these liabilities would also qualify as international reserves, guaranteed by a multinational agency and its member countries, and their purchase by the central banks and government agencies of developing countries would redirect external savings back into the economies of the countries that own them rather than into the financial markets of strong currency countries.

International closed-in funds would provide additional benefits as well. They would encourage the development of securities markets denominated in local currencies in poor and middle-income developing countries, would reduce the need for capital controls if countries chose to accept foreign portfolio investment only through this channel, and would help pension plans in developing countries diversify their portfolios while minimizing country risk and transactions costs.

²² Unlike open-end mutual funds that must buy back an unlimited number of shares in response to investors' demand, closed-end investment pools issue a finite number of shares that trade on stock exchanges or in over-the-counter markets and are only redeemed at the initiative of the fund itself. This structure would allow the prices of shares to fluctuate without triggering destabilizing purchases and sales of the underlying investments. The structure could be made more suitable for long-term investors such as pension funds by requiring that 10 to 20 percent of the value of shares sold to investors be used to purchase and hold government securities of major industrial countries in amounts roughly proportional to the holdings of the funds' shares by residents of those countries. This would give investors a partial guaranteed return, denominated in their own currencies, and capital backing in addition to the guarantee of the multilateral agency and its member countries. Moreover, the introduction of these securities would benefit both private and official investors by adding more low-risk instruments with long maturities to the menu of assets in international financial markets.

A more important contribution of these funds, however, would be their inauguration of a meaningful shift into a non-national reserve asset and the phasing out of a system in which the choice of financial assets as reserve holdings centers on a few countries whose wealth supports the strength of their currencies.²³ Encouraging developing countries to hold these securities as reserves would provide them with a *multilateral* guarantee from industrial countries and, in time, from wealthier emerging economies.²⁴

Given the focus on development, a major function of the funds should be to finance infrastructure that is both commercially and socially useful. Both criteria would be met by projects that build and improve roads, construct or renew sewers and extend electrical grids and communications systems. But these projects must be initiated in remote areas as well as cities and towns. Other areas qualifying for financing should include systems to provide health care and clean water, projects for cleaning up polluted areas and restoring and preserving forests, investments in renewable energy and transportation and in local institutions that will provide funding for communities to design and build their own affordable housing.

These and many other similar investment areas are among those that fail to attract financing in the marketplace in both developing and advanced economies. For example, the US found it necessary to undertake a wide range of public-purpose market innovations in the 1930s – most notably the Reconstruction Finance Corporation and the Tennessee Valley Authority – and continued adding new strategies into the 1970s, including the development of the secondary mortgage market. These and numerous other examples from other countries underscore the need for governments to take the lead in laying the institutional groundwork for financing productive economic and social investments. Another indication of that need is the fact that, even in many advanced economies, investments in renewable energy, infrastructure, the environment, transportation and affordable housing are seriously underfinanced.

Structuring such a channel for portfolio investment need not reinvent the wheel. Mechanisms and potential assets already exist in the marketplace and the authority to manage these funds is wholly consistent with the World Bank's original mandate to facilitate private investment in developing countries. Moreover, the Bank's experience in issuing its own liabilities in international capital markets would expedite the start-up of one or more closed-end funds which could then be transferred to a separate institutional structure created for the purpose.

But, like other Bretton Woods institutions, these public sector funds must be required to operate in a far more open, accountable and responsive fashion than is the

²³ Wealthy countries, too, could hold these securities as reserves and avoid the credit-generating effects their reserve investments impose on other advanced economies. The credit-generating capacity of reserve assets could then be utilized multilaterally to benefit a wider group of countries – developed and developing – and moderate the constraint on demand that imbalances in external savings have created.

²⁴ The institutional guarantee would be the same as the existing guarantee for World Bank liabilities, but the capital investment in the government securities of advanced economies would enhance that guarantee and provide a partial hedge against exchange rate risk.

current norm. Properly structured to include collaborative decision-making by both the managers of the funds and the countries in which investments are made, they could make a significant down payment against the democratic deficits that characterize private portfolio investment decisions as well as governance and policymaking at the international institutions.

Reforming the International Payments System

The above proposal – to use international credit liabilities as reserve assets – is evolutionary in nature and, while it addresses a critical flaw in the current international monetary system, an equally critical one – the means of payment - would still need to be addressed. Permitting the continuation of a key or strong currency regime for cross-border transactions tends to perpetuate the export-led growth paradigm by requiring the majority of countries to shape their economies to ensure that they can earn – or borrow – key currencies to conduct external trade and investment transactions. Ideally, every country should be able to use its own currency and the wealth created within its own borders to participate in the global economy. An equitable and laudable solution, no doubt – but how might it be arranged?

One way would be to mine John Maynard Keynes' Bretton Woods proposal to create a new institutional framework that would accomplish that objective. While Keynes' overall proposal was designed for a very different world, the basic structure in his concept - an international clearing agency (ICA) - could be revised to serve as the institutional platform for a new global payments system that would foster more egalitarian objectives and outcomes. A revision of Keynes' proposed structure is necessary because payments imbalances are no longer settled by transactions through central banks but through private financial institutions. An ICA that would meet current needs and conditions would have to include a mechanism for clearing private cross-border payments as well as create a reserve system that would reinstate transactions among central banks as the primary channel for settling balance of payments surpluses and deficits.

The proposed ICA would clear transactions denominated in members' own currencies and change the ownership of reserves by crediting and debiting their clearing accounts. These clearing accounts would, in fact, constitute the international reserves of the system, held for the member countries by the ICA and valued using a trade-weighted basket of all members' currencies. Thus the clearing process would change the ownership of reserves and reinstate the original intent of the Bretton Woods Agreement to maintain public control of international payments. It would also permit exchange rate adjustments over a set period of time in response to changes in reserve levels, preserving the valid role of market forces in shaping currency values through trade and investment flows while ensuring that speculators would no longer dominate the process.

A revised ICA proposal could also reintroduce former US Undersecretary of the Treasury Harry White's Bretton Woods proposal to authorize the International Monetary Fund to engage in open market operations by permitting the new clearing agency to acquire government securities of its member countries as backing for its reserve

holdings.²⁵ This would give the ICA means and authority to conduct open market operations at the international level, enabling it to correct imbalances and promote stability by altering holdings of international reserves relative to national central bank reserves invested in domestic assets. When approved by a super-majority of its member countries, the ICA's money creating powers would also allow it to operate as a true lender-of-last resort – a role the IMF cannot play given its dependence on taxpayer contributions. In this capacity, the ICA could assist a national central bank in supplying or contracting liquidity by buying or selling government securities from or to residents in the national market – actions that would augment or reduce the country's supply of international reserves.

Membership in the ICA would be open to national central banks of all participating countries and branches of the clearing agency would operate in every major financial center across the globe. The Agency would be governed by a rotating executive committee that would at all times represent half the world's population and half its total output. Its role in clearing members' payments in their own currencies ensures that it would not infringe on their sovereignty as would an international central bank that issued a single currency.²⁶ The conduct of national monetary policy would remain the prerogative of national authorities. But the ICA's ability to create and extinguish international reserves would give it the power to change the availability of liquidity at the global level. The absence of and need for that power has been increasingly evident throughout the post-Bretton Woods era as crisis after crisis has underscored the inadequacy of the current institutional framework.

This is a brief sketch of a proposal offered elsewhere that attempts to incorporate the still-valid objectives of the Bretton Woods Agreement for an open international trading system while reforming the institutional framework to promote more egalitarian participation by all countries in the global economy (D'Arista 1999). No doubt other, better systems could and will be designed. But they, too, must incorporate a more egalitarian payments system as well as more democratic governance of its institutional structure.

²⁵ In the US, the Federal Reserve had developed open market operations as a countercyclical policy tool in the 1920s, but it was not widely used by other central banks at the time of the Bretton Woods negotiations and the White proposal was dropped from the agreement.

²⁶ Not only would the ICA not issue the international means of payment, it also would not create and issue reserves the way the IMF issues Special Drawing Rights. Its primary role would be to administer the process by which cross-border payments alter the reserve accounts of member countries. Its design is intended to enhance sovereignty by allowing all countries to use their national currencies to make international payments and by reducing the influence of speculative capital flows on policy decisions at the national level. The only choice member countries would lose would be their ability to decide how to invest their international reserves since their reserves would automatically be invested in their own national liabilities.

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Table 1: U.S. International Investment Position, Year-end 2004 -2005ⁱ

Net Creditor/Debtor (-) Position		Net Creditor/Debtor (-) Position		Change: 2004-2005		
2004		2005		Financial Flows	Valuation Adjustments ⁱⁱ	Total Change
\$U.S. billions	As Pct. GDP ⁱⁱⁱ	\$U.S. billions	As Pct. GDP	\$U.S. billions	\$U.S. billions	\$U.S. billions
-2,448.7	-20.5	-2,546.2	-20.1	-785.4	466.1	-97.4

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*

ⁱ Direct investment positions at market value.

ⁱⁱ Includes price changes, exchange rate changes, changes in coverage, statistical discrepancies and other adjustments to the value of the assets.

ⁱⁱⁱ GDP in current dollars

Table 2: Selected Components of U.S. International Investment Position, Year-end 2004-2005
(\$U.S. billions)

	2004	2005	Change: 2004-2005		Total Change
			Financial Flows	Valuation Adjustments	
U.S.-owned assets abroad	10,073,337	11,079,202	426,801	577,064	1,003,865
U.S. government assets	272,653	265,566	-19,635	12,548	-7,087
Official reserve assets	189,591	188,043	-14,096	12,548	-1,548
Other assets	83,062	77,523	-5,539	-----	-5,539
U.S. private assets	9,802,684	10,813,636	446,436	564,516	1,010,952
Direct investment abroad	3,287,900	3,524,459	9,072	227,487	236,559
Foreign securities	3,553,387	4,073,997	180,125	340,485	520,610
Bonds	992,969	987,543	37,991	-32,565	-5,426
Corporate stocks	2,560,418	3,086,454	142,134	383,902	526,036
Non-bank claims	733,538	784,521	44,221	6,762	50,983
Claims reported by banks	2,227,859	2,430,659	213,018	-10,218	202,800
Foreign-owned assets in the U.S.	12,524,081	13,625,377	1,212,250	-110,954	1,101,296
Foreign official assets	2,001,407	2,216,123	199,495	15,221	214,716
U.S. government securities	1,499,293	1,649,397	156,450	-6,346	150,104
Other U.S. assets	502,114	566,726	43,045	21,567	64,612
Other foreign held assets	10,522,674	11,409,254	1,012,755	-126,175	886,580
Direct investment	2,703,697	2,797,165	109,754	-16,286	93,468
U.S. Treasury securities	562,288	704,875	199,491	-56,904	142,587
Other U.S. securities	3,995,506	4,390,682	474,140	-78,964	395,176
Corporate and other bonds	2,035,149	2,275,197	388,357	-148,309	240,048
Corporate stocks	1,960,357	2,115,485	85,783	69,345	155,128
U.S. non-bank liabilities	507,668	563,749	30,105	25,976	56,081
U.S. liabilities reported by banks	2,420,780	2,600,632	179,849	3	179,852
U.S. currency	332,735	352,151	19,416	-----	19,416

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*.

NOTE: 2004 figures are revised; 2005 figures are preliminary. Valuation adjustments include changes in prices, exchange rates, coverage, statistical discrepancies, and other adjustments to the value of assets. Direct investment is at market value. Numbers may not add up due to rounding.