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Global Economic Imbalances and International Security: Perils and Prospects

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What adjustment burdens fall on developing countries?

What are the security implications for deficit countries during the adjustment process?

What lessons can we learn from history?

For over a year now, a debate has raged among politicians, economists, and editorialists on both sides of the Atlantic about the role of the U.S. current account deficit and Germany's surplus in causing the financial crisis in 2008 and the euro-zone crisis in 2010. Along with very different opinions about the causes and who is to blame for these developments come very different proposals about what politicians and central bankers need to do in order to get the economic and financial world back in order.

The turbulent period following the financial crisis of 2008 and the subsequent recession has also made clear that these issues are not only a matter for political elites but also have consequences for ordinary people in the U.S. and Europe as well. Perhaps even more important than the crisis itself were the consequences of countering the downturn, which have had severe effects on countries around the world, causing economic disruptions, political turmoil, and regime change. Thus the security implications of the global economic imbalances are very immediate and real.

Furthermore, such macroeconomic imbalances are not unique, and we must look more carefully at the past if we are to understand the future. Economic analysis as well as history demonstrate that we can expect further disruptions caused by these persistent macroeconomic imbalances and that the recent regulative, fiscal, and monetary measures will not be enough to bring the world economy smoothly back into balance.

A Game of Political Hot Potato

In the aftermath of the recent financial crisis, many observers have feared a broader unraveling of the international order. From the "end of American dominance" to the rise of an expanded "G20," in which emerging nations such as China, India, and Brazil play a larger role in international affairs, apprehension about the future world economic system has been steadily increasing. The United States remains focused on reviving its stalled economy, while Europe grapples with its own political and economic dilemmas, leaving the world adrift in a leaderless "G-Zero" world, where developed nations navel-gaze and developing economies stick their heads in the sand and hope for the best.[1]

Much of the uncertainty about political stability stems from the continued imbalances within the global economy, which many analysts believe helped trigger the financial meltdown in 2008.[2] Federal Reserve Chairman Ben Bernanke warned back in early 2005 of a "global savings glut" among creditor nations in East Asia and the Middle East, who transferred their savings to the United States and countries along the periphery in the European Union, helping finance both trade deficits and real estate bubbles across the North Atlantic, from California to southern Spain and northern Ireland.[3] The expansion of deficit spending by the United States since 2009 has no doubt softened the post-crisis downturn, but it has also deepened the macroeconomic imbalances between debtor and creditor nations and led some to worry that an impending "re-balance" will be all the more painful, chaotic, and destabilizing.[4]

The United States has periodically been criticized for its deficits, but has not been shy about heaping blame on creditor nations either. The Obama administration, like the Bush administration before, has accused China, for example, of currency manipulation by maintaining an artificially low exchange rate against the dollar, thereby expanding Chinese exports and deepening China's trade imbalance with the U.S.[5]

Obama administration officials have also criticized countries like Germany for running excessive trade surpluses by pursuing a neo-mercantilist policy. Germany was also criticized by its EU partners, namely, the French finance minister Christine Lagard, for the country's extensive trade imbalance within the euro-zone that have contributed to the sovereign debt crises in Greece, Ireland, and Portugal and ultimately the euro-zone crisis.

In this game of political hot potato, creditor economies with large export surpluses blame high-debt economies for fiscal laxity and overconsumption, while debtors blame exporter nations of blindly supporting a *de facto* vendor finance regime that props up demand for their products yet creates enormous credit risk. Moreover, powerful domestic interest groups within all these countries seek to maintain the status quo. Thus there is virtually no international consensus about a common strategy to re-balance, as politicians and governments are more concerned with appeasing domestic publics in the short term, rather than adjusting to a new pattern of production and demand in the long term.

While much attention has focused on the immediate build-up to the financial crisis of 2008, we should not lose track of the broader historical trajectory of the world economy since the end of World War II. This Issue Brief seeks to put the political dimension of economic imbalances into perspective by examining the historical forces that have shaped the world economy since 1945, especially the role of the dollar as the world's reserve currency. It will also offer some possible scenarios for the future of international security in an age of protracted economic imbalances.

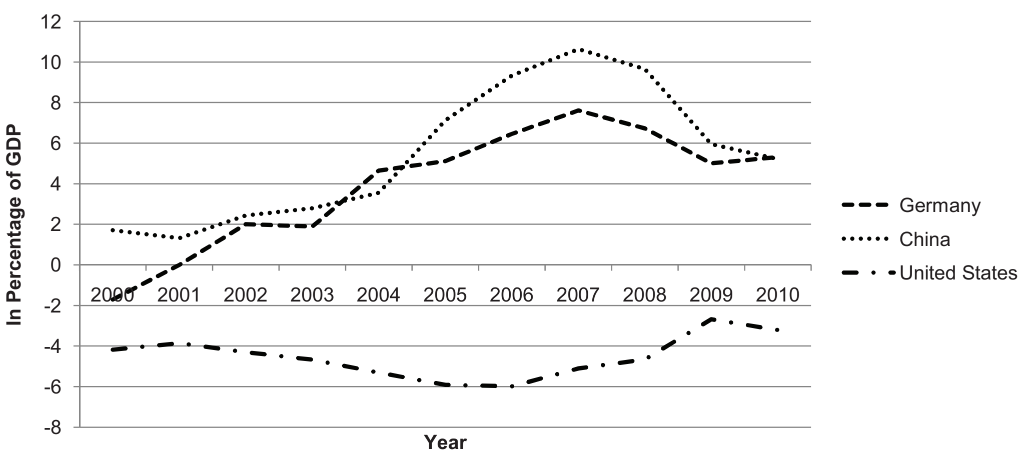
Bretton Woods: Then and Now

The postwar international order hammered out at Bretton Woods in 1944 is often viewed as a proverbial golden age of international stability. But, then as now, economic imbalances undergirded these arrangements. Historians of the period tend to underscore the geography of the financial imbalances facing policymakers at the time as well as the emergence of the dollar as a reserve currency.

Unlike the current imbalance between the United States and China at the beginning of the twenty-first century, the imbalances around the middle of the twentieth century had other origins. By the end of World War II, the United States held two-thirds of the world's monetary stock, buoyed by the decision to raise the price of gold as well as capital flight from Europe in the 1930s. In 1947 gold and dollar reserves were so

Figure 1: Current Account Balance as a Percentage of GDP

Source: International Monetary Fund, "World Economic Outlook" <http://www.imf.org/external/pubs/ft/weo/2011/01/weodata/download.aspx> (19 May 2011).



depleted in Europe and Japan that the Marshall Plan was created in order to allow Europe to finance imports from the U.S., while Japan received monetary transfers through the American military occupation until 1952 and afterward through other means. Thus the United States became both the economic and financial center of this new economic order, lending dollars to the economic periphery and managing the devaluation of the former global reserve currency, the British pound, in 1949.[6]

This not only helped alleviate Britain's substantial current account deficit but also demonstrated that only a carefully managed devaluation would avoid a speculative run by delaying adjustment until investors were ready. In the period stretching to 1958, the Bretton Woods system of capital controls, limited adjustable currency pegs against the dollar, and multilateral agreements such as the crisis-prevention functions of the International Monetary Fund (IMF) helped rebuild Europe and Japan under American leadership, opening up world trade and allowing war-torn economies to regain their productive capacity.[7]

This system also established the dollar as the reserve currency of choice—it was used as the unit of account to invoice imports and exports, as a medium of exchange for interbank transactions, and as a store of value for private claims. In addition, the dollar was also used as the primary intervention currency by the IMF, which meant that central banks in Europe maintained their currency pegs through the buying and selling of dollars.

As exports from Europe to the United States grew throughout the 1950s, so too did demand for dollars. Both military and non-military aid also continued to flow to the periphery, leading to growing deficits in the U.S. Even in 1958 when many European nations moved toward full convertibility after achieving current account surpluses, central banks continued to hold reserves in dollars rather than convert them to gold. By the mid-1960s, more than a third of total reserves were held in dollars, helping provide the necessary liquidity for the expansion of international trade. Yet experts began to worry that the dollar would have to be revalued as gold supplies waned and could not keep pace with the increase of dollars in circulation.

Robert Triffin offered a powerful critique of this feature of the Bretton Woods system in 1960, arguing that the unlimited pledge to convert dollars into gold would come under attack as the U.S. ran current account deficits to fund the world's demand for dollars. Known as the Triffin Dilemma, the economist held that when a national currency served as the world's reserve currency, conflicts would arise over domestic and international policy goals.[8]

Thus, central banks in Europe and Japan expanded their holdings of dollars in excess of United States' gold reserves, and the supply of dollars grew to cover both domestic and international obligations. With gold reserves winnowed away by the expansion of domestic spending in the U.S. and by the reluctance of European and Japanese nations to re-value their own currencies for fear of damaging their export-oriented growth, collective action was taken to alleviate speculative attacks against the dollar through gold pools and Special Drawing Rights (SDR). Yet the United States continued to run current account deficits in the late 1960s, providing incentives for investors to exchange dollars for gold and leading the U.S. to fully abandon the convertibility of the dollar to gold in 1971.

In the late 1960s the French finance minister, Valery Giscard d'Estaing, coined the term "exorbitant privilege" to describe the benefits enjoyed by the United States, whose currency provided liquidity for the world economy and allowed the government to cover its deficits simply by printing more dollars. Yet investors continued to abandon the dollar in the early 1970s, especially in light of the U.S. trade deficit that opened up in 1971.[9]

Ironically, it was the OPEC oil crisis that helped the dollar regain traction, as oil was denominated in dollars and the fourfold increase in energy prices not only fed inflationary pressures throughout the world but also led to a massive "recycling" of dollars through debt markets and banks. Thus the center and periphery of the post-1945 world grew more integrated financially, as credit shifted to developing nations in Latin America and East Asia in search of higher yields. Although the 1970s remained a period of severe dislocation and adjustment—both the Bundesbank and the Bank of Japan revaluated their currencies upward to accommodate the rise in energy prices—the dollar persisted as the only major reserve currency for the world economy.[10]

Fast forward to the year 2004. After a breathtaking expansion of credit and productive potential with the end of the Cold War and the dawn of information technology, financial markets had grown even more integrated. An influential view emerged that the international financial system had coalesced around a new center and periphery not unlike the Bretton Woods arrangement of forty years ago. In the 1960s, the center was the United States and the periphery was Europe and Japan, with many developing countries not yet having been fully integrated into the international system. With the spread of globalization, there was now a new periphery, the emerging markets of Asia and Latin America, but the same old center, the United States, with the same tendency to live beyond its means. The periphery, which was still catching up to the center, was committed to export-led growth based on the maintenance of an undervalued exchange rate, a corollary of which was its massive accumulation of low-yielding international reserves issued by the United States and denominated in dollars.

The main difference between the 1960s and now is the existence of a third bloc. While today the periphery is Asia, Europe is still a factor in the equation but without the new periphery's scope for catching-up or the United States' ability to live beyond its means through *seigniorage*. Understood as "Bretton Woods 2" many analysts came to see this arrangement as a new grand bargain, in which China and the rest of under-developed Asia would be happy to finance American deficits over the long haul.[11] Other experts feared that sooner or later, the Asian economies would abandon their collective interest in low exchange rates and cheap exports and forego forced savings and artificially depressed consumption for a more balanced development, especially as sterilization costs increased, real estate bubbles threatened, and inflation rose.[12]

Yet for all the speculation about a general "decoupling" of emerging markets in East Asia and mature markets in Europe from their consumer of last resort—the United States—the basic premise of Bretton Woods 2 seems alive and well. China has been willing to finance the United States stimulus efforts since 2009, even as its leaders groan about the Federal Reserve's programs of "quantitative easing" (thus far there have been two rounds: "QE I" and "QE II") and other emerging economies worry about large inflows of speculative capital that are forcing their currencies to appreciate and threatening growth to stall.

With the extensive increase of the dollar supply, the Federal Reserve has not only pumped liquidity into the sluggish U.S. economy but also dumped billions of dollars onto world financial markets without an equivalent expansion of the real economy. This extra liquidity has not been matched with additional output of the U.S. economy; therefore, market participants expect prices to increase. Consequently they are investing in commodities such as oil, gold, or agricultural products. And because this extra demand encounters a relatively fixed supply, prices of such commodities have increased more sharply than they would have otherwise.

Perils

While all of this is a manageable challenge for a wealthy surplus country like Germany, developing and emerging countries must carry a much heavier burden. Their share of income for inputs such as basic foodstuffs, oil, and gas is much higher than for industrialized countries. Their exports are also frequently more price sensitive than those high-tech engineering products typical of Germany's export industry. As a result, people and governments in developing and emerging countries suffer heavily because of the current macroeconomic adjustment process and the political measures taken by the industrialized West to counteract the downturn.

Yet attempts by the U.S. to rebalance by devaluing the dollar carries very real geopolitical risks. Discontent with deteriorating living standards due to higher prices and stagnant wages has been an important factor in the uprisings throughout the Arab world. The protestors' motives were not only shaped by their quest for liberty and democracy, but also by the simple need to feed their families. The inability of Arab regimes to keep up with exploding food prices through subsidies has been just as important to feeding discontent as the glut of over-educated, under-employed young people who have flooded into the streets over the last few months.

Even in stable countries such as South Africa and Brazil the tone toward the United States is getting angrier as the adjustment burden falls on them. There is open talk about a currency war and some governments are trying to keep their local currencies from appreciating by re-establishing capital controls or intervening in the currency markets by purchasing dollars. Thus, while many players are growing apprehensive about the overall financial position of the United States, the dollar remains the only viable reserve currency.

Figure 2: Exchange Rate Development of U.S. Dollar (standardized with Jan. 1, 2007 = 100)
Source: Bloomberg and BIGS

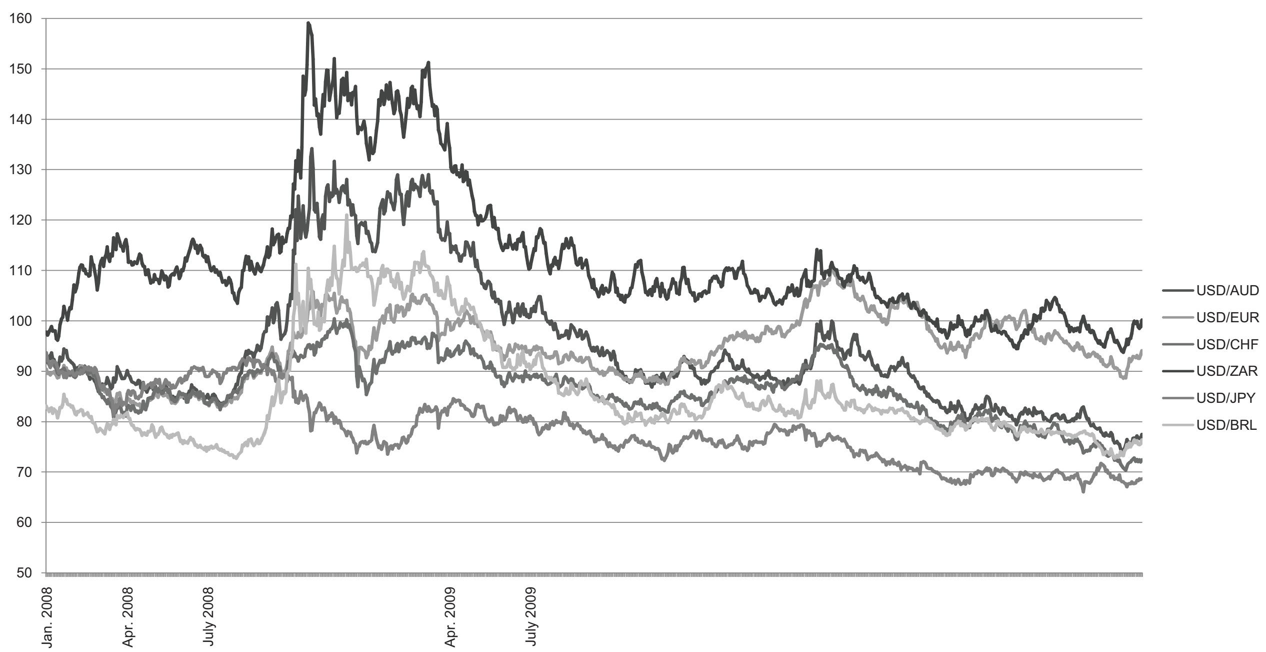


Figure 3a: Food Development

Source: FAO, "World Food Situation," <http://www.fao.org/worldfoodsituation/wfs-home/en/> (19 May 2011).

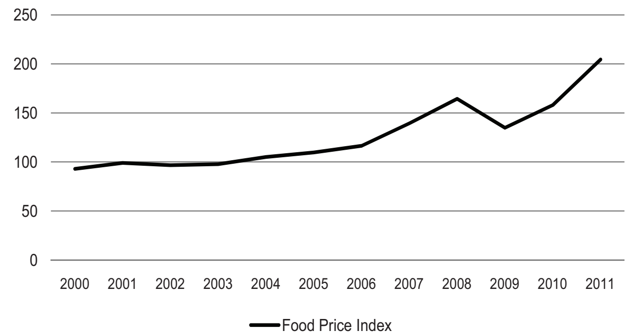


Figure 3b: Oil Development

Source: Illinois Oil and Gas Association, "History of Illinois Basin Posted Crude Oil Prices," <http://www.ioga.com/Special/crudeoil_Hist.htm> (19 May 2011).

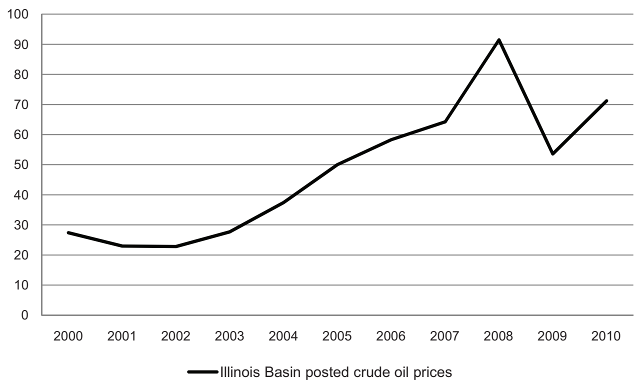
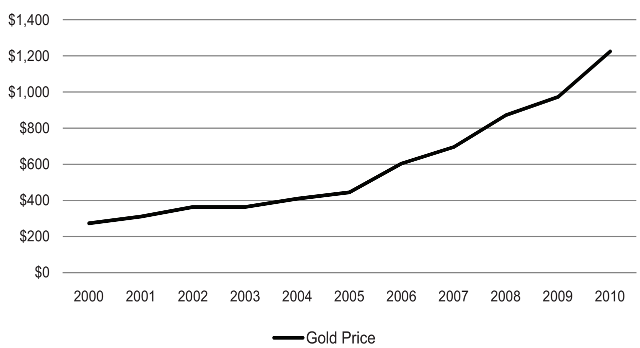


Figure 3c: Gold Development

Source: World Gold Council, "Prices," <http://www.gold.org/investment/statistics/prices/> and "Average annual gold prices since 1990," <http://www.gold.org/investment/statistics/prices/average_annual_gold_prices_since_1900/> (19 May 2011).



The imbalances within the euro-zone point in an opposite direction as deflation has been pushed on the weaker economies, but this strategy carries political risks of its own. After monetary union in 1999, periphery countries of the euro-zone like Greece, Spain, Portugal, and Ireland experienced huge capital inflows as investors discounted the risks of lending to fiscally weak governments and investing in real estate. These inflows also raised the costs of labor relative to Germany, and now that the bubble has burst, these economies are having a hard time adjusting. At the same time wages in Germany and other surplus countries within the euro-zone increased only very little, sometimes even less than the increase in productivity. This increased their competitiveness even further and added to the trade surplus.

So far the adjustment burden has fallen on the periphery to deflate, as Germany, the Netherlands, and others insist that inflation be kept in check. Thus the euro-zone has bifurcated into a two-tier system, one marred by low growth, austerity, and social crisis, and the other experiencing booming growth and record exports.[13] Even the IMF has begun to criticize the European Central Bank (ECB) for being too eager to fight inflation and not concerned enough with the economic imbalances within the euro-zone.[14] Popular hostility toward Germany is on the rise in the European South and in Ireland, as the burden to rebalance is placed almost solely on debtor nations,[15] while in surplus countries euro-skepticism is on the rise and supported by some prominent voices or sometimes even political parties.[16]

Prospects

In the aftermath of the Asian financial crisis of 1997, many central bankers believed that in a world of dynamic capital markets, large dollar reserves would provide a hedge against speculative runs on their currency. Even if they have "over-learned" the lesson from this crisis, the dollar remains the only viable reserve option in a world of uncertainty. As in the late 1960s, when much was done to create Special Drawing Rights (SDRs) and alternatives to the "dollar glut" that would ameliorate the global imbalances of the time, today many observers talk about the need to move away from the dollar as a reserve currency, yet no concrete steps have been taken. While much has changed since then, the exorbitant privilege of the United States has not.

This is partly the case because no other country or group of countries has been willing to step in as either a lender or consumer of last resort.[17] The world is left with a situation in which the U.S. is trying to inflate itself out of the recession and devaluate its debt crisis, while China sticks to its export driven growth model by keeping its currency undervalued. The other big surplus country, Germany, is tied to much weaker economies in a monetary union that appears unstable enough to investors to keep the euro from appreciating. Even here, however, worries about the dollar recently started to push the euro upward.

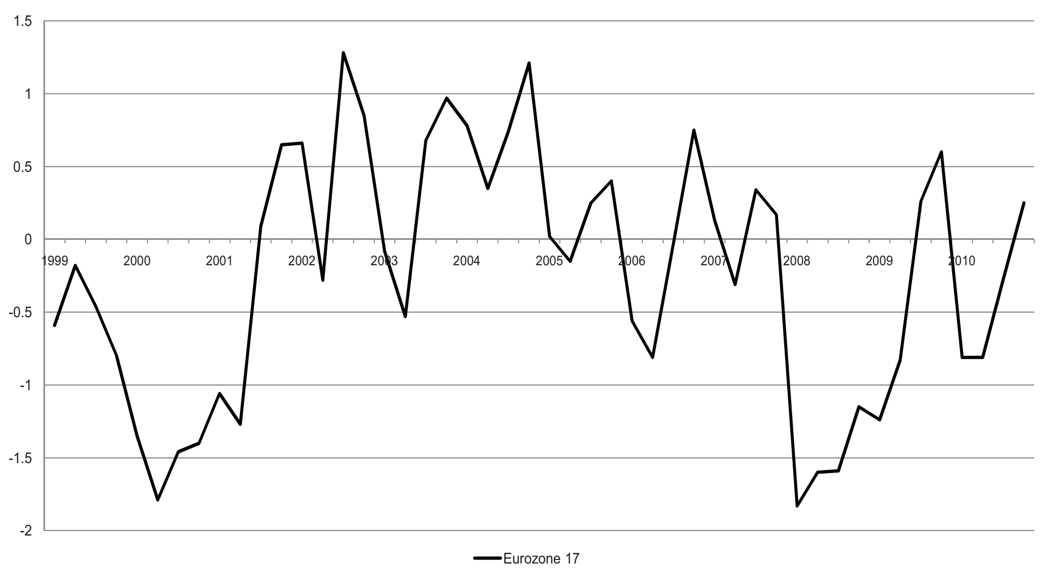
While Germany has taken the role of economic leader by acting as Europe's lender of last resort, it refrains from taking on the trade imbalances within the euro-zone. The angst about inflation and a culture of wage restraint keep prices under control. Tax cuts or deregulation of the service sector to support consumption seem to be politically impossible.[18] As a consequence it leaves the country highly competitive compared to many European partners while consumption increases only modestly. In the grand scheme of things, Germany is doing just enough to keep Europe afloat but leaves the adjustment burden for the global imbalances to others. However, this can be somewhat justified since the euro-zone has a relatively balanced current account and therefore as a whole no direct impact on the imbalances of the rest of the world.

One observer has characterized the current predicament as a "Bretton Woods 3" world, where state indebtedness has supplanted consumer debt, while the United States continues to be a safe haven for much of the world's capital. If Japan and Germany were to cure themselves of their mercantilistic ways and generate domestic demand-led growth this would take important pressure off the U.S.' shoulders. The same effect would occur if developing countries decided that globalization had become safer and that integration into financial markets did not rely on their hoarding dollars. Finally, if China learned from its own ongoing rebalancing in the context of massive fiscal stimulus measures that a greater reliance on domestic rather than external demand is in its own national interest, this would reduce the need and scope for Bretton Woods 3 as well.[19]

With Germany content to act only as a regional hegemon, China unwilling to change its policy of keeping the renminbi undervalued, and the U.S. unwilling or perhaps unable to fully shoulder the burden of adjustment, much of the inflationary pressure is placed on developing and emerging countries. The "burden of adjustment" may seem like an anodyne economic term, but in practice it means that governments face increasing costs to keep their local currency from appreciating and to

Figure 4: Nominal Unit Labor Costs: Total Economy (Ration of Compensation per Employee to Real GDP per Person Employed)
Source: AMECO

Figure 5: Euro-zone Current Account
Source: European Central Bank, "Statistical Data Warehouse," <http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=DD.Q.I6.BP_CU.PGDP.4F_N&> (19 May 2011).



subsidize food and energy. Since at some point they become overburdened, the adjustment cost will have to be carried by the citizens through higher food and energy prices while their income remains constant at best. Food riots and civil unrest across much of the Arab world but also elsewhere in the developing world was triggered not only by growing frustration about the long-term job prospects of many young people but also by the rise in food prices that affected the whole population. Therefore the question is how long people in the emerging and developing world will be willing to endure economic hardship caused by developments outside of their control.

Over the next few years, we are bound to see emerging markets like the BRICs challenge the U.S. over its monetary policy. Capital controls have already been instituted in Brazil to stem speculative inflows with what essentially amounts to a Tobin tax on equities and securities purchased by foreign borrowers. India has slowed the liberalization of its own capital markets, which have soaked up much liquidity over the last two years.

China is already looking to position the renminbi as a global currency, engaging banks in New York to trade debt instruments denominated in the Chinese currency and offering global corporations like Caterpillar and McDonalds the opportunity to issue bonds denominated in the yuan as well.[20] While it will not replace the dollar anytime soon as a reserve currency, the rise of the renminbi is part and parcel of the enormous growth of China in becoming the second-largest economy in the world. Thus the potential of the Chinese currency to play a larger role in global trade and finance along with the euro is a very real prospect in the near future.[21]

If history is any guide, the road toward rebalancing will get even bumpier. The last great era of rebalancing in the global economy came in the late 1970s as monetary tightening sought to stem run-away inflation. The then-Fed Chairman Paul Volcker's massive interest rate hikes were painful medicine for a struggling economy, but were triggered by a crisis in the U.S. bond market after investors refused to buy more treasuries unless something was done about inflation.[22] Many experts have warned that the massive debts run up by the U.S. in recent years might lead investors to flee the dollar once again in the near future.[23]

Domestic considerations also remain a top priority for politicians in many countries who hear their populations clamor for less activism on global problems and more focus on the home front. Americans want less involvement by their government in world affairs, while Germans long for the days before the euro and the massive bail-outs along the euro-zone periphery. Rising gas prices in the United States are starting to stoke populist anger about the overall increase in commodity prices. In Germany fears of inflation have been persistently sticky in popular memory, despite any real uptick in core inflation, and the German response to the euro-zone crisis has been governed by domestic political concerns. In this environment forging common solutions to the global problem of imbalances remains elusive and perhaps awaits the next crisis for the international community to come alive.

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4 Jeffry A. Frieden, "Global Imbalances, National Rebalancing, and the Political Economy of Recovery," *Council on Foreign Relations Working Paper* (October 2010).

5 In a policy brief by Arvind Subramanian from the Peterson Institute for International Economics the renminbi undervaluation is estimated to be as much as 30 percent. Arvind Subramanian, "New PPP-Based Estimates of Renminbi Undervaluation and Policy Implications," *Peterson Institute for International Economics Policy Brief* 10-8 (April 2010).

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7 Ibid.

8 Robert Triffin, *Gold and the Dollar Crisis: The Future of Convertibility* (New Haven: Yale University Press, 1960).

9 Barry Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (New York: Oxford University Press, 2011).

10 Eric Helleiner, *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca: Cornell University Press, 1994).

11 Michael Dooley, David Folkerts-Landau, and Peter Garber, "An Essay on the Revived Bretton Woods System," *NBER Working Paper* No. 9971 (September 2002).

12 Barry Eichengreen, "Global Imbalances and the Lessons of Bretton Woods," *NBER Working Paper* No. 10497 (May 2004). With sterilization policy a central bank swaps domestic securities, such as government treasury bonds, for incoming foreign assets. The net impact of a sterilization policy is that the monetary base remains unchanged, but the amount of foreign reserves in the central bank's asset holdings have increased. See Kenneth Kletzer and Mark M. Spiegel, "Sterilization costs and exchange rate targeting," 3 April 2000, p. 3, <http://people.ucsc.edu/~kkletzer/kletspei.pdf> (3 May 2011).

13 Paul Mason, "Trichet: welcome to my big fat Euro fiasco," *BBC*, 11 April 2011, <http://www.bbc.co.uk/blogs/newsnight/paulmason/2011/04/trichet_welcome_to_my_great_bi.html> (21 April 2011).

14 See Olivier Blanchard's comments at the unveiling of the IMF's World Economic Outlook, 11 April 2011, <http://www.imf.org/external/mmedia/index.aspx> (27 April 2011).

15 Based on remarks made by Matthias Matthijs at AICGS' conference on "Balancing Global Macroeconomic Discrepancies: A Question of National Security?" on 1 April 2011 in Berlin, Germany.

16 See for example the massive gains of 15 points to 19 percent for the True Finns party in the Finnish national election on 17 April 2011. See Jonathan Stearns and James G. Neuger, "Finnish Vote Dents Euro Area's Debt-Crisis Shield, Experts Say," *Bloomberg*, 18 April 2011, <http://www.bloomberg.com/news/2011-04-18/finnish-vote-dents-euro-area-s-debt-crisis-shield-analysts-say.html> (27 April 2011).

17 See also Liaquat Ahamed, "Currency Wars, Then and Now," *Foreign Affairs*, Vol. 90 Issue 2 (Mar/Apr 2011): 92ff.

18 See also Tim Stuchtey and Jackson Janes, "Two Different Sides of an Equation," in *United States-German Economic Yearbook 2010*, ed. German American Chambers of Commerce (2011): 32.

19 Jörg Bibow, "Toward Bretton Woods 3? Prospects for Global Rebalancing," *New American Contract Policy Paper*, 7 October 2009.

20 Tracy Alloway, "Yuan-tied: McDonald's new bond," *The Financial Times*, 20 August 2010, <http://ftalphaville.ft.com/blog/2010/08/20/321211/yuan-ted-mcdonalds-new-bond/> (27 April 2011); Robert Cookson, Hal Weitzman, "Caterpillar to Issue Yuan-Denominated Bond," *The Financial Times*, 24 November 2010, <http://www.cnbc.com/id/40350492/Caterpillar_to_Issue_Yuan_Denominated_Bond> (27 April 2011).

21 Eichengreen, *Exorbitant Privilege* (2011).

22 Michael Bordo and Barry Eichengreen, "Bretton Woods and the Great Inflation," *NBER Working Paper* No. 14532 (2008).

23 Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009).

The global economy has still not managed to overcome effects of the financial and economic crises in 2008 and 2009. Despite improvements in the American and European financial markets in 2010, the fiscal crisis in Greece and the continually rising U.S. deficit have caused a decline of trust in the capital markets and have overshadowed any growth in the real economy. Fear of a new recession remains, especially as unemployment figures in the U.S. stagnate. Overcoming the recession and returning to a sustainable growth pattern, however, is of paramount importance for the wealth and security of all nations and has an impact on almost all other policy areas. This Issue Brief is a result of a conference in Berlin in April 2011 that examined these issues and is part of a larger project on "The End of the Years of Plenty? American and German Responses to the Economic Crisis."

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