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Imbalances in the International Economy in 2007
Shrawan Nigam

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Shrawan Nigam*

Senior Consultant at Indian Council for Research on International Economic Relations and former Economic Adviser to the Government of India

*"It was the best of times, it was the worst of times,
it was the age of wisdom, it was the age of foolishness,
it was the epoch of belief, it was the epoch of incredulity,
it was the season of Light, it was the season of Darkness,
it was the spring of hope, it was the winter of despair."*

Quotation from 'A Tale of Two Cities', by Charles Dickens

It is said that every cloud has a silver lining. However, the turbulence that is being experienced since August 2007 in global financial markets and in the G-3 economies—United States of America (US), European Union (EU), and Japan—is creating a situation in which every silver lining has a cloud. The turbulence in financial markets and the global imbalances have led to a lot of uncertainty and are expected to result in a slowdown in the global economy owing to the slowdown in the G-3 economies. Fortunately for the global economy, a divergence in growth prospects seems to be emerging between the developed North and the emerging South, with the large developing economies of the South providing the impetus to growth, which till recently was being provided by the US. Though GDP growth in the advanced economies grew by 2.7 per cent in 2007, the world GDP grew by 4.9 per cent buoyed by the emerging and developing economies which grew by 7.9 per cent. Asia continued to grow rapidly and is estimated to have grown by 9.7 per cent in 2007, the highest in two decades. The other developing regions of the world also performed reasonably well. GDP is estimated to have grown by 5.6 per cent in Latin America; by 5.8 per cent in Eastern Europe; by 8.5 per cent in the Commonwealth of Independent States (CIS); by 6.2 per cent in Africa; and by 5.8 per cent in the Middle East. However, in 2008 IMF expects the world economy to grow at a slower pace of 3.7 per cent owing to the slowdown in the G-3 economies, with the US even facing the possibility of a recession. The emerging markets of China and India, which took over the mantle of driving world growth, are also expected to be affected but are still estimated to achieve high rates of growth.

* The opinions expressed in this article are exclusively personal

In spite of the slowdown in the G-3, Asia is expected to grow at over 7.5 per cent in the coming two years. This is because emerging market economies have restructured during the past couple of decades and are now benefiting from the macroeconomic reforms they introduced. Their sustained high rates of growth appear to reflect the effectiveness of these policies. In 2007, according to estimates in IMF's World Economic Outlook (April 2008), China's GDP grew by 11.4 per cent; India's by 9.2 per cent and Russia's by 8.1 per cent. These three countries accounted for half of global growth during the year. Most other developing economies also showed good growth rates but these are under threat owing to the turbulence in the financial markets, particularly of the US, which has got transmitted to the rest of the world. Fortunately for the commodity exporting developing countries of Africa and Latin America, the high growth expected in the rapidly growing large developing countries can be expected to continue to provide growth stimulus to them.

The Global Economy in 2007

The global economy did quite well in 2006, growing by 5.0 per cent, and was initially expected to grow strongly in 2007 as well. Owing to the changed global environment, the World Economic Outlook, April 2008, estimated that the global economy grew at 4.9 per cent as against the earlier estimate in July 2007, of 5.25 per cent. This downward revision and the downside risk for future growth were attributed to the turbulence being experienced in financial markets. The growth estimates were also subject to risks from inflationary pressures, volatile commodity markets—particularly oil, metals and food-grains—reduced capital flows into emerging markets, continued large global imbalances, and increasing protectionism.

Global imbalances in trade and in domestic savings can create situations that disrupt normal market signals and result in unpredictable outcomes. In economic theory, the rational expectation is that in an economy marked by low savings, interest rates will be high. However, owing to the massive flow of savings from the nations of savers, such as China, Japan and the oil producers, to the high-spending low-savers such as the US, interest rates in the US were very low. These low interest rates led to imprudent lending leading up to the sub-prime mortgage crisis in the US, which is now threatening the growth of the world economy.

Sub-prime Crisis

The web of derivatives based on sub-prime loans in the US housing mortgage market, which started to unravel in August 2007, has cast a pall not only over the US economy but over the global economy as a whole. The US banking and financial system is under extreme stress as banks,

structured investment vehicles and home mortgage institutions try to make provisions for a growing mountain of bad and doubtful debts. The decline in house prices could lead to the problem extending beyond the sub-prime loans, as even creditworthy borrowers may seek to dump assets whose values can no longer cover their debts. The negative wealth effect of declining house values and uncertainties about future incomes, can be expected to lead to a reduction in spending in the US and reduced aggregate demand for goods and services.

In mid-2007 the sub-prime crisis appeared to be a domestic problem of the US, but owing to the global linkages of the financial system, it has affected first the other G-3 economies and then the rest of the world. The troubles are no longer confined to the lending institutions but have spread to stock markets and also to the real sectors of the economies. In the US it was but natural for the construction industry to be affected but it has a chain effect—industries producing construction materials, then employment and incomes of workers in the construction and related industries and then the effect of their reduced incomes on the wider economy.

The situation could worsen before it improves, because of the banking sector's provisioning requirement for bad and doubtful debts. The liquidity of banks has been sapped, because of their need to clean their balance sheets, which were forced to shelter the bad and doubtful loans of their investment entities (the so-called structured investment vehicles). The consequent reduction of liquidity in the banking system can also be expected to play its part as companies in need of capital may not be able to easily access bank credit and may be forced to postpone investment decisions.

Possible Slowdown of Imports and Exports

In globally integrated markets, the ripples are felt world-wide. The decline in demand would not be limited to US companies but will also be felt by countries exporting to the US. As the US share of world imports is over 15 per cent (Table 1), it has a direct impact on the whole chain of its suppliers and also, in turn, on the latter's demand for input materials from their suppliers.

Table 1: Share of Selected Countries in Total World Imports (%)

	2001	2002	2003	2004	2005	2006
Argentina	0.32	0.14	0.18	0.24	0.27	0.28
Brazil	0.96	0.78	0.69	0.73	0.75	0.83
Chile	0.28	0.26	0.25	0.26	0.30	0.29
Mexico	2.96	2.88	2.46	2.33	2.27	1.97
Venezuela	0.31	0.20	0.14	0.18	0.22	0.26

Australia	1.05	1.15	1.20	1.20	1.22	1.17
New Zealand	0.21	0.23	0.24	0.24	0.24	0.21
Developing Africa	1.75	1.78	1.92	2.05	2.14	2.25
Developing Asia	17.61	18.34	18.89	19.85	20.36	21.16
China	3.81	4.45	5.32	5.92	6.14	6.37
India	0.92	.89	0.95	1.05	1.25	1.48
Middle East	2.93	3.16	3.14	3.43	3.59	3.57
European Union	38.28	38.38	39.84	39.43	38.13	37.54
Japan	5.46	5.08	4.93	4.80	4.79	4.67
United Kingdom	5.05	5.05	4.94	4.78	4.49	4.40
United States	18.47	18.11	16.81	16.10	16.12	15.45

Source: Direction of Trade, IMF.

The shares of different countries and regions in the imports by the US are shown in Table 2. The countries which have a larger share of their exports going to the US would feel the effects of a cut-back in orders first, while other countries would feel it with a time lag. Thus EU, Japan and Developing Asia-including China, can be expected to be among the first to feel the effects of the slowdown in the US. Japan's exports to the US have been declining but are still a large share of its own exports; in addition, its exports to China, which uses many of these intermediates as inputs for its exports, have been increasing. Consequently, Japan's exports can be expected to fall with a slowdown in US imports. However, in spite of the slowdown, China and India are still expected to experience high rates of growth owing to their large domestic economies.

Table 2: Leading Sources of US imports (%)

	2001	2002	2003	2004	2005	2006
UK	3.59	3.48	3.35	3.13	3.02	2.85
EU	19.81	19.97	20.03	19.17	18.45	17.79
Japan	10.99	10.37	9.29	8.74	8.19	7.93
China	9.27	11.10	12.15	13.80	15.00	15.93
India	0.87	1.04	1.05	1.08	1.15	1.20
Developing Asia	24.56	26.34	27.00	27.74	27.99	28.77

Source: Direction of Trade, IMF.

Current Account Balances

The current account deficits of the US are as famous as the trade surpluses and savings rate of China. The US spends more than it produces and this over-spending is financed by the savings of other countries. On the other hand, potential exporters to China say that it saves too much and, consequently, does not buy enough. In 2006 US consumers spent \$ 857 billion more than they produced, i.e., about 6.5 per cent of GDP. This was possible because of the inflow of foreign savings. China's savings, even after the recent decline continue to be in excess of 40 per cent of GDP (47 per cent of GDP in 2006), and were a major source of funding the US current account deficit, which also benefited from the flow of funds from the oil exporters.

The flow of foreign savings for investment in the US was because foreign investors trusted the US financial sector as being mature and well regulated. However, the sub-prime crisis has shown that the institutions in the US financial sector, including the credit-rating agencies, have feet of clay as they were unable to properly assess the risk of the securities and consistently over-rated them.

The large flow of foreign funds to the US helped in keeping interest rates low there, in spite of negative savings rate, making it easier for sub-prime borrowers to take loans at low interest rates. The IMF had flagged the growing current account imbalances as a matter of concern and, in 2006, finance ministers and central bankers from the G7 group of OECD countries promised to take "vigorous action" to resolve the imbalances between the countries that had high savings (particularly China, Japan and the oil exporters) and those that were large borrowers (especially America). The IMF-sponsored Multi-lateral Consultation on Global Imbalances among China, Japan, Saudi Arabia, the European Union and the US resulted in a number of proposed actions by them. The current account deficit of the US is reported to have declined in 2007 to about 5 per cent of GDP, but this is more because of the slowdown than any conscious action.

But the good times for the over-spenders may not last. China's government, which holds close to a trillion dollars worth of American treasury bonds, has announced that it will create a new investment agency. This sovereign wealth fund is expected to seek a better return on its foreign-exchange reserves and it is only reasonable to expect that this agency will diversify some of China's assets out of American Treasury bonds.

Trade Balance and Exchange Rates

The developing countries, particularly of Asia, have been increasing their share of world trade. As their economies grow they have been a major source of additional demand for commodities, and in the face of supply constraints, have been adding to the upward pressure on global commodity

prices. As most of them are low cost producers, owing to lower nominal wage rates, their exports have been growing rapidly and many of them have burgeoning trade surpluses. The trade surpluses of the oil exporters, as of other primary commodity producers, have of course, benefited from higher world prices occasioned by the surge in demand.

Table 3: Foreign Exchange Reserves of Selected Countries (Billion US\$)

	2001	2002	2003	2004	2005	2006
Australia	18.0	20.7	32.2	35.8	41.9	53.4
New Zealand	3.6	5.0	6.1	6.9	8.9	13.7
Euro Area	234.9	247.2	223.1	212.0	184.7	197.0
Japan	395.2	461.2	663.3	833.9	834.3	879.7
United States	57.6	68.0	74.9	75.9	54.1	54.9
Brazil	35.7	37.7	49.1	52.7	53.6	85.6
China	215.6	291.1	408.2	614.5	821.5	1068.5
India	45.9	67.7	98.9	126.6	131.9	170.7
Mexico	44.7	50.6	59.0	64.1	74.1	76.3
Saudi Arabia	17.6	20.6	22.6	27.3	26.5	27.5
United Arab Emirates	14.1	15.2	15.1	18.5	21.0	27.6
Venezuela	9.2	8.5	16.0	18.4	23.9	29.4
Kuwait	9.9	9.2	7.6	8.2	8.9	12.6
ASEAN-4 (Indonesia, Malaysia, Philippines and Thailand)	102.6	115.7	133.5	162.6	169.5	208.4

Source: International Financial Statistics, IMF.

The trade surplus of China has been targeted by the US and other developed countries as being excessively large. They have been asserting that this is principally because the Yuan is under-valued and have been seeking its revaluation. The Schumer-Graham bill in the US Congress (which was subsequently withdrawn) had proposed a 27.5% across the board import tariff on all Chinese goods to offset the Yuan's alleged under-valuation. It may, however, be mentioned that the Yuan has had an 8 per cent revaluation between 2005 and 2007, while simultaneously the US dollar has had a devaluation of 16 per cent since 2002. The softening of the US dollar, in a period of slowdown, could have a beneficial effect if US exports can grow in its wake while imports decline. This could help in limiting the impact of the slowdown and also reduce the trade balance. Once the US economy's downturn and weaker dollar have reduced the US external imbalance, the economy can be expected to revert to its earlier growth path.

On its part China may need to do more, as its large trade surplus with the US could lead to increasing protectionist measures—a development which is not in anybody's interest. Though US senators, seeking additional protection for domestic products, also need to remember that trade helps the average American. The "cheap" Yuan may be an unfair subsidy for Chinese exporters vis-à-vis competing exporters but the cheap imports subsidize American consumers by lowering prices and increasing their real incomes.

Inflation

The rapid growth of world output has had its impact on commodity prices, particularly of oil, metals and food-grains, which have been rising sharply over the past couple of years. From the point of view of inflation a slowdown could have a dampening effect on commodity prices, which have skyrocketed to unprecedented levels. Over the last year, crude oil has seen a price increase of 68 per cent, coal of 120 per cent, iron ore of 66 per cent and tin of 43 per cent. Prices of food items have also risen at an alarming rate—wheat by 121 per cent, rice by 78 per cent and palm oil by 102 per cent.

While prices of industrial commodities have risen owing to the increase in GDP growth rates, the prices of food items have risen because of improving income levels in low-income countries leading to an increased demand for food items, without a corresponding increase in supply. A reduction in their prices cannot, therefore, be expected merely because of a slowdown in the G-3 economies. The prices of food-grains have risen not only because of the rising demand for food from the new income earners in the developing world, particularly in Asia and Africa, but also because of the growing supply constraint, owing to the diversion of farmlands from food-grain production to the production of crops for bio-fuels.

Rising oil prices and OPEC quotas on crude oil production coupled with concerns for global warming, have led to the promotion and subsidization of bio-fuels. This has turned the terms of trade against food-grains and in favour of crops for bio-fuels. As a consequence, there is a supply side constraint on grain availability leading to an increase in food-grain prices. Rising food and fuel prices are stoking headline inflation in most developing countries as food and fuel constitute a large share of the consumption basket of the lower and middle-income earners in the developing world. The subsidies for bio-fuels are adding to the imbalance between the desire to fill the fuel tanks of cars and the empty stomachs of the world's poor. This has implications particularly for food-grain importing developing countries and their efforts to achieve the millennium development goals (MDG) of poverty reduction.

Capital Flows: FDI, FII and ODA

The major difference between developed and developing countries is in the availability of capital. Developing countries have abundant labour but little capital. The international flow of capital has considerably bridged the investment gap in the emerging economies. But the slowdown in the global economy and the crisis in the financial sector in the developed countries could lead to reduced flow of investments to developing countries. Fortunately, the global flows of private capital in the form of Foreign Direct Investment (FDI) and Foreign Institutional Investment (FII) have dwarfed flows of official development assistance (ODA). The fast growing developing economies, particularly the large ones, are no longer dependent on aid flows in this period of increasing integration of global financial markets and inter-linked supply-chains.

Global FDI has grown strongly in 2004-07, corresponding with the high growth rates in the developing world. According to an estimate by the Economist Intelligence Unit (EIU) after a temporary decline in 2008, investment flows will resume steady growth to reach US\$ 1.6 trillion by 2011:

Table 4: World FDI Flows

Foreign direct investment projections										
(US\$ billion unless otherwise indicated)										
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
World FDI inflows	618.1	563.4	730.2	971.7	1,335.1	1,474.7	1,406.4	1,470.3	1,536.8	1,604.0
% change, year on year	-27.4	-8.8	29.6	33.1	37.4	10.5	-4.6	4.5	4.5	4.4
% of GDP	1.9	1.5	1.8	2.2	2.8	2.8	2.5	2.5	2.4	2.4
FDI inflows to developed countries	421.1	354.6	379.5	546.8	824.4	940.2	879.0	925.5	972.6	1017.3
% change, year on year	-25.2	-15.8	7.0	44.1	50.7	14.0	-6.5	5.3	5.1	4.6
% of GDP	1.7	1.3	1.2	1.7	2.4	2.6	2.3	2.3	2.3	2.4
% of world total	68.1	62.9	52.0	56.3	61.7	63.8	62.5	62.9	63.3	63.4
FDI inflows to emerging markets	197.0	208.9	350.7	424.9	510.7	534.6	527.4	544.8	564.2	586.7
% change, year on year	-31.5	6.0	67.9	21.1	20.2	4.7	-1.3	3.3	3.6	4.0

% of GDP	2.5	2.4	3.4	3.5	3.6	3.3	2.9	2.7	2.6	2.4
% of world total	31.9	37.1	48.0	43.7	38.3	36.2	37.5	37.1	36.7	36.6
World stock of inward FDI	7,185	8,615	9,981	10,455	12,216	13,622	14,955	16,347	17,796	19,307
% change, year on year	11.4	19.9	15.9	4.7	16.9	11.5	9.8	9.3	8.9	8.5
% of GDP	22.1	23.6	24.3	23.6	25.6	25.9	26.5	27.4	28.3	29.0
Developed country stock of inward FDI	5,151	6,246	7,189	7,265	8,510	9,441	10,306	11,216	12,171	13,169
% change, year on year	20.7	21.2	15.1	1.1	17.1	10.9	9.2	8.8	8.5	8.2
% of GDP	20.6	22.2	23.0	22.3	24.9	25.6	26.4	27.8	29.2	30.4
% of world total	71.7	72.5	72.0	69.5	69.7	69.3	68.9	68.6	68.4	68.2
Emerging markets stock of inward FDI	2,034	2,369	2,792	3,189	3,706	4,181	4,649	5,130	5,626	6,139
% change, year on year	-6.8	16.5	17.9	14.2	16.2	12.8	11.2	10.4	9.7	9.1
% of GDP	26.2	27.1	27.2	26.3	26.3	25.7	25.6	25.7	25.6	25.3
% of world total	28.3	27.5	28.0	30.5	30.3	30.7	31.1	31.4	31.6	31.8
Sources: National statistics; IMF; OECD; UNCTAD; all forecasts are from the Economist Intelligence Unit.										

Source: EIU

International flows of capital tend to go to countries that are low risk and economies that are growing rapidly. This is observed in the increased flow of FDI to developed countries with mature financial markets, taking their share of global inflows to 61.7% in 2006, as compared to 38.3% for emerging markets. Nevertheless, FDI flows to emerging markets are well-over US\$ 500 billion and are likely to register further increases in the future. Scenarios like a global financial crisis and severe slowdown in the developed world can upset these projections and lead to international flows seeking safe destinations—in the current scenario the fast growing developing countries may be the safer destinations.

Table 5: Projection of FDI Flows

FDI inflows			
(2007-11 average)			
	US\$ billion	Rank	% of world total
US	250.9	1	16.75
UK	112.9	2	7.54
China	86.8	3	5.79
France	78.2	4	5.22
Belgium	71.6	5	4.78
Germany	66.0	6	4.41
Canada	63.2	7	4.22

Hong Kong	48.0	8	3.20
Spain	44.9	9	2.99
Italy	41.6	10	2.77
Netherlands	38.5	11	2.57
Australia	37.8	12	2.52
Russia	31.4	13	2.10
Brazil	27.5	14	1.84
Singapore	27.1	15	1.81
Sweden	26.1	16	1.74
Mexico	22.7	17	1.51
India	20.4	18	1.36

Source: EIU

According to the EIU analysis, key expected medium-term trends for FDI include the following.

- The US and the EU-15 (inclusive of intra-EU inflows) will continue to dominate as recipients of world FDI, after the current slowdown passes.
- Greenfield investments will continue to be the major vehicle for FDI in emerging markets.
- Among emerging markets, China will remain by far the main recipient, with almost 6% of the global total and 16% of projected inflows into emerging markets.
- Sectorally, services like banking, insurance, telecom, organized retail and real estate will continue to dominate flows to emerging markets.
- There is likely to be some relocation of labour-intensive manufacturing to emerging markets.
- The off-shoring of services will accelerate, which might also give rise to protectionist sentiment.
- Investment by companies from leading emerging markets is likely to continue to gain in importance.

As the GDP of countries grows and they cross the threshold of development, FDI flows to them are likely to accelerate. This is based on the observation that growth pulls in FDI and is rarely led by it.

Sovereign Wealth Funds and Global Financial Flows

The turbulence in financial markets could lead investment banks of the developed countries to try to minimize risk and this could result in a reduced

flow of funds from developed countries to emerging markets. A reduced availability of capital would affect their investment plans and thereby their growth prospects. Such a development could contribute to further slowing of global GDP growth. Fortunately, there is a silver lining to the clouds over the financial markets. This is the large and growing resources of the Sovereign Wealth Funds (SWG) of developing countries. Some developing country governments with large current account surpluses have already established, or are in the process of establishing, investment entities to manage their funds to earn higher returns. Given the fact that the developing countries are the fastest growing economies, the returns on investment there are often the highest. Therefore, it is only natural to expect that these sovereign wealth funds will invest a large proportion of their resources in developing countries. This should, to some extent mitigate the reduced capital flows from developed countries.

Balance Between Environment and Development/MDG

It has been said that poverty is one of the greatest polluters. Thus rapid GDP growth, which reduces poverty, could by itself help in reducing environmental pollution. However, GDP growth comes with its own problems, as one of the most important inputs for growth is energy. In developing countries there is often a shortage of foreign exchange as well as of transport and port infrastructure, because of which they have to rely as much as possible on locally available resources, such as wood and coal. These generate a lot of green-house-gases (GHG), particularly carbon dioxide.

High energy use, first in the developed countries and now in the developing countries, has led to a growing concern about global warming, climate change and environment protection. Al Gore and R.K. Pachauri, Chairman of the Inter-Governmental Panel on Climate Change, who jointly received the Nobel peace prize in 2007, have put the climate change sceptics on the defensive. Australia, which had not signed the Kyoto Protocol, has recently signed it, though the US continues to hold out. The target for GHG emissions is being proposed at levels that would contain the extent of global warming to 'acceptable' levels. However, in this debate the need to maintain a balance between environment protection and poverty alleviation is not being fully recognized.

It needs to be borne in mind that concerns about the quality of life become relevant only after livelihood is assured and a person has reached a threshold level above the poverty line. Estimates of acceptable levels of global warming and the corresponding limits to GHG emissions, need to explicitly estimate the consequent reduction in GDP. The US has not signed the Kyoto protocol citing such concerns, and these are even more relevant for developing countries where almost all the poor of the world reside. Exhortations for the reduction of emissions need to have optimal rather than

ideal targets, as they have a direct bearing on developing countries' ability to achieve the universally accepted Millennium Development Goals (MDG) on reduction of poverty and malnutrition.

Outlook for the Global Economy. Financial Supervision

The current parlous state of the global economy is mainly on account of the inadequate supervision and regulation of financial institutions, with respect to their off-balance sheet assets, such as the structured investment vehicles, and their complex derivative instruments, whose risk is difficult to determine. As mentioned earlier, the credit rating agencies gave investment grade ratings to a pool of securities that have now become non-performing. This has put even pension funds to avoidable loss though they invest only in investment grade instruments. Here also financial supervision needs to establish a balance between financial innovation and prudent investment. At the least, treasury managers of risk-averse funds need to be advised to avoid financial instruments whose risk is not fully understood by them. The recent experience suggests that implicit faith cannot be placed upon credit ratings determined by someone else.

Economic Recovery

One saving grace in the whole scenario is that most of the problems in the US are in the financial sector and not so much in the real sectors, except as a ripple effect. The US financial system has the ability to recognize its short-comings and quickly rectify them. Once this is done, one can expect the crisis to blow over and growth to resume by the middle or end of 2009.

A US recovery would be aided by the weakening dollar, which could lead to increased exports and reduced imports, thereby reducing the trade deficit. The rising rate of inflation should ultimately lead to an increase in interest rates, after the current housing loans crisis has been addressed. The increase in interest rates and the adverse wealth effect on consumer spending of the decline in house prices should, in turn, lead to an increase in the US savings rate. Once the US economy's slowdown and weaker dollar have reduced the US imbalances, the relative strengths of the US economy would again drive its growth—fortunately, the US has comfortable demographics and, given its large domestic economy, the current slowdown could be less short-lived than many believe.

Predictions about the relative shares of different countries in future global GDP had indicated that the emerging economies of China, India, Russia and Brazil, will progressively have a growing share. The current slowdown in the OECD countries could accelerate this process. This faster transformation in the world economy could then lead to speedier reform of the multilateral institutions of global governance.