The United States as a HIPC*
– how the poor are financing the rich.

*Heavily Indebted Prosperous Country
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A report from JUBILEE RESEARCH

at the New Economics Foundation

by Romilly Greenhill and Ann Pettifor

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This short report outlines the role the US deficit has played in driving the process of globalisation. Secondly, it analyses the way in which poor countries are financing the US deficit and therefore the high living standards of US citizens. The following are our chief conclusions:

The US deficit as the real driving force behind globalisation

• The growing US deficit has, since the 1960’s, been the dominant driving force behind financial globalisation. Elected representatives of the US and UK have actively promoted international financial liberalisation, or “globalisation” – to finance the US deficit. Globalisation has not, we argue, been primarily driven by corporations or by developments in new technology.

• Today capital liberalisation is once again – as in the 1920’s and 30’s – leading to financial instability and growing international tensions. Above all financial liberalisation leads to the loss of policy autonomy by democratic as well as undemocratic governments.

• The exceptions are those highly indebted states dominant in the global economy, – the United States and the United Kingdom – whose indebtedness has not led to major economic adjustments nor to the loss of policy autonomy.

The US – a heavily indebted country

• The accumulated external debt of the world’s richest country, the United States of America, is equal to $2.2 trillion. This is almost the exact amount owed by the whole of the developing world, including India, China and Brazil – $2.5 trillion.

• In other words, three hundred million people in the US owe as much to the rest of the world, as do five billion people in all of the developing countries.

• Or to put it differently, every American citizen owes the rest of the world $7,333 while every citizen of all the developing countries only owes the rest of the world $500.

• Moreover, while developing country economies are bled dry through debt service repayments totalling more than $300bn per year, the US must only pay $20bn per year to service an almost equivalent amount of debt.

• Americans have been engaged in a consumer binge, which has led to the largest current account deficit in history, a staggering $445 billion or 4% of US GDP. This deficit has been increasing by 50% a year in recent years, and economists predict it will rise to $730bn by 2006.

• Given this daily deficit of up to £2bn, plus capital outflow of $2bn, the US in effect has to borrow $4bn from the pool of world savings every day.

How the US deficit is being financed by the poor of the world

• The US deficit is financed by a) the thrifty savers of East Asia, in particular Japan, China and Singapore; but also b) by surpluses built up by countries like France and Switzerland.

• More disturbingly, the US deficit is being financed by the poor through a) capital flight from poor countries and b) the forced holdings of high levels of dollar reserves.

• To build up reserves, poor countries are borrowing hard currency from the US at interest rates as high as 18%; and lending this back to the
US (in the form of interest on US Treasury Bonds) at 3%.

- Asian and African countries are forced, by the financial instability caused by globalisation, to maintain dollar reserves, at 14% and 7% of GDP respectively. The US in contrast holds only about 1.3% of her GDP in reserves.

- The cumulative cost for developing countries of holding such high dollar reserves may be as much as 24% of GDP over ten years; which represent a significant drag on growth rates.

- Inflows of capital into the US and UK: a) help to lower interest rates and therefore borrowing costs for the people of these countries and b) inflate the value of their currencies by about 20%. This enables rich countries, therefore, to purchase imports from the rest of the world 20% cheaper than they would otherwise have been able to.

- If it were not for capital flight, at least 25 African countries would be net creditors, not debtors.

- Countries like Argentina find that their governments are borrowing hard currency, only to find it promptly leaves the country (in the form of “capital flight”) for Wall St., London, Zurich or Madrid – a legitimate process under capital liberalisation.

- However the poor in these countries are then saddled with huge public debts. Argentina’s total external debt of $150 bn is almost exactly equal to unrecorded “capital flight” of $130bn.

**The next crisis?**

- The US deficit is not sustainable. The issue before us is the form that the necessary adjustment takes?

- While there is much debate about when or how this will happen, our report notes that it is inevitably the poor countries that will bear the highest costs of any correction to the US’s unsustainable debts.

- Some countries will also lose substantial inflows of private capital.

- Countries that are dollarised, like Ecuador, will bear the brunt of high interest rates, as the US is forced to ratchet up rates to attract new capital.

- Other countries will pay in the form of declining terms of trade; those exporting commodities will be hit the hardest.
Reports by Jubilee Research at the New Economics Foundation, like those from its predecessor, Jubilee 2000 UK, have concentrated on the debts of the poorest countries; on the economic adjustments imposed on them by creditors; and on their loss of policy autonomy. In this report we turn our attention to the debts of the United States and Britain, governments, which until recently, were major creditors. By doing so, we hope to provide a more balanced picture of global sovereign indebtedness – and to frame developing country debt in the context of global savings.

We have done this to illuminate five important developments:

- that the growing indebtedness of rich countries has been the driving force behind the phenomenon of financial globalisation;
- that a relative few in the rich countries are using up a much bigger share of the world’s savings than billions in the poorest countries;
- that a system in which the richest countries have their excessive consumption financed by the poorest countries is unjust and iniquitous;
- that the imbalances and injustices caused by this excessive consumption of the world’s savings, are leading to increased tensions in the world, and to more frequent financial crises;
- that while the US relies increasingly on foreign creditors – the US government continues to exercise policy autonomy. This is in stark contrast to poor sovereign debtors, who sacrifice such autonomy to anonymous “capital markets” on the one hand, and the IMF (acting as agent of all creditors) on the other.

The injustice of transfers from the poor to the rich through unfair terms of trade and through excessive consumption of natural resources by the rich has been widely explored in development literature. However, we do not believe that sufficient attention has been paid to financial transfers which enable rich countries to live off poor countries, while avoiding unpleasant economic adjustment, and retaining policy autonomy.

This short report sets out therefore, to provide some balance to the big picture of global indebtedness.
Globalisation: the US deficit as the real driving force

Many argue that the phenomenon known as “globalisation” came about largely because of advances in new technology and communications. Walter Wriston, for example, has argued that:

“Today we are witnessing a galloping new system of international finance. Our new international financial regime differs radically from its precursors in that it was not built by politicians, economists, central bankers or finance ministers, nor did high-level international conferences produce a master plan. It was built by technology….by men and women who interconnected the planet with telecommunications and computers.”

Others, particularly anti-globalisation activists, agree with Wriston and hold strongly to the view that globalisation, (often broadened into “corporate globalisation”) was, or is, promoted by big, aggressive corporations, keen to expand their markets and brutal in promoting self-interest.

We contest this view of the driving force behind financial globalisation – central to the whole globalisation project. On the contrary, we argue, democratic governments and their elected leaders have been the real driving force behind financial liberalisation. These leaders were motivated to embark on the “globalisation” project, as Eric Helleiner has cogently argued, because of the steady expansion of the US trade deficit in the 1960’s and 70’s. This led to deliberate decisions by the US and UK governments to remove statutory controls over the movements of capital.

The US trade deficit had to be financed, and the US was determined to finance it without making any unpleasant adjustments, or without giving up its policy autonomy to foreign creditors. The City of London, backed by the UK government, was only too happy to broker financing for the US deficit - through the “stateless” Eurodollar market based in London - a market carefully created by elected representatives of two of the world’s most powerful states.

As Helleiner has argued

“ever since the first dollar crisis in late 1960, the (US) government had attempted to postpone adjustment measures by persuading foreign central banks to finance its external deficit through dollar holdings …..Taking an approach that would prevail throughout the 1970s and 1980s, Washington policymakers fostered a more liberal international financial system as a way of preserving their policy autonomy in the face of growing external constraints.”

The emergence of the Eurodollar market began the process of dismantling capital controls in the 1960s. But as Helleiner notes, the other

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2 See, as example of this thinking, David Karten, “When Corporations Rule the World” (1995) and Naomi Klein’s best-seller, “No Logo” (2001) in which she argues that, “At the heart of this convergence of anticorporate activism and research is the recognition that corporations are much more than the purveyors of the products we all want; they are also the most powerful political forces of our time…..We have read how a handful of powerful CEOs are writing the new rules for the global economy, engineering what Canadian writer, John Ralston Saul has called “a coup d’etat in slow motion”…..because corporations have become the ruling political bodies (our emphasis) of our era, setting the agenda of globalization. We must confront them, in other words, because that is where the power is”. Page 339-40.


4 ibid
“advanced industrial states remained wary of international capital movements for the reason discussed at Bretton Woods: disequilibrating speculative capital movements could restrict their policy autonomy and disrupt both the Bretton Woods system of stable exchange rates and liberal trading relations.”

The removal of these capital controls, which gained terrific momentum as the US deficit ballooned, (see the graph below) was pushed by the US and the UK; and has been central to the process of “globalisation”. Today, the US deficit can only be sustained by mobilising a staggering $4bn of foreign savings each day of the year.

It was not always thus…..

Back in 1944, as part of the Bretton Woods Agreement, the US had helped construct the post-war economic order with other western governments. The new order, which the IMF and the UN were tasked to defend, set out to

- prevent and limit the imbalances and disorder brought about by the capital liberalisation of the 1920’s and 30’s;
- restore policy autonomy to nation states (primarily by imposing controls on the movement of capital); while
- liberalising trade, which included challenging the UK’s protectionist policies for “imperial preferences”.

Twenty years after the Bretton Woods Agreement, the Euromarket represented the first attempt at bypassing the exchange controls of nation states, and enabled the US to mobilise additional finance from a foreign capital market. The existence of the Eurodollar market gradually led to the erosion of capital controls by all major western governments and finally, most developing country governments. This in turn laid the ground for a massive expansion in the role of finance capital in the global economy; and, as a consequence, for greater trade liberalisation.

Globalisation and its consequences…..

According to the US Congress, before 1970, 90% of all international transactions were accounted for by trade, and only 10% by capital flows. Today, despite a vast increase in global trade, that ratio has been reversed, with 90% of transactions accounted for by financial flows not directly
related to trade in goods and services. Most of these flows have taken the form of loans, highly volatile stocks and bonds; derivatives and other forms of financial betting, gambling and speculation; and short-term investment. McKinsey and Company reckon that the total financial stock reached $53 trillion by the year 2000 – “triple the economic output of the OECD economies”. In other words, the often unproductive lending, gambling and speculating of global creditors and financiers generates a financial stock which is probably worth more than three times the productive output of the OECD countries. While many may castigate companies like McDonalds and Nike for their role in the global economy, at least they can claim to be producing actual goods, even though these may be inedible hamburgers and unaffordable trainers, produced in unsustainable ways. Their counterparts in banks and financial institutions are making money in the most unproductive way; by lending, gambling and speculating. In other words, thanks to financial liberalisation, it is easier now for these institutions to dis-engage from the productive economy, and make money from money.

These volatile and often unproductive flows, have led in turn, to imbalances and instability in the global financial system, and to periodic crises, which have impacted most adversely on developing countries or emerging markets. As governments lose policy autonomy, these imbalances are leading, in turn, to global tensions not unlike those experienced by countries in previous periods of “globalisation” – like the 1920s.

Managing the economy – should the US be going back to school?

While the growing deficits of rich countries are not understood, are ignored or tolerated by academics, experts and public opinion, the debts of poor countries are the subject of much opprobrium. Rich countries are held to be prudent, efficient and competent in managing their economies - and therefore “deserve” their historically high, extravagant and environmentally unsustainable living standards. In contrast, poor countries are judged on the whole, as incompetent and corrupt in managing their finances – a fact which is seen to explain the “huge” quantities of poor country debt. Like children competing in an athletics tournament, poor countries must sacrifice policy autonomy, and clear ever more difficult high jumps to demonstrate to their rich world creditors that their economic management makes them worthy of the paltry levels of debt ‘forgiveness’ on offer.

Chart 2: Total external debt of US and the developing world, 2000

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6 From William Greider, One World, ready or not, Simon and Shuster, 1997 page 232.
But look a little closer and we see that the accumulated external debt of the world’s richest country has reached levels that make the external debt of, say, Benin, look like the crumbs left over from a midday meal. Less than three hundred million people in the United States owe a total of $2.2 trillion – almost equal to the $2.5 trillion debt owed by the five billion people in the developing world. Of course, the size of the US economy means that her debt is only 25% of her GDP, lower than that of most developing countries. But as Chart 2 makes clear, her total debt, in absolute terms, exceeds that of the whole of sub-Saharan Africa by a factor of ten.

If the United States is the richest country on earth, why does she owe so much? Put simply, the United States has been living beyond her means. Consumer greed over the past decade has been sucking imports into the United States at a much faster rate than she has been able to generate exports to pay for those imports. US consumers have been getting high on cheap manufacturing products from Asia: cameras from Korea; cars from Japan. But they have not been producing goods that the rest of the world wants in return – last year, exports to the rest of the world were only at half of US imports. Americans have, in short, been using the rest of the world’s production to go on a prolonged, and no doubt enjoyable, consumer binge.

US greed is taking its toll on the current account deficit, however, which reflects the balance of trade in goods and services – exports minus imports – plus other incomes from abroad, and the balance of interest payments on foreign debt. The US now has the largest current account deficit in history, a staggering $445bn or 4% of US GDP, and this has been increasing at more than 50% a year in recent years. Economists at Goldman Sachs and Morgan Stanley are predicting that the deficit will rise even further over the coming years, and could reach $730bn by 2006. According to the IMF, continued financing of the US deficit is taking up 7.5% of the world’s total savings, up from 2.5% over the past two decades.

While the US may be the biggest culprit, she is not the only country which is consuming more than her fair share of the global savings cake. In 2000, other rich countries including the UK ($25bn), Australia ($15bn), Germany ($19bn) and Spain ($17bn) were also sucking in the savings of the rest of the world. Some of the Latin American countries, including Brazil ($25bn), Argentina ($9bn) and Mexico ($18bn), were also using up a large share of the global savings cake.

Table 1: Largest Debtors and Creditors, 2000

<table>
<thead>
<tr>
<th>The Debtors ($bn)</th>
<th>The Creditors ($bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>-$444.7bn</td>
</tr>
<tr>
<td>Brazil</td>
<td>-$24.6bn</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>-$24.5bn</td>
</tr>
<tr>
<td>Germany</td>
<td>-$18.7bn</td>
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<tr>
<td>Mexico</td>
<td>-$18.2bn</td>
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<tr>
<td>Spain</td>
<td>-$17.3bn</td>
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<tr>
<td>Australia</td>
<td>-$15.3bn</td>
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<tr>
<td>Portugal</td>
<td>-$11.0bn</td>
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<tr>
<td>Poland</td>
<td>-$10.0bn</td>
</tr>
<tr>
<td>Argentina</td>
<td>-$9.0bn</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>-$593.3bn</strong></td>
</tr>
<tr>
<td><strong>Japan</strong></td>
<td>$116.9bn</td>
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<tr>
<td>Russian Federation</td>
<td>$46.3bn</td>
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<tr>
<td>Switzerland</td>
<td>$32.5bn</td>
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<tr>
<td>Singapore</td>
<td>$21.8bn</td>
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<tr>
<td>France</td>
<td>$20.5bn</td>
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<tr>
<td>China (incl. Taiwan)</td>
<td>$20.5bn</td>
</tr>
<tr>
<td>Netherlands</td>
<td>$13.8bn</td>
</tr>
<tr>
<td>Malaysia</td>
<td>$12.6bn</td>
</tr>
<tr>
<td>Korea, Rep</td>
<td>$11.0bn</td>
</tr>
<tr>
<td>Thailand</td>
<td>$9.4bn</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$305.3bn</strong></td>
</tr>
</tbody>
</table>

8 Source: Global Development Finance 2001
9 Source: The Economist, February 14th 2002
10 Source: The Economist, February 14 2002
12 Source: ‘An unsustainable black hole’, by Martin Wolf, Financial Times 27nd February 2002
13 Source: IMF World Economic Outlook, Spring 2001
14 Source: IMF International Financial Statistics November 2001
Bankrolling the rich: who is picking up the tab?

If the world’s richest country is so in debt, who is she borrowing from? Partly, US debt is being financed by the thrifty savers of East Asia, in particular Japan, China and Singapore. Partly it is being funded by surpluses in other rich countries such as France and Switzerland. In other words, the prudence and generosity of the rest of the world is enabling the US to consume more than its fair share of the global savings cake.

Unsurprisingly, the US does not see it this way. In an act of collective self-denial of almost unbelievable proportions, the US administration, and the economists who provide intellectual legitimacy to the regime, believe that it is actually doing a service to the rest of the rest of the world. In a series of disgruntled announcements, the US is expressing its unwillingness to continue to act, as it sees it, as ‘buyer of last resort.’ As Grant Aldonas, the Under-Secretary of Commerce for International Trade, said recently ‘we’re unwilling to say we’re going to continue to let other countries export their unemployment to the US. We recognise there are a lot of consequences to flow from that.’15 This is a bit like an overweight hamburger lover refusing to keep on propping up the local McDonalds.

Moreover, as Financial Times columnist Martin Wolf has pointed out, even the official surpluses of those countries in credit are not nearly large enough to fund the whole of the US deficit. The figures simply do not add up. As Wolf notes, ‘about this black hole little can be said, except that it must largely consist of unrecorded exports and so capital flight from developing countries.’16

What Wolf is saying – though he does not make this explicitly clear – is that the poor are financing the rich. Poor countries that desperately need capital to fund basic investments in their own economies are losing billions of dollars each year to fund the Sony Playstations of US Teenagers and the Cartier Watches and Toyota Land Cruisers of their parents. As Nobel Prize winning economist Joseph Stiglitz has noted, ‘There should be flows of capital going from the rich countries to poor countries, not from the poor countries to the rich countries…this is just the reverse of what we would normally think of as an equitable system.’17

In the past, the process of capital flight from poor world to rich world often took place illegally, hidden from the gaze of official foreign exchange controls. With financial liberalisation, rich capital owners in poor countries are able to shift resources out of their own countries with impunity – but the effects on foreign exchange holdings in their own countries are no less damaging.

How important is capital flight?

Quantifying flight capital is notoriously difficult, as much of it has, historically, taken place away from the prying eyes of official statistics offices. Capital flight is, if anything, recorded in the ‘errors and omissions’ sections of official balance of payments statistics – but even here, the extent of capital flight versus real measurement errors is far from clear.

But what is clear is that for some countries, total capital flight has been almost as high as external debt. In Argentina, for example, total capital flight is estimated to be $130bn – almost equal to her $150bn public debt. In a study of capital flight from 25 severely indebted African countries, Boyce and Ndikumana18 calculated that total capital flight from these countries between 1970 and 1996 was $193bn in 1996 dollars; adding compound interest to this figure yielded a total of $285bn. This compares to a total external debt of these countries, according to the official statistics, of only $178bn.

16 Source: Martin Wolf op. cit.
In other words, countries like Argentina, and the African countries studied by Boyce and Ndikumana are, in fact, net creditors of the West. Rather than bleeding their own economies dry through debt service payments, these countries should be sitting back and enjoying the debt service payments made by the West. But needless to say, no payments are being made – at least not officially, and thus with no benefit to the countries to which they should be flowing.

For developing countries as a whole, the figures are even more dramatic. In a background paper to the UK Department for International Development’s White Paper on Globalisation, Fitzgerald and Cobham cite work by Schneider that suggests that capital flight for all countries could be much larger. For 1994, Schneider estimated that capital flight from all developing countries was as much as $122.4bn, of which $24.2bn was accounted for by China alone. Latin America and the Caribbean accounted for a further $37bn, of which Argentina ($19bn), Brazil ($4.3bn) and Mexico ($11.2bn) were the largest source countries. Other countries within East Asia were also important, with a total flight from the region of $30.6bn, of which $20.7bn was accounted for by Indonesia.

We know who loses when rich elites use a poor country’s hard earned currency to fill the coffers of Wall Street Banks. It is people in poor countries, already chronically short of the resources they need for development. In particular, it is the poorest within those countries, who are most vulnerable to economic dislocations caused by the adjustment programmes which follow economic crisis. Capital flight also, paradoxically, increases a country’s reliance on foreign capital, forcing it to keep on borrowing, further pushing up its debt and increasing its external vulnerability.

We also know who gains from capital flight. It is the recipients of that capital. Flight capital goes to prop up the stock exchanges of New York, London, and Frankfurt. Demand for dollars, pounds and euros from flight capital pushes up the values of these currencies, allowing British and American residents to import goods from abroad more cheaply. While poor countries lack basic resources to stop their own people dying, consumers in the north are able to suck more imports in at knock down prices.

**Financial crisis hurts emerging economies – but who benefits?**

We have already made it clear that consumers in the US and UK are doing well out of the global financial instability that encourages capital flight – and the financial liberalisation that makes the movement of capital so much easier.

But richer countries also gain from globalisation in other ways. Rich countries gain whenever there is a financial crisis because of so-called ‘flight to quality.’ When a crisis hits, funds flow rapidly out of the country in crisis, and back to the ‘safe’ investment markets of the North. After the East Asian crisis in 1997/8, for example, the dollar appreciated rapidly due to the large flows of money fleeing Asia and taking refuge in the US. As a result of this inflow, interest rates were able to fall from 7% in 1997 to 5% in 1999, stimulating the US economy further through lowering borrowing costs and reducing the costs of servicing the budget deficit.

Of course, any crisis brings the danger that global financial stability will be put at risk. But the US’s allies, notably Japan, have protected the US from any threat of financial turmoil, often absorbing substantial losses themselves. During the 1987 crisis, for example, when the dollar depreciated rapidly, Japan deliberately lowered

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21 It should be noted that these figures were highly variable – in 1993, for example, Schneider estimated that capital flight was only $60.5bn.
her interest rates in order to ensure that global production would be maintained. Thus, the US is able to benefit from crises elsewhere – but is insulated, by her allies, from the costs of global financial instability.

**Insuring against financial disaster – but at what cost?**

The US also gains from increasing global instability through increased holdings of reserves on the part of developing countries. All countries hold reserves, usually short term liabilities of one of the major reserve currencies, most often the US dollar. These reserves enable the country to fight off speculators determined to undermine the currency, as when Hong Kong successful fought off the combined power of George Soros’s Quantum Fund and Julian Robertson’s Tiger Fund in 1997/824. Reserves also protect countries from a sudden drop in export earnings.

As the globalisation process has increased global financial turmoil and reinforced the power of currency speculators in relation to domestic economies, developing countries have been holding ever higher reserves. But reserves have a cost; in effect, a dollar held in reserves is a dollar that could otherwise have been invested in health, education, or roads. The system is also fundamentally regressive. Poorer countries are holding much higher levels of reserves due to their higher levels of financial vulnerability. As of 1995, Asia was a whole was holding reserves of a staggering 14.6% of GDP, while Africa held almost 7% of her GDP in reserves and the Western Hemispheric developing countries a further 8%. By contrast, the US only held 1.3% of her GDP in reserve.25

Of course, dollar holdings do yield some return as the interest payments on US securities. But this amount – usually 2% or 3% – pales in comparison with the interest rates the country is having to pay on the money it has borrowed from abroad. As Stiglitz puts it, ‘the current arrangements involve the country borrowing from the United States at 18% and then lending to the United States at 3%. It may be good for the United States but its hardly good for the developing country and hardly consistent with the general principles of equity.’26

Baker and Walentin, at the Centre for Economic Policy Research, have quantified the effect of increased reserve holdings on the developing countries.27 They calculated that the cumulative cost of reserve holdings over the last 10 years may be as much as 24% of GDP in East Asia and the Pacific; up to 16% in Latin America and the Caribbean; up to 9% in Sub Saharan Africa and South Asia; and up to 24% in the Middle East and North Africa. These amounts, even spread over a 10 year period, represent a significant drag on growth rates – rates which are already far off those required to make a significant impact on poverty. Again, the poor are suffering from the consequences of economic globalisation.

**A new international economic order?**

In the textbook model of the international economy, exchange rates are largely determined by imports and exports of goods and services. Poor countries will import more than they export, and will borrow from abroad to finance this gap. When the current account deficit gets too large, the currency starts to depreciate, increasing exports and reducing imports until a balance is restored.

But financial liberalisation, through the globalisation process, has meant that exchange rates are no longer determined by the physical movement of goods and services, but by flows of capital. Ashraf Laidi, Chief Currency Analyst of the MG Financial Group has observed that ‘as business cycles in Group of Seven nations have grown increasingly in synch thanks to the surge in cross-border investments (bonds and equities), capital flows have taken precedence over trade flows in

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causing the asset market model of currencies to displace the trade balance model.  

This means that, as long as the capital keeps flowing in, countries such as Britain and the United States are able to maintain exchange rates which are 20% over-valued – meaning that they can import products from the rest of the world 20% cheaper than they would otherwise have been able to.

But the implications of this new paradigm are that imbalances on the trade balance are often reversed through financial crises rather than gradual adjustment. As Thailand and Mexico know well, when financial markets decide that a current account balance is unsustainable, they move fast, with severe consequences for the host economy.

The United States is lucky. Her unique position as the issuer of the world’s main reserve currency means that her currency has, to date, been protected from the ravages of global financial markets. And because interest rates on her foreign debt are much lower than those she earns from her investments abroad, her debt service is low – only $20bn per year, compared to total debt service payments of more than $300bn paid by developing countries on an equivalent stock of debt.

But current account deficits cannot remain forever. As the IMF warned in the Spring 2001 version of their bi-annual World Economic Outlook, ‘this situation would run the risk of large adjustments in the current account and the external value of the dollar, potentially leading to substantial dislocations in the global economy and disruptions in US and world financial markets.’

Financial markets will not be willing to tolerate excessive current accounts indefinitely.

There are already worrying signs that the US, like Thailand before her, has not used the capital inflows into her country to invest in productive expenditures, but to push up asset prices. As Walden Bello and others have noted with respect to East Asia, ‘foreign capital did not gravitate to the domestic manufacturing sector or to agriculture, for these were considered low yield sectors that would, moreover, provide a decent rate of return only after a long gestation period of huge blocks of capital. The high-yield sectors with a quick turnaround time to which foreign investment and foreign credit inevitably gravitated to were the stock market, consumer financing and, in particular, real estate development.’

Worrying parallels emerge with current trends in prices of non-productive assets, particularly house prices, in the US and Britain. During 2001 there was a real increase in American house prices of 5.6%, with an overall increase of 20% in real terms since 1980. But in New York – the centre of stock-market activity in the US – the trends are much more extreme. Since 1980, house prices have increased by more than 100% in real terms; while they increased by 8.4% in 2001 alone. Furthermore, as the Economist has noted, in most countries house prices have a greater impact on consumer spending than equity prices, helping to further stimulate the speculative boom.

Moreover, the current account deficit is starting to have repercussions for the stability of the global economy more broadly. The over-valued dollar is imposing costs on the US manufacturing sector, costs which are starting to show. While the successful dollar is benefiting holders of capital in the US, the manufacturing sector is being priced out of the global market. The recent decision of the US administration to place a tariff on imports of steel in order to protect their own industry is just one symptom of these tensions.

As well as protecting her own manufacturing sector, the US may also be trying to further increase her exports of services – an area in which she is already in some surplus. As Catherine

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28 Source: Letter to the Financial Times, March 5th 2002
33 Source: The Economist, 28th March 2002
Mann of the Institute for International Economics pointed out in a submission to the Trade Deficit Review Commission in the US, ‘changes in the composition of global trade could ameliorate this asymmetry [the current account deficit], particularly if trade negotiations are focused on services.’ The explanation for recent attempts to foist liberalisation of services onto ill-prepared and unwilling developing countries through the General Agreement on Trade in Services (GATS) suddenly becomes all to clear.

The next crisis?

No-one is sure exactly how long the US current account deficit can last on its current trajectory. But what is clear is that, at some point, the deficit must be reversed. As Greider writes, ‘This reality may surface as a dramatic thunderclap or simply emerge from the slow, bleeding process that is already in progress. Either way, the moment of recognition promises crisis, not only for the United States, but also for the global economy at large.’

The general consensus amongst economists is that the dollar is currently over-valued by about 20%. But international economists Kenneth Rogoff, Chief Economic Counsellor of the IMF, and Maurice Obstfeld, have suggested that the required drop in the dollar could be as much as 40%. As they observe, this scenario ‘may seem drastic, but it is less radical than one in which the US actually is forced to start repaying its debt, as happened to a number of highly indebted middle-income countries during the LDC debt crisis of the 1980s and again after the Asian crisis of the late 1990s.’

Given that exchange rates are no longer determined largely by trade in real goods and services, but by trends in capital flows, how will this adjustment come about? The most likely scenario appears to be, as in Thailand or Mexico, a reversal in investor confidence in US stock markets. As Fred Bergsten, Director of the Institute for International Economics in Washington, has noted, ‘at almost any time, markets could decide that the deficits and debt are unsustainable and sell dollars, driving the exchange rate down sharply…. [this] would produce increases in US price levels and higher interest rates and almost certainly a fall in the stock market as well.’

A reversal of capital inflows into the US will also come about if, as seems likely, Asia no longer provides a sufficient surplus to fund the deficit. As FT correspondent John Thornhill has predicted, already ‘some Asians are tiring of making the world cushy for Joe Six-pack and are determined to live a little themselves by splashing out on cars, holidays and new homes.’ Bob McKee, chief economist at Independent Strategy, a London based investment consultancy, has also predicted that savings trends in Asia are on the decline. As he writes, ‘Growth in Asia was previously built on exports and high investment rates. Households were expected to have a miserable life and save. But the middle-income economies in Asia are now adopting a more modern and mature economic model. Consumers will borrow more and spend more over the next decade while savings rates will come down to European or US levels. That trend is already beginning.’

The ever downward trend in the Japanese economy suggests that Japanese investors may start to pull their savings to better uses back home. Indeed, in January 2002, Japanese investors made their largest net selling of foreign bonds in four years - $24bn in total.

But the sad story is that, whether the US deficit is reversed through a sudden crash or a continued decline, the developing world will suffer. When, as is inevitable, the dollar depreciates, output growth slows and interest rates rise, developing countries, now increasingly integrated into the global economy, will lose out.

37 Source: Bergsten, F (2002) op. cit, page 2
38 Source: ‘Asia Awakes’ Comment and Analysis by John Thornhill, Financial Times, April 2nd 2002
39 Ibid.
40 Source: ‘Wanted, $2bn a day.’ The Economist, 14th February 2002
The biggest blow for poor countries will be in declining terms of trade for commodity exporting developing countries. According to the IMF, there is a ‘strong correlation’ between output growth in the G7 countries and the terms of trade for developing country exports. As any development economist will tell you, terms of trade shocks have a fundamental impact on growth prospects in the developing world. Some estimates put the impact of terms of trade shocks on output fluctuations in developing countries at as much as 50% of output. And as the IMF notes, the distributional impacts of terms of trade shocks could be even more severe, as commodity prices have a greater impact on rural agricultural areas, where the poor are often concentrated.

Developing countries will also lose if financial markets are affected by the collapse of the dollar. In times of financial turmoil, investors will flee to less risky areas. Given the current outlook for Japan, the euro area and the UK are likely to be the biggest winners, while developing countries which rely on substantial flows of private investment, particularly short term investments, will also lose. For countries which are dollarised, such as Ecuador, higher interest rates in the US will force them to increase their own interest rates as well, whether or not this is beneficial for the domestic economy. Moreover, poor countries will be less able to withstand macroeconomic shocks given that the value of the reserve holdings, even at the current high levels, will be decimated by the dollar’s demise.

Tucked away in an appendix of the Spring 2001 World Economic Outlook, the IMF have attempted to model some of these impacts. Like other economists, the IMF staff estimate that reversing the deficit will require a 20% fall of the dollar against the euro and yen and a 15% fall against other major currencies. Their model assesses the likely impacts under either a ‘soft’ or a ‘hard’ landing, depending on the speed of adjustment. Unsurprisingly, under both scenarios, poor countries lose out, by up to 0.5% off their annual growth rates. These figures may not sound large, but considering that average growth between 1998-9 was only 2% in Sub Saharan Africa, and 0% in Latin America and the Caribbean, this represents a relatively substantial cut in growth rates. Furthermore, the scenarios they present will only result in an improvement of the US trade balance of $85bn by 2005 – barely denting the current deficit of $445bn. As they admit, this is ‘in all probability not large enough to fully address the trade imbalances that are currently present in the global economy…. [the impacts] could be significantly greater if the hard landing in the United States is accompanied by a substantial deterioration in financing conditions for emerging markets.’

Conclusions

There is urgent need to address global instability and to reverse the searing inequalities inherent in the global system, which ensure that the poor continue to finance the rich. To do this, the US deficit must be reversed, the debt repaid, the US must learn to stop consuming more than her fair share. Without such changes, global tensions which are starting to show and the costs of global inequities will surely mount, with worrying implications for global stability.