The financial imbalances of a “bizarre world”

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How much longer can the imbalances in the world economy continue to grow before they give rise to a major crisis? That is the question being increasingly asked in leading financial, academic and government circles.

Earlier this month the *Financial Times* published an eight-page supplement on the world economy, in which it warned that despite seemingly strong growth and low interest rates there were increasing causes for concern.

“The world economy,” it noted, “continues to grow strongly. Interest rates are low. Financial markets show few signs of stress. And the world’s economic future seems bright. After the best growth in 30 years, the International Monetary Fund expects growth to remain healthy at 4.3 percent in 2005 and 2006.

“But all is not well. Growth and trade flows in the world’s economy have never been as imbalanced as they are today. Global growth is concentrated in China and the US. Asia, Germany and oil exporting countries have record surpluses. Correspondingly the US has the largest current account deficit ever, which the IMF estimates will reach $760 billion or 6.1 percent of GDP [gross domestic product] in 2005.”

One of the most striking imbalances is the rapid growth in foreign currency reserves of Asian central banks as they buy up US financial assets—often at low rates of interest—in order to prevent their currencies rising against the dollar. This process, which began after the Asian financial crisis of 1997-98 when Asian central banks sought a financial buffer against future turbulence, has accelerated in the recent period.

Pointing to the “extraordinary” build-up of Asian reserves, the *Financial Times* noted: “Just over a decade ago, the seven leading Asian economies held $509 billion foreign exchange reserves or 36 percent of the global total excluding the US. At the end of 2004 the same economies held 2,300 billion, 60 percent of the global total.” Asian reserves, which were once similar in quantity to those of the seven biggest industrial nations (G7), are now 10 times their size.

The growing imbalances, which are being exacerbated by rising oil prices, have not escaped the attention of the leaders of the IMF and the G7. They were high on the agenda at the annual meeting of the IMF held last September.

“If the autumn meetings were judged by numbers of police, size of delegations or number of documents produced, the world was getting to grips with the subject,” the *Financial Times* commented.

“However, little changed and an increasing number of participants—central bankers and finance ministers—publicly or privately expressed frustration with the current crop of international financial institutions’ ability to co-ordinate the global economic environment.

“While countries and institutions pay lip service to the need for co-ordinated action, they cannot resist the urge to blame others for the risks in the global economy. The US bangs the drum, for example, about how it is doing its part to foster good growth, while Europe and Japan highlight the dangers of unsustainable US budgetary policies.”

One of the biggest dangers overhanging the world economy is that at some point the financial inflows from the rest of the world into the US will dry up or at least start to decrease, leading to a fall in the value of the dollar, a sharp increase in interest rates and the rapid onset of a US and global recession.

A paper published last month by economists from the Levy Economics Institute posed the question: The US and her creditors: can the symbiosis last? According to the report’s authors, the “strategic problems now facing the US and world economies can only be achieved via an international agreement.” However, there is no immediate pressure to bring about such a change because of the “symbiosis” in the present situation.

The US enjoys a short-term advantage as the inflow of foreign capital enables it to consume 6 percent a year more than it produces. On the other hand, Japan and Europe receive a boost to their economies from exports to America as China and the other east Asian countries undergo rapid industrialisation while at the same time accumulating a huge stock of liquid assets. So while the imbalances worsen, “those hoping for a market solution may be chasing a mirage.”

The Levy Institute report predicted that even if the US trade position does not worsen, the deficit in the current account could reach as high as 8.5 percent of GDP, compared to the present level of around 6 percent. Once the housing market peaks and household indebtedness stops growing and consumption spending tapers off, increased spending by the government will be needed to prevent a recession—rising to as much as 8.5 percent of GDP compared to the present level of around 4 percent.

If nothing happens to improve the US net export position and if the government is “unwilling to apply this huge fiscal stimulus, the US economy will enter a period of stubborn deficiency in aggregate demand with serious disinflationary consequences at home and abroad.”

While it is impossible to make any hard and fast predictions, there are increasing concerns that what the *Financial Times* characterised as a “bizarre world,” in which relatively poor countries supply money to the US economy at low rates, cannot continue indefinitely and that when an “adjustment” does take place it will have far-reaching consequences.