

Global imbalances and developing countries

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The main distinguishing features of present-day global imbalances go beyond their sheer amount and generalisation. First, the world economy is characterised by an increased and dynamic presence of many developing countries that simultaneously have turned from deficit into surplus economies. Second, imbalances happen in a context of variable exchange rates and under an accelerated process of financial globalisation. Third, the international reserve currency is basically the currency of just one advanced country in the world.

Both the variability of exchange rates –in principle freeing countries of the need to defend their parities– and the easy availability of private foreign finance –liberating them from the limits imposed either by the amount of foreign exchange reserves or the conditional access to IMF resources– go to a great extent to explain the increase and generalisation of current account deficits. But, additionally, the capacity of the United States to run deficits financed by the fact of their issuing the international reserve currency, has decisively contributed to the explosion in the magnitude of the imbalances. Of course, the ability to finance deficits by resorting to foreign inflows is dominated by its variability and by the accumulation of debt frequently ending up in severe crises. Thus, financial stability is endangered.

On the surpluses side, quite a few major advanced countries persist in generating them instead of promoting fast rates of growth and improving the lot of their own citizens. Thus, the old-time deflationary bias that places limits on deficit countries while leaving the major surplus countries to unfettered run restrictive policies playing beggar-thy-neighbour on the rest of the world still rules the present-day non-system. Surely, many fast growing developing countries, having on the contrary become the dynamic force in the world economy, play a completely different role based on their having overcome the restrictions that deficits used to place on their performance.

Redressing global imbalances to avoid financial instability, therefore, would, at the international level, require regulating “speculative” private international capital flows, on the one hand, and devising a new international monetary system that would run on the basis of a multilateral reserve currency. Additionally, a less restrictive mechanism than the conditionality-run IMF should be established for clearing temporary imbalances with similar obligations for surplus and deficit countries, although growth rates and the stage of development would have to be taken into account.

Redressing global imbalances, however, should not be made at the expense of growth in the world economy that as mentioned before has come to increasingly depend on the developing countries’ economies. Room, therefore, would have to be built for the surpluses of the developing countries following successful export-led strategies to be accommodated within such a system. This way, developing countries will keep being able to pursue expansionary policies, reduce inequality and continue to represent a dynamic force in global terms.

In the last months, global imbalances have been back under the limelight. With a recovery even mild and fragile, some of the largest imbalances that had decreased under the impact of the slowdown in economic activity, have resumed climbing.

For instance, with some ups and downs, the US balance of trade deficit has been increasing since April 2009. In turn, a few other major countries have been expanding their surpluses. Most recently, Germany and Japan have seen their trade balances growing, while that of China –after a strong upswing in the years 2003-2008– has been gradually decreasing as depicted, with monthly frequency, in the following graph. In addition, the IMF estimates that the United States current account deficit will be increasing from USD 378 billion, last year, to USD 466.5 billion in 2010, while the combined surplus of Germany and Japan will increase this year to USD 366.5 billion from USD 305 billion last year (China's current account surplus is estimated to reach USD 270 billion, less than the sum of those two major advanced countries and 4.7% of its GDP not far away from the 4% standard being suggested by the US Secretary of Treasury at Seoul in November this year).¹

The renewed rise in global imbalances is a cause for concern as the experience of the last forty years has shown that their sustainability after a point is far from assured and that they give way to current account reversals accompanied by crises characterised by major changes in exchange rates and in capital flows.²

Some of the features of the last few years in the accumulation of current account mismatches, however, set it apart from the previous experiences.

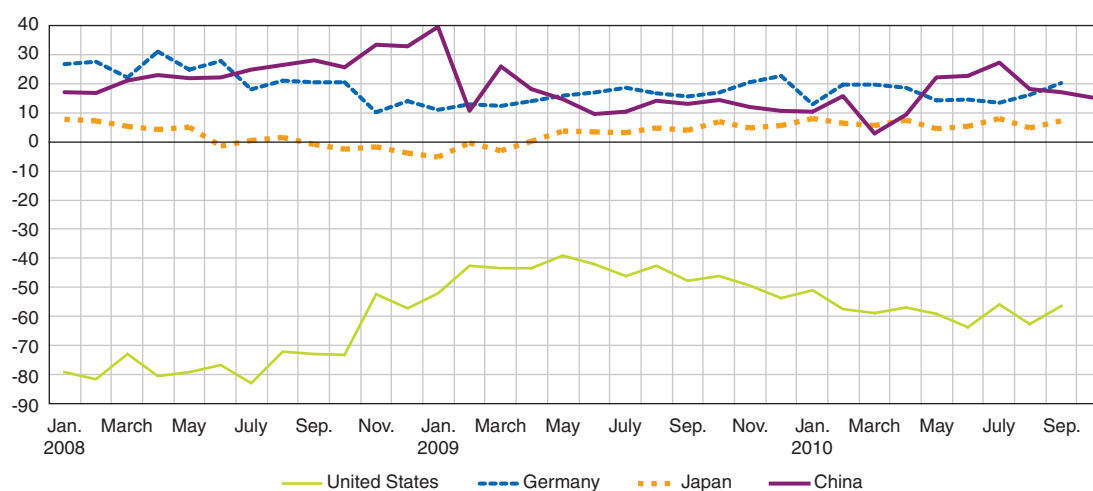
1 | MAGNITUDE AND GENERALISATION OF GLOBAL IMBALANCES

The magnitude of global imbalances both in absolute terms and relative to world GDP is much larger than in the previous three decades as may be gathered from the following graphs.

A second trait of global imbalances is their generalisation to an increasing number of countries. Measures of their dispersion do confirm that it is on the rise (the dispersion grows over time

Chart 1
China, Germany, Japan & US trade balances

(USD billions; seasonally adjusted monthly figures)

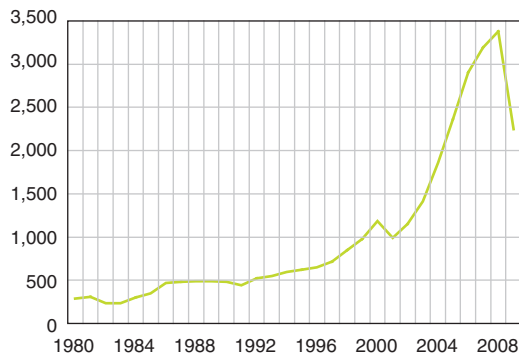


Source: IBRD GEMData, Goods exports and goods imports, seasonal adjusted value, November 2010.

- 1 See IMF, WEO, Database, by country, October 2010. China's trade surplus increased in October but it is difficult to predict if it's a seasonal movement or if it reveals a switch in its downward trend.
- 2 At the beginning of the 1970s, accumulation of current account imbalances led to the demise of the Bretton Woods system plus the temporary introduction of trade protectionist measures by the United States. Again, the 1980s showed a renewed accumulation of current account mismatches with a serious overvaluation of the US dollar, to some extent managed through international agreements but anyway leading to serious disruptions. And of course, the 1990s were characterized by serious imbalances, most specifically involving some developing countries ending up in drastic negative shifts of many points of their GDP in capital flows and overall crises.

Chart 2
Current account balances
Sum of absolute values

(USD billions)



Source: IMF, WEO, Database, October 2010.

even if the United States and China are excluded), accompanied also with asymmetries and “fat tails”, i.e., there are some extreme cases. Dispersion is found to be closely associated with financial globalisation.³ Persistence is also an attribute of imbalances; but even correcting for a trend in this direction, the case of the US deficit stands on its own as it is much larger than what that trend would explain.⁴

But as it will be shown later, in the aggregate, developing countries have in this first decade of the XXIst century managed to become surplus countries when they used to be deficit ones; a true break in the above mentioned persistence of current account signs.

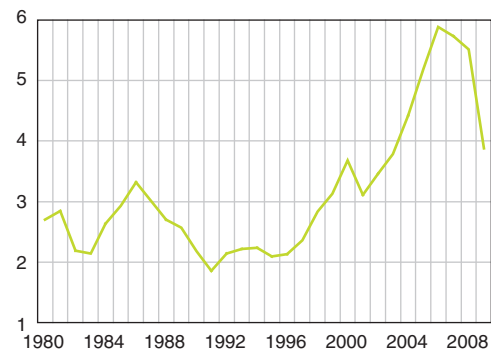
2| FINANCIAL GLOBALISATION AND THE PREDOMINANCE OF THE US DOLLAR AS A RESERVE CURRENCY

2|1 The process of financial globalisation and developing countries

Of course, as just mentioned, the increase in magnitude, but more specifically the generalisation

Chart 3
Current account balances
Sum of absolute values

(% of world GDP)



Source: IMF, WEO, Database, October 2010.

of current account imbalances, is associated with an equivalent process in relation with financial flows as well as to the specific case of the United States being able to finance its deficits by the issuance of the predominant “reserve currency”. In the last two decades the process of “financialisation” –or financial deepening– and of its internationalisation has built up room to resort to private finance, liberating countries of the limits placed by their foreign exchange reserves or borrowing under “conditionality” from the IMF to manage their balance of payments deficits.

As to “financialisation” just in the United States, beginning in 1980 and up to 2007, financial assets as a proportion of GDP had gone up from 192 to 442 per cent.⁵ Worldwide, between 1990 and 2007, financial assets went from a figure close to that of world GDP in the initial year to more than 3.5 times world GDP in the last one (from USD 55 billion to 196 billion).⁶ Moreover while in the year 2000 only 11 countries had financial assets above 3.5 times their own GDP, by 2007 this “financial depth” had reached 25 countries, some developing countries among them. In this last year, 50 per cent of the increase in financial assets was located in the developing countries.⁷

Up to 2007, internationalisation of financial flows was even faster than the process of financial deepening.

3 See Faruquee, Hamid and Jaewoo Lee (2009): “Global dispersion of current accounts: is the universe expanding?”, IMF Staff Papers, Vol. 56, No. 3. See, also, Baclet and Vidon (2008): “The world distribution of external imbalances: revisiting the stylised facts”, Banque de France, Occasional Paper, No. 6, June.
4 See Faruquee, op.cit., Figure 5, p. 548 and Baclet, op.cit., Chart 4 D, p. 6, this last one shows a spike in “kurtosis” in the early 2000s that almost disappears when the US is excluded.
5 See McKinsey Global Institute: “Global capital markets: entering a new era” (September 2009), Exhibit 1 and IMF “Global financial stability report” (April 2009), Table 3 where it might be verified that for emerging market countries as a whole, the relation between financial assets and GDP was 272% but for Asia it was 389%.
6 See McKinsey Global Institute: “Mapping global capital markets: Fifth annual report” (October 2008) and “Fourth annual report” (January 2008).
7 See McKinsey Global Institute, (October 2008), op.cit., Exhibit 7.

Beginning in 1990 international capital movements were growing at 15 per cent per year reaching a volume 8.3 times that of the initial year (while international trade only increased 3.4 times in that same period). Their proportion, in 2007, relative to that of world GDP was around 20 per cent (some USD 11 trillion).⁸ Admittedly, the largest part of these international financial movements involved the United States, the United Kingdom and the euro area. But flows involving developing countries were growing at twice the rate of those involving only the advanced ones.

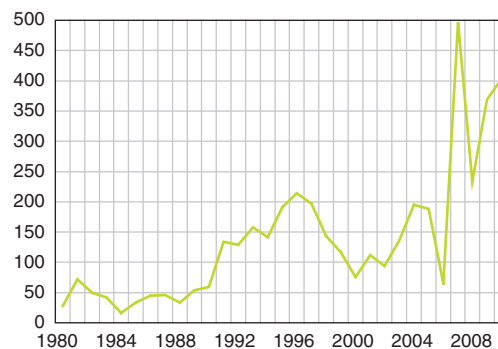
The following graphs show the accelerated expansion of net capital inflows to developing countries and most specifically of private capital flows as net official flows –bilateral and multilateral– not only lost importance but in several years actually became negative. The process was facilitated by the measures of financial account liberalisation undertaken by the developing countries. But as more than one study has argued the “push” factors in major financial centres are much more important than the “pull” factor of policies in the receiving country.⁹

2|2 The instability of capital flows and the “boom-bust” cycles in developing countries

But what also stands out under examination of the performance of capital flows to developing countries is their instability. Particularly unstable are official flows, on the one hand, and private flows other than foreign direct investment. The sheer fact that capital flows show such a degree of instability underlines the fact that they are not driven by policy errors in the receiving countries as many observers would like us to believe. If such would be the case differences in

Chart 4
Emerging markets and developing countries
Net capital inflows

(USD billions)



Source: IMF, WEO Database, October 2010.

cyclical position and policy mistakes in the different countries would cancel each other out. Therefore, “push” factors are driving net capital flows from developed to developing countries to a great extent connected to financial conditions in the mature economies.

In fact, to a certain degree capital flows tend to be countercyclical vis-a-vis the performance of the source economies. On the downside of the cycle with interest rates at low levels both due to a dearth of opportunities for investment but also as a consequence of the attempt by monetary authorities to stimulate activity, low interest rates “push” investors to search for more profitable placements, the nowadays so-called “carry-trade”, like under quantitative easing 2 (QE2) in the United States right now. The contrary happens at the top of the cycle.¹⁰ Additionally, capital flows have shown to be pro-cyclical, i.e., rather than smoothing income and consumption in the receiving country, they do the contrary.¹¹

⁸ See McKinsey Global Institute (October 2008), op.cit., Exhibit 4 and (January 2008), op.cit., Exhibit 3.2.

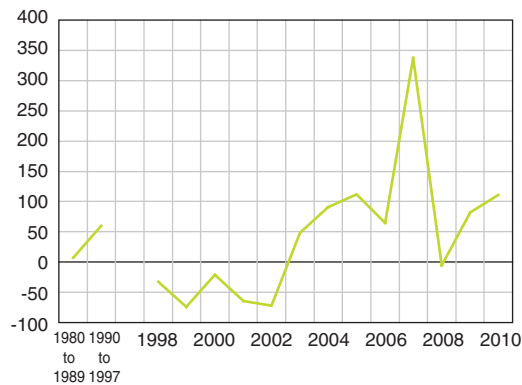
⁹ For a contribution summarising and reformulating other studies on “push” vis-a-vis “pull” factors in the determination of capital flows to developing countries, see Ferrucci, Herzberg, Soussa and Taylor: “Understanding capital flows to emerging market economies”, in Bank of England Financial Stability Review, June 2004. Their conclusion was: “The main lesson to be drawn is that banking flows and bond spreads are both significantly influenced by push factors, although banking flows relatively less so, possibly due to the nature of the bank-borrower relationship. This implies a need for caution by developing countries in borrowing too heavily during times of a benign external financing environment, as a reversal in credit conditions is more often than not beyond the control of the borrower”. “...it is important to bear in mind that what is a sustainable level of leverage during good times is potentially unsustainable over a longer horizon, regardless of the creditworthiness of the borrower”.

¹⁰ See, for instance, Suter, op.cit. or Pettis: “The volatility machine”, OUP (2001), especially Chap. 4 “180 years of liquidity expansion and international lending”. The first Secretary General of UNCTAD, Raúl Prebisch, had already detected such a pattern in the 1920s in the case of an Emerging Market of that era, i.e., Argentina. In various issues of the “Economic Review” of the Banco de la Nación Argentina in the years 1928 to 1929, Prebisch describes, for instance, how the “boom” in Wall Street and the tight monetary policy introduced by the Federal Reserve to cope with that era of “irrational exuberance” had driven funds away from the Argentine market that had entered in a previous period of easier money conditions in the United States. Moreover, Prebisch argued that the volatility of capital flows was one of the two main driving forces behind the “Argentine economic cycle”, the other one being the behaviour of exports.

¹¹ See, for instance, Lane: “Do international investment income flows smooth income?” Trinity College Dublin and CEPR (May 2001).

Chart 5
Emerging markets and developing countries
Net private capital inflows excluding foreign direct investment

(USD billions)



Source: IMF WEO Database, October 2010.

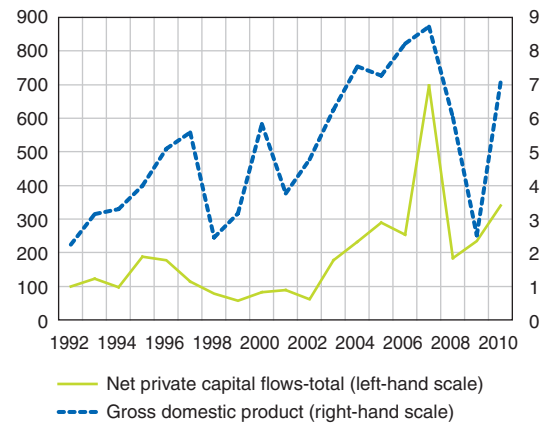
The above behaviour leads to a well established boom-and-bust cycle in developing countries dominated by “push” factors associated with the instability of capital inflows responding to the domestic cycles of the major advanced economies.

Responding to such a “push” cycle another one gets established in the developing country that acquires some independence vis-a-vis the first one. During the first phase, driven mainly by events in international markets –although also influenced by a shift to “market-friendly” policies in the developing countries– private capital starts flowing to these far-away lands. Those inflows simultaneously add to demand and provide the wherewithal –in terms of foreign currency– to start an economic expansion. In an environment of growth, government revenues increase and price stability is achieved with more ease, most specifically as the easy availability of foreign finance tends to depress –viewed from the “pesos” per foreign currency ratio– the exchange rate, a crucial element of price pressures in those economies. A virtuous cycle looks like having been instituted.

Chart 6
Emerging and developing countries
Net capital inflows and GDP rates of growth

(USD billions)

(at constant prices, % rates of growth)



Source: IMF, WEO Database, by country groups, October 2010.

Fragilities, however, accumulate through trade deficits, foreign indebtedness and an exchange rate that puts the tradable goods sectors at a disadvantage.

A sudden “rationing” of capital flows and/or the increase in “country risk” spreads, results in less growth and declining government revenues. Higher interest rates and lower growth rates determine a reduced debt sustainability requiring –at high levels of indebtedness– larger and larger primary and/or trade surpluses, to avoid an explosive increase in, respectively, public or external debt ratios to GDP. Reduced debt sustainability calculations lead to further rationing and higher interest rates. The country is forced to undergo a drastic macroeconomic adjustment. The crisis has set in. Notice that even if the beginning of such a cycle got support from the “push” cycle originated in the advanced economies, the crisis in this case does not necessarily require an increase in international interest rates.¹² Once it gets started it is an endogenous process, in the final phase capital outflow responding more to the circumstances of the developing country economy than to international phenomena.¹³

12 Although, for instance, the increases in interest rates in the United States at the end of 1970s and beginning of 1980s and, again, in early 1994, had a lot to do with the following crises, the first one, almost only in Latin America and the second, first in Mexico and then extended to a whole series in Asia, Russia and Latin America.

13 See, for instance, “When it rains it pours: Procyclical capital flows and macroeconomic policies” by Kaminsky, Reinhart and Vegh, NBER Working Paper No. 10780, September 2004. Their conclusions are: 1. that net capital inflows are pro-cyclical (vis-a-vis the borrowing countries including OECD countries and not only for EMEs), 2. that fiscal and monetary policies in developing countries are also pro-cyclical and 3. that periods of large capital inflows are associated with expansionary macroeconomic policies and the contrary happens in periods of capital outflows.

Several mechanisms could explain the pernicious effects of instability on growth. One key channel could be the negative effect on “animal spirits” discouraging firms to expand their investment in more output capacity. Instability also could lead to restrictions on access to long-term finance necessary for development projects. On the whole, in the words of Kose and Prasad, financial integration “seems to strengthen the negative relationship between growth and volatility”.¹⁴

2|3 Financial inflows and growth in developing countries

More in general, however, the relationship between financial opening up or between capital inflows and growth, beyond indirect effects via instability has seriously been put into question. From doubts about a positive effect to the conclusion that there might be a negative effect of capital inflows for growth, the literature has made significant progress in the years previous to the present-day crisis.

Already, back in the 1990's Jagdish Bhagwati had insisted in the fact there were no theoretical grounds –equivalent to those that applied to international trade– to support the view that financial opening-up was good for growth.¹⁵ But then Rogoff *et al.* at the

Research Department of the IMF and again, in a first version, Raghuram Rajan, from the same position, were some of the authors of a stream of papers showing that capital inflows could not necessarily be good for growth, in fact, in the case of Rajan and his co-authors, actually deleterious to growth. Additionally, Professor Aizenman at the University of California would show that self-financing was associated with high rates of growth. In the two last cases, and in that of other less well-known authors, running a current account surplus –paradoxically for traditional thinking on the subject– was shown to be good for growth.¹⁶

The experience of the series of crises involving almost all latitudes of the world and the conclusions of the above mentioned studies, led to the conviction, for more than one government and sector of public opinion that financial liberalisation was a force for instability and not for growth.¹⁷ Consequently, developing countries rather than running current account deficits and financing them with inflows of capital –as had been the case over the previous almost two decades of financial globalisation– had to the contrary been trying –not always successfully– to avoid running deficits. It was found rather preferable to run surpluses and to keep capital inflows at bay, particularly those not associated with foreign direct investment. To put it into a nutshell, many countries opted for an “export-led” strategy instead of a “debt-led” one.

14 See Box 2.3. “Why is volatility harmful?” in “Output volatility in emerging market and developing countries” a section of Chap. II “Two current issues facing developing countries” of International Monetary Fund World Economic Outlook, April 2005. The preoccupation with negative effects of instability is rather recent in conventional literature and it runs against conclusions of Lucas: “Models of business cycles”, 1987 welfare costs of fluctuations being minor in his opinion. See also Kose, Prasad and Terrones “Growth and volatility in an era of globalisation”, IMF Staff Papers, Vol. 52, Special Issue, 2005. In their view trade and financial integration could have significant effects on the instability of the developing economies.

15 See his “The capital myth: the difference between trade in widgets and dollars” by Jagdish N. Bhagwati, Foreign Affairs, May/June 1998. Bhagwati, paraphrasing the farewell speech of Gral. Eisenhower as President of the United States, concocted the expression the “Wall Street-Treasury Complex” to depict what he thought was the way the IMF was governed.

16 See “Effects of financial globalisation on developing countries: some empirical evidence” by Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose, IMF, March 17, 2003. This report was discussed at the Fund in an IMF Economic Forum at which three of the authors were present (Prasad, Rogoff and Wei) plus C. Fred Bergsten –from the Washington Institute of International Economics– Jeffrey Frankel –from the Kennedy School of Government at Harvard University– and Prof. Daniel Tarullo, from the Georgetown University Law Center (presently Member of the Board of the Federal Reserve System); see the transcript in “Is financial globalisation harmful for developing countries?” Washington, D.C., May 27, 2003. If anything the discussants reinforced the report's conclusions. Bergsten made the point that a confusion between domestic financial liberalisation and financial account openness had become too habitual, with the former bringing in unmitigated benefits while the latter not having shown to be particularly positive. Frankel also came in favouring some kind of restrictions on capital movements à la Chile. From the same IMF Research Department see “The elusive gains from international financial integration”, prepared by Gourinchas and Jeanne, IMF Working Paper, WP 04/74, May 2004. In their estimate the gains between total financial autarchy and perfect capital mobility could be of the order of a permanent 1 per cent increase in consumption. For Prof. Aizenman contribution see Aizenman: “Financial liberalisations in Latin America in the 1990s: an assessment”, Economic Journal, 2005, pp. 959-983, where a positive relation is established between self-financing and growth and also for his previous paper where the methodology of the self-financing coefficient is developed, see a paper prepared for the World Bank, Aizenman, Pinto and Radziwill “Sources for financing domestic capital- is foreign saving a viable option for developing countries?”, April 2005. For Rajan and his colleagues, see Prasad, Rajan and Subramanian: “Foreign capital and economic growth” in Brookings Papers on Economic Activity, Nov.2007. Moreover, Prof. Stiglitz had commented on the Rogoff et al. paper in his “Capital market liberalisation, globalisation and the IMF”, Oxford Review of Economic Policy, Vol. 20, No. 11 (2004), questioning how come it had been a surprise for the authors to find out that liberalisation of capital inflows was not a necessary neither a sufficient condition for growth.

17 In fact, due to the Asian crisis, the IMF stopped to discuss a change in its Articles of Agreement that would have made compulsory to liberalise capital flows for all member countries, in an equal footing to current account transactions.

2|4 The US deficit and the “exorbitant privilege” as a reserve currency issuer

Resort to private international financial markets to finance current account deficits, therefore, became less attractive. But there was one exception and not precisely that of a developing country, e.g., the United States. In this case, deficits could be financed by issuing what remained, even after the breakdown of the Bretton Woods system, as the single, by far, most important “reserve currency” in the world economy.

In fact, for the world at large, as may be gathered from the following graph, the proportion of the US dollar in foreign exchange reserves lies between 60 and 65 per cent. For advanced countries this proportion even increased during the first phase of the present-day crisis, from the last quarter of 2007 to the first quarter of 2009.

Consequently, for the United States –the crisis unleashed– there was none of the habitual run against the currency as in the case of other countries or even under its own early 1970's troubles. On the contrary over several quarters there was a “run towards” the US dollar, the so-called “flight-to-quality”, in spite of serious difficulties in the financial sector as well as the presence, even if reduced, of the well-known external deficit. The US government and their monetary authorities, therefore, could enjoy the privilege of fighting the crisis with substantial

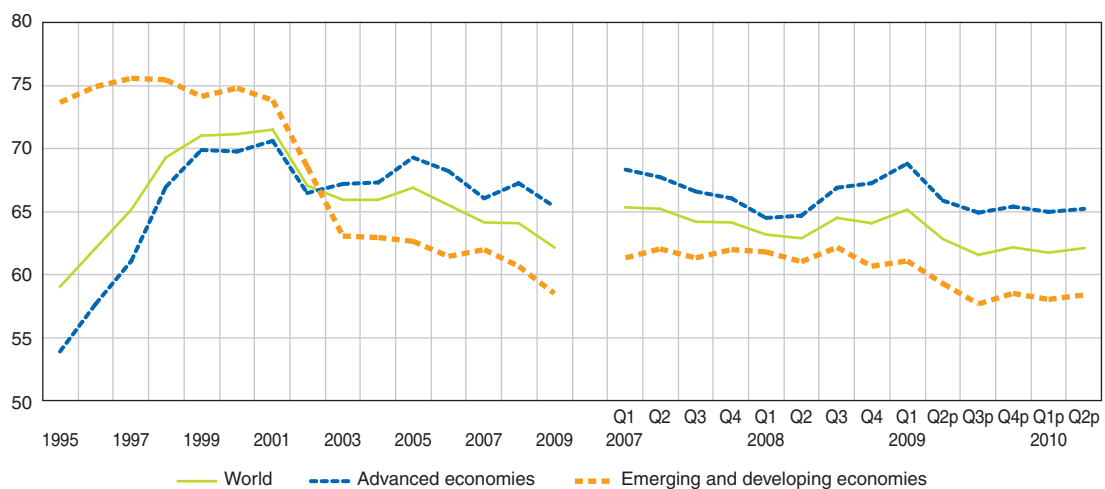
monetary expansion and a significant increase in fiscal deficits, something that the rest of the countries running deficits could never have imagined. Moreover, the latter would never have been allowed by the IMF to take such measures under Fund-supported programmes or access to their “facilities”.

The episode just confirms one more side of the “exorbitant privilege” that has allowed the United States to run year after year –even under crisis conditions– considerable external deficits. Such a condition accounts to a significant degree for the persistence and increasing magnitude of the “global imbalances” problem. As long as the currency of a single country remains being the “dominant” reserve currency, for the world at large, external deficits both become unavoidable and at the same time a potential fulcrum for crises dominated by current account reversals (the famous Triffin paradox), if the “flight-to-quality” process at some point reaches exhaustion.

If one would try to extrapolate some trends, a look at what is happening with the composition of the foreign exchange reserves of the fast growing developing countries, would point towards that potentiality possibly becoming actual. In fact, the proportion of US dollars in their foreign exchange reserves has been following a deep downward trend. Additionally, in their case there was little of the “reverse run” vis-a-vis the USD during the crisis as it was the case with advanced economies.

Chart 7
Proportion of USD in allocated foreign exchange reserves

(%)



p: preliminary data

Source: IMF, COFER, November 2010.

To summarise, financial globalisation, the other side of the coin of deficits in current account, providing an apparently easy way to balance them, had proved to be a force for instability and against growth for developing countries. On the contrary, experience has shown that running surpluses in current account is a force for growth. In the following we will be showing the way in which such a process has asserted itself.

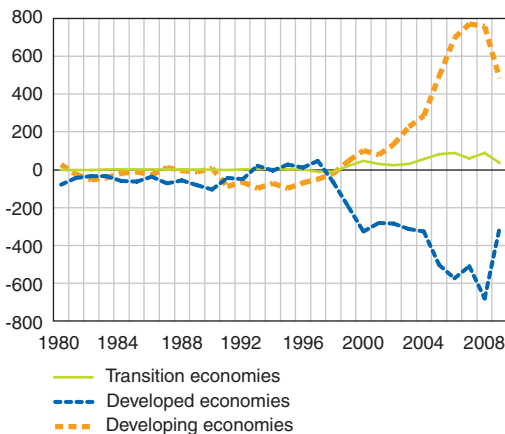
3| DEVELOPING COUNTRIES: SURPLUSES IN CURRENT ACCOUNT AS AN INSTRUMENT OF GROWTH STRATEGY AND THE POLICIES TO SUSTAIN THEM

3|1 The shift in current accounts, the reduction in indebtedness and the accumulation of foreign exchange reserves

In the following graph, the shift in the current accounts of the developing countries comes out very clearly. However, it is less than a generalised circumstance as, for instance, among those countries, there are several major ones as Brazil and India, that keep running a deficit.

Chart 8
Current account balances

(USD billions)

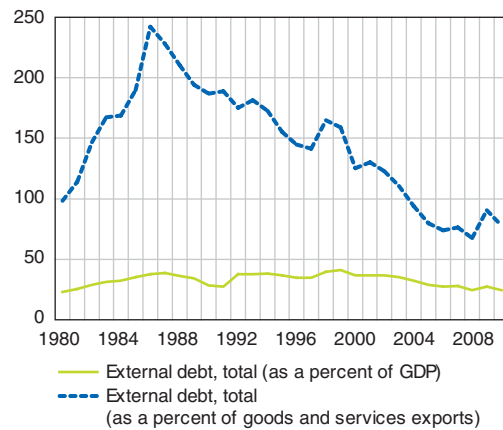


Source: UNCTAD, UNCTADSTAT, *Economic Trends, Balance of payments, current account, net, 1980-2009.*

Surpluses, as may be gathered by the following two graphs, have resulted in a significant decline in external debt levels, which in our country is called a “disindebtedness” strategy. As to external debt levels, for developing countries in the aggregate, the highest points were reached, respectively, in 1998 and 1999 (165% of exports in 1998 and 41% of GDP in 1999). They now –2010– stand at 78 and 25 per cent.

Chart 9
Emerging and developing countries
External debt, total as a proportion of GDP
and of exports of goods and services

(%)



Source: IMF, WEO Database, by regions, October 2010.

Chart 10
Emerging and developing countries
External debt, total debt service as a proportion of GDP
and of exports of goods and services

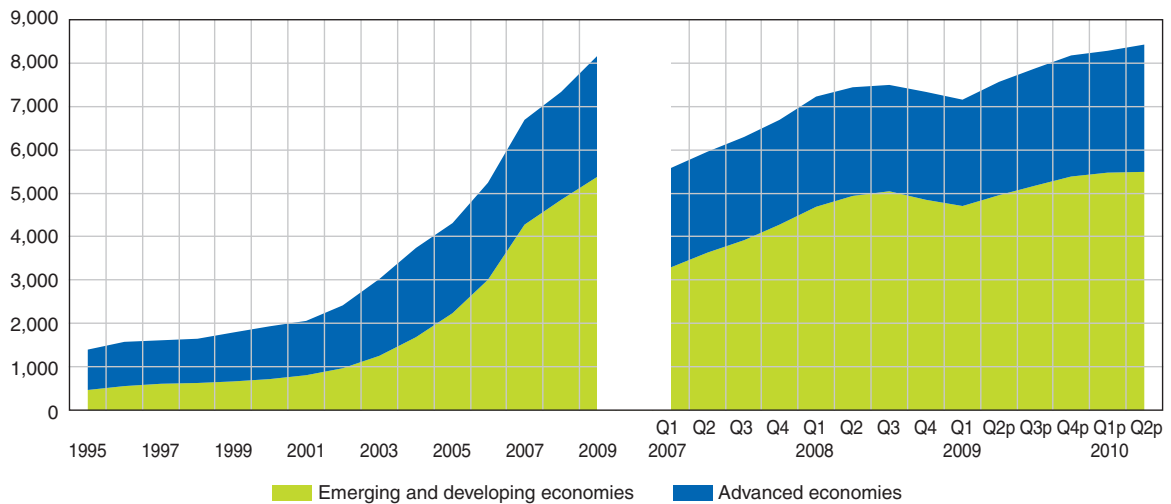
(%)



Source: IMF, WEO Database, by regions, October 2010.

Chart 11
Foreign exchange reserves: distribution between advanced and developing countries

(USD billions)



p: preliminary data

Source: IMF, COFER, November 2010.

As to debt service, the highest points were reached, respectively, in 1999 and 2002 (40% of exports in 1999 and 25% of GDP in 2002) while nowadays those figures stand at 26 and 8 per cent.¹⁸

The shift into surpluses by developing countries, also, has resulted in considerable accumulation of foreign exchange reserves. Between 1995 and 2009 foreign exchange reserves of developing countries expanded from USD 458 billion to USD 5.394 billion and from a third to two thirds of world foreign exchange reserves.

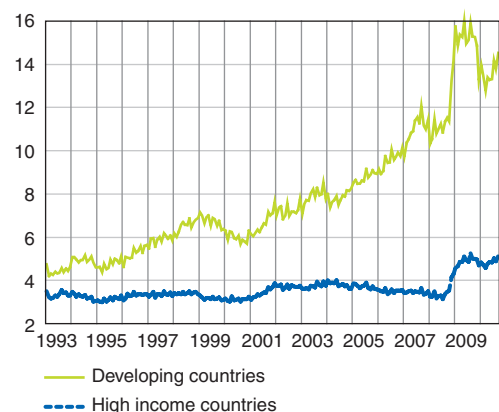
As argued by Rodrik, the foreign exchange reserve accumulation is not due to trade opening as the advanced countries, very much involved in trade liberalisation, have kept holding an equivalent of 2 to 4 months of imports, with some increase in the last two years. While in the case of developing countries, reserves are now equivalent to about 14 months of imports up from the same level as that of the advanced countries 30 years before as may be gathered from the following graph.¹⁹

In the case of developing countries, accumulation of foreign exchange reserves could be a policy target pursued on its own for pure prudential

purposes. In a world of high volatility of capital flows and moreover of foreign exchange receipts arising out of trade balances under the influence of significant shifts in prices and sometimes even in quantities depending on the vagaries of the weather, accumulating foreign exchange reserves could be a reasonable policy of preparation for a “rainy day”.

Chart 12
Foreign exchange reserves months import cover

(in months)



Source: IMF WEO Database, by country groups, October 2010.

¹⁸ Comparisons with a majority of the advanced countries would take us too far away from the main line of argument.

¹⁹ See Rodrik, (2006): “The social cost of foreign exchange reserves”, January, NBERw11952.

Moreover, as most countries have found IMF recipes for adjustment far away from what in their view –and that of a significant section of academic opinion– was adequate to sort out their problems under crises, accumulation of foreign exchange reserves becomes a way to self-insure against unexpected shocks.²⁰

As long as financial flows to developing countries continue to be ridden by instability and that resort to the IMF is to be avoided on grounds of quantitative restrictions and misplaced “conditionality”, accumulation of foreign exchange reserves is a powerful instrument of self-insurance as it was proved under the present-day crisis.

3|2 The exchange rate policy

The export-led strategy endlessly recommended as the one to be followed by developing countries has added an additional element to the accumulation of foreign exchange reserves. Many developing countries having opted for such a strategy of entering into foreign markets with not only primary produce but also with recently acquired capacities to produce ever more sophisticated manufacturing goods, realised –something already well-known 50 years before– that their exchange rates should not become overvalued. Overvaluation could be a consequence of the well-known “Dutch disease” for countries that traditionally had been primary products exporters but additionally the result of being on the receiving end of the “carry-trade” during the “push” phase of capital flows from advanced countries.

In cyclical terms, as already mentioned, once a phase of overvaluation has begun soon the country runs

external deficits and foreign obligations accumulate. The end of the process has always been a crisis either because of a shift in financial markets in advanced countries or by the sheer accumulation of external obligations.

Consequently an active policy to combat overvaluation of the exchange rate has become more widespread, combined, in a few cases, with the introduction of some form of controls against short-term capital inflows.

No doubt, exchange rate policy remains an area of controversy and shifting opinions set against a background of changes in the actual regimes put into practice by the different countries and again in a world context that has experienced significant transformations. On the whole, *de jure*, but more importantly *de facto* most countries have gone over from the fixed exchange rate system under Bretton Woods to some form of “managed floating”, the so-called “middle” regimes.

The problem with exchange rates and most specifically in the case of developing countries, is that they are simultaneously the most important price for financial markets and for foreign trade at the same time (and the domestic price level). The workings of financial markets make for it to be the most unstable price while the consequences of such instability in terms of price signals for the “real” economy are far from positive even if hedging for short-run purposes could be eventually developed.²¹

Moreover, the conclusion was drawn that due to such instability, if capital movements are free, there is no real monetary policy autonomy under flexible exchange rates, a situation having been baptised

20 See Aizenman: “International reserves” *The Palgrave Dictionary, new edition* (2005) and also Aizenman and Lee: “International reserves: precautionary versus mercantilist views, theory and evidence”, mimeo (August 2005). For earlier contributions see Ben-Bassat and Gottlieb: “Optimal international reserves and sovereign risk”, *Journal of International Economics*, 33 (1992). An even earlier attempt at estimating optimal level of reserves was that of Heller: “Optimal international reserves”, *Economic Journal*, 76 (1966).

21 In the words of Cooper, in his “Exchange rate choices” (June 1999): “... movements in exchange rates, while providing a useful shock absorber for real disturbances to the world economy, are also a substantial source of uncertainty for trade and capital formation, the wellsprings of economic progress” (underlined in the original). Cooper, in this same piece, also strongly criticises Harry G. Johnson strenuous advocacy of floating exchange rates a few decades ago: “He (Harry G. Johnson) demonstrates a charming faith in the ability of private markets to get the exchange rate right, and to keep it there” and goes on to criticise his various assertions on which the case for floating rates were based, e.g., that the foreign exchange market was as any other one small relative to the size of the economy, that it was a stable market, that the exchange rate movements would be dominated by inflation differentials and that the market would develop the necessary hedging instruments. Work by Obstfeld, jointly with Rogoff, has shown that the cost of floating could be of the order of 1% of GDP under fairly restrictive conditions for risk aversion; see Obstfeld and Rogoff: “Risk and exchange rates”, NBER Working Paper No. 6694 (August 1998) and also Aghion, Bacchetta, Rancière and Rogoff, developed a model and tested it over an 83 country data set spanning the years 1960-2000 showing that but for countries in a very advanced level of financial development –as measured by the ratio of private credit to GDP– exchange rate volatility reduces growth; see Aghion, Bacchetta, Rancière and Rogoff: “Exchange rate volatility and productivity growth: the role of financial development”, NBER Working Paper No. 12117 (March 2006).

as the “impossible duality” rather than Mundell’s impossible trinity.²²

Making room for an autonomous policy therefore, implies introducing controls on at least short-term capital movements –an issue that will be addressed later– and avoiding floating exchange rates. But then what would be the appropriate exchange rate regime for a developing country intended on enhancing growth but not relying on “foreign savings”, or if at all in a most cautious way?

The exchange rate regime, non-floating so as to deliver a degree of autonomy for monetary policy, should at the same time be such that it promotes exports, most especially non-traditional exports and additionally a small surplus on trade and real services balance to ensure service of a low degree of indebtedness and FDI. An answer, for instance, has been offered by John Williamson, i.e. the crucial element for developing such a “real” external positive balance is that of maintaining a competitive real effective exchange rate (REER) level, in his words a “development strategy approach” to an exchange rate regime.²³

Further contributions to the debate on the right exchange rate policy for developing countries have later been made. Professor Dani Rodrik has quite convincingly argued that an undervalued exchange rate leads to much faster growth by examining a large sample of developing countries over the 1950–2004 period. Professor Rodrik argument revolves around breaking down externalities that do not allow

for faster growth in the traded-goods, especially in the non-traditional sector; overvaluation, instead, dampening growth.²⁴ And in a recent IMF working paper by Andrew Berg and Yanliang Mao, using a different definition of deviation from “equilibrium” exchange rates, on the whole, the same conclusion is reached.²⁵

Of course, one could easily point out that a “fallacy of composition” is involved if all countries in the world aim at exchange rate targets, i.e., there are only $n-1$ degrees of freedom to set the exchange rates of the n countries in the world. The above reasoning boils down to the fact that in a very basic sense there is an interphase between the international trade and financial systems. Developing countries would need the more advanced countries to accept adopting exchange rates so that their “real external surpluses” could be accommodated. This, in turn, means accepting an aggregate import surplus, something that, bearing in mind the either surplus or low negative Net international investment position of the advanced economies, would be far from impossible in balance of payments terms. Otherwise the present-day dynamic role of developing countries could be coming to a halt.

3|3 The introduction of capital controls

After the examination of the effects of financial liberalisation, an obvious conclusion comes to one’s mind, i.e., a first way to gain autonomy –“policy space”– from the instability of world financial markets –and its negative effects on both instability and growth

22 See Cooper, op.cit. “...free movements of capital and floating exchange rates are basically incompatible...of course, free movements of capital are also incompatible with fixed but adjustable exchange rates...they (countries) may reasonably choose to preserve the right to control at least certain kinds of capital movements into and out of their jurisdictions, in the interests of reducing both nominal and real exchange variability” quoting himself in the “Should capital controls be banished?”, op.cit. The “impossible duality” expression is coined in Flassbeck: “The exchange rate: economic policy tool or market price?”, UNCTAD Discussion Papers No. 157, Geneva (November 2001).

For a predecessor advocating the need for exchange controls to gain monetary policy autonomy one could look back to the 1930s and the opinions of the First Secretary General of UNCTAD, Raul Prebisch, at that time General Manager of the newly created Central Bank of Argentina. Prebisch –who always had thought of himself as an orthodox economist– ended up defending the exchange control system that had been instituted in September 1931. In his view, exchange controls were absolutely necessary in order to be able to introduce a “national monetary policy” that would gain some autonomy for the country from world forces beyond her control, echoes, maybe, of the “managed money” advocacy by Keynes. Exchange controls were considered by him as a mechanism only for the financial sphere and not –at least in his writings– as an element of protectionism for the country’s produce. For that, Argentina –he said– must have her own customs policy; otherwise it would be imposed by the great powers. See O’Connell: “The return of vulnerability and Raul Prebisch’s early thinking on the ‘Argentine Business Cycle’”, ECLA Review No. 75 (December 2001).

23 See Williamson: “Exchange rate policy and development”, Initiative for policy dialogue, Barcelona, June 2, 2003. The author, however, assigns the paternity of the idea to Bela Balassa and mentions that Max Corden somewhat derogatorily had labelled this approach as “exchange rate protection”.

24 See Rodrik: “The real exchange rate and economic growth”, Brookings Papers on Economic Activity (2008), 2, pp.365-412. In Prof. Rodrik contribution the undervaluation is relative to a PPP level after adjusting for per capita income to take into account the Balassa-Samuels effect.

25 See Berg and Mao: “The real exchange rate and growth revisited: the Washington consensus strikes back?”, IMF Working Paper, WP/10/58, March 2010. Berg and Mao use a definition of “Fundamental equilibrium exchange rate”(FEER) bringing in terms of trade, government consumption (as a share of GDP), investment (also as a share of GDP) and openness and, therefore, under-or-overvaluations are referred to that rate.

of developing countries– is to introduce some system of administration of capital flows. Additionally, according to the well-known Mundell trilemma, the adoption of some form of capital controls allows a country to have an exchange rate policy without having to relinquish autonomy over monetary policy.²⁶ Curiously enough, such a device even if not extremely popular in policy circles is within the formal “rules of the game”. As a matter of fact, the articles of agreement of the International Monetary Fund do allow for the introduction of capital controls.²⁷

In a contribution surveying about 30 empirical studies of the effects of capital controls, four reasons are offered for their introduction. First, avoiding exchange rate appreciation that would reduce competitiveness. Second, avoiding an accumulation of “hot money” ready to leave the country at the first perceived sign of difficulties. Third, avoiding too large inflows that might generate asset price bubbles and overconsumption as well as dislocations in the financial system and, fourth, avoiding the loss of monetary autonomy.²⁸

Several types of capital controls have been applied or suggested. Within policy-circles as well as the academic ones little sympathy has been shown for administrative-type of capital controls that in many advanced countries were only dismantled in the last two decades. There is also an overwhelming opinion that capital controls are better applied to inflows rather than to outflows and, in the extreme case when the latter are applied, they should basically be temporary. There is however no unanimity on these matters.²⁹

The better known and most widely accepted form of capital controls was the application of an “uncompensated reserve requirement” (URR) to some or all capital inflows, i.e., to sterilise a significant proportion of the inflow in a non-interest bearing deposit, making it less profitable to play with short-term capital movements. Such an instrument was applied by Chile in the 1990s and by Argentina in this last decade beginning in 2005. Capital inflow surges –and the ensuing accumulation of fragilities could thus be tempered– and “policy space” for fiscal and monetary policy would be earned. Minimum stay requirements could also be imposed or as in Colombia, inflows to invest in real-estate and portfolio investment could be prohibited to reduce volatility of capital flows and asset price bubbles.

Another measure to dampen down capital inflows would be to tax them; and, in fact, such an instrument was alternatively applied in the case of Chile and, again, presently by Brazil.³⁰ Or a tax on capital outflows, enough to make short-term speculation unprofitable could also be introduced.

The conclusion from the already mentioned paper by Magud and Reinhart is that controls on capital inflows have succeeded in making monetary policy more independent, reduce the pressure on exchange rates and alter the composition of capital flows towards the longer-term variety. Their total volume, however, seems to have gone unaffected.

On the other hand, there is a widespread consensus that controls end up being circumvented but,

26 As more than one author –most prominently John Williamson– has underlined the trilemma strictures have been over-dramatised by conveying the wrong idea that only “corner” solutions to it are possible, i.e., that there are no possible combinations of some degree of autonomy over the three elements.

27 Art. VI (Capital Transfers) Section 3 (Controls of Capital Transfers) states “Members may exercise such controls as are necessary to regulate international capital movements...”. The crisis in Asia stopped short a very active attempt to actually reform these provisions and make it compulsory for Fund members to liberalise capital movements in parallel to the very basic obligation not to restrain current account transactions vested in Article VIII (General Obligations of Members), Section 2 (Avoidance of restrictions on current payments). In fact, the same article VI, Section 1 a) of the IMF Articles of Agreement states that “A member may not use the Fund’s general resources to meet a large or sustained outflow of capital...” a prescription that has been somewhat overlooked under the 21st century crises –in Mr. Camdessus words– hitting the financial account of Mexico, first, and various other countries thereafter. It was precisely the modification of this article that the IMF was discussing when the Asian crisis exploded.

28 See Magud and Reinhart: “Capital controls: An evaluation”, NBER Working Paper 11973, January 2006; the authors rather than using the word “avoidance” use the term “fear”, maybe in the tradition of Carmen Reinhart jointly with Guillermo Calvo of the “fear of floating” vision; see Calvo and Reinhart: “Fear of Floating”, *Quarterly Journal of Economics*, Vol. CXVII, Issue 2, May 2002.

29 See, for instance, Epstein, Grabel and Jomo: “Capital management techniques in developing countries”, January 2004. These authors dismiss four habitual criticisms against capital controls on the basis of what has been the experience of Chile, Colombia, Malaysia and Singapore. In their opinion, there is no justification to believe that i) capital controls only work in the “short-run” (not the case of Singapore), ii) that they have to keep being ever more restrictive (not the case of Chile, for instance), iii) that they only work as to inflows but not as to outflows (the case of Malaysia –to which I would add that of Korea that had severe controls on outflows without making them as explicit as in the first case– shows that controls on outflows could be quite effective to gain “policy space” under the crisis of 1997-1998) or iv) that microeconomic costs –most specifically on small firms– could be significant to the point of negating their advantages.

30 A proposal, also, has been floated to introduce a tax on all receipts of foreign exchange and return it to exporters via the VAT rebate system and to those earning income from abroad through the income tax system. This tax would be levied by financial institutions on all and any receipt of foreign exchange on a withholding basis. See Zee: “Retarding short-term capital inflows through a withholding tax”, IMF WP/00/40, March 2000.

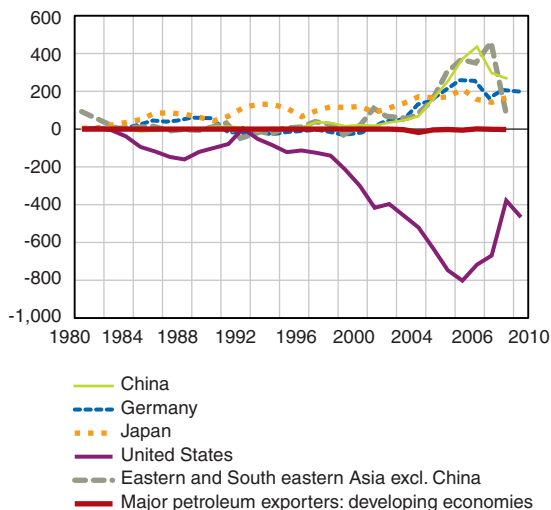
as Richard Cooper has argued, the presence of significant margins are witness to some of their effectiveness.³¹ As Stiglitz has put it, a dam might have leakages but it would still avoid massive flooding of the valley below.

4| DEVELOPING COUNTRIES AS THE “LOCOMOTIVE” OF THE WORLD ECONOMY VIS-A-VIS THE ROLE OF SOME OF THE ADVANCED SURPLUS COUNTRIES

With the aim of preserving themselves of the vagaries of the international financial markets or as a consequence of avoiding the overvaluation of their currencies, developing countries in the aggregate –but as mentioned before not all of them– have become countries generating a surplus on current account. But, as it is illustrated in the following graph, besides some of the developing countries and regions having had a surplus on current account, Germany and Japan, also show sizable surpluses. In fact, their surpluses have kept growing in the last years, while

Chart 13
Current account balances

(USD billions)



Sources: IMF, WEO, Database, October 2010 and UNCTAD, UNCTADSTAT, Economic trends, Balance of payments in current account, 1980-2009.

³¹ See Cooper: “Should capital controls be banished?” *Brookings Papers on Economic Activity*, 1, Washington, D.C., 1999.

³² For China its surplus in current account that was almost USD 372 billion in 2007 fell to USD 297 billion in 2009 and will additionally drop to an estimated USD 270 billions in 2010. For Germany and Japan, on the other hand, even if their joint surplus also decreased from USD 464.7 billion in 2007 to USD 305 billion in 2009, it is estimated to go up to USD 366.5 billion in 2010. Source: IMF, WEO, Database, by country, October 2010.

there has been a decline in those of China and of the oil exporting developing countries.³²

The difference, however, between the developing countries and the major advanced countries in surplus is that developing countries are growing fast having become the fundamental dynamic force in the world economy while those other countries in surplus are trailing behind.

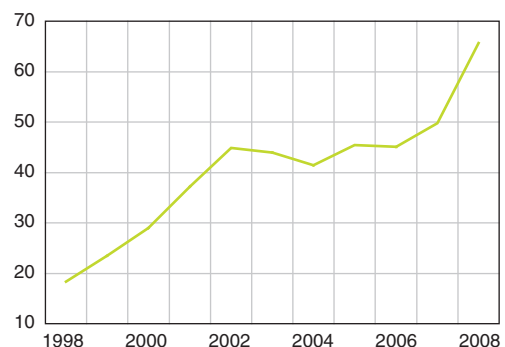
The contrast is clear. Over the period between 1998 and 2009, while developing economies grew by 175 per cent, Germany and Japan, the main advanced surplus countries, only increased their real GDP by, respectively, 10.7 and 7.2 per cent.

Moreover, as shown in the following graph in only a 10-year period developing economies went from generating 20 per cent of the increase in world GDP to generate almost 70 per cent of it. In fact, last year, while world GDP decreased, developing economies continued growing.

Developing countries in surplus, differently from the major advanced countries with a positive current account, are, consequently, playing the role of “locomotive” of the world economy, by following policies to achieve fast rates of growth.

Chart 14
Developing economies
Proportion of world growth in real GDP
(at year 2000 prices and exchange rates)

(%)



Source: UNCTAD, UNCTAD Stat, GDP in constant (2000) prices and exchange rates, November 2010.

On the contrary, those advanced surplus countries growing at a languishing pace are reproducing the well-known deflationary bias characteristic of the international system. Differently from deficit countries, they are able to unfettered continue to design their own policies; unfortunately, as revealed by their growth rates, restrictive policies playing beggar-thy-neighbour role on the rest of the world, the only limit being the capacity

of the other countries to finance their deficits and sustain debt accumulation. Deficit countries –among them quite a few developing countries but also lately European countries– continue, instead, to either live under the limits imposed by their amount of foreign exchange reserves or of (the wrong) conditionality-ridden IMF –or of the newly established EU/eurozone– resources forcing them into a deflationary path.

Redressing or at least moderating global imbalances in the coming years would require action at international and domestic levels. But no solution should be at the expense of growth, full employment and social justice.

In the international sphere, a major issue would be that of regulating cross-border capital flows other than foreign direct investment ones so as to curb their volatility, an issue that has almost not been tackled at all in the last years' discussions about financial regulation.

A second issue, would be to work on the reform of the international monetary system so as to provide a means of payment and a reserve currency other than that of a nation or group of nations, thus eliminating not only an "exorbitant privilege" but also a driving force for explosive global imbalances.

A third issue, would be that of designing a system to clear temporary imbalances between surplus and deficit countries less restrictive than the conditionality-ridden International Monetary Fund, with symmetrical obligations for surplus and deficit countries but due attention to differences in growth rates and stage of development.

Fourth, a cooperative arrangement should be struck among the major advanced and developing countries so that the advanced ones should avoid "beggar-thy-neighbour" policies that impart a deflationary bias to the world economy. On the contrary, room would have to be made for the surpluses generated by the export-led strategies of developing countries that have become the "locomotive" of the world economy. Otherwise an endless recessionary phase might be entered.

As long as little or no progress is made in those directions, developing countries should keep trying to generate growth by avoiding overvaluation of their currencies, protecting themselves from the vagaries of international financial markets by introducing financial account controls and self-insuring themselves by accumulating foreign exchange reserves and fighting social inequalities as well as assuring minimal and increasing living standards for all of their citizens attending to their basic needs.