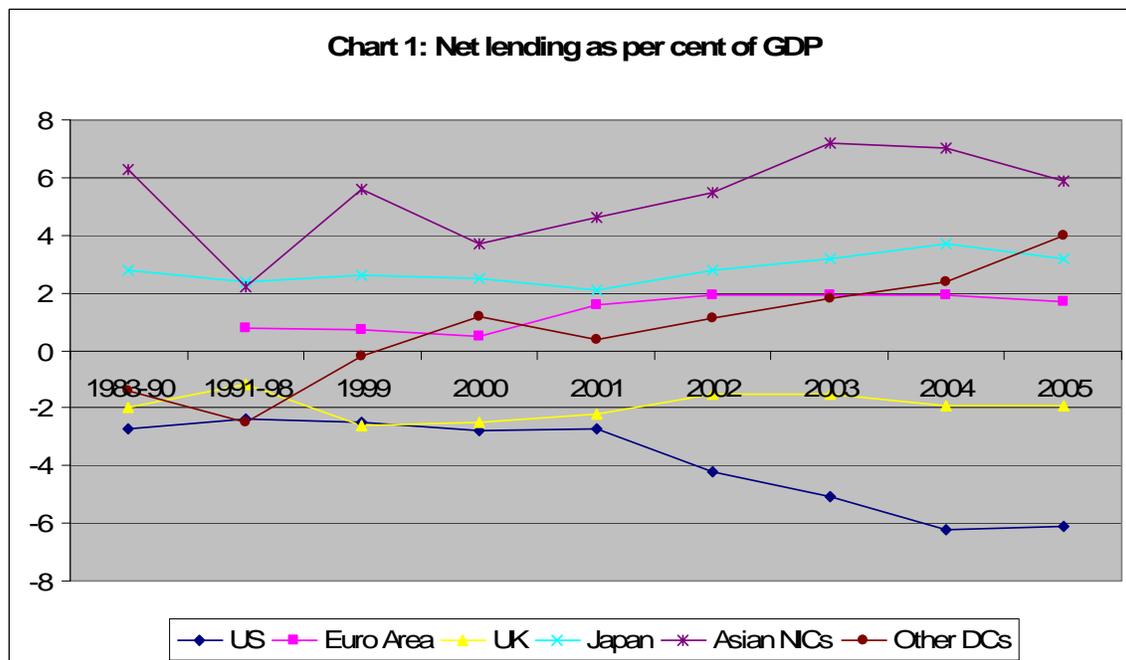


## DEVELOPING COUNTRIES AND THE DOLLAR

C. P. Chandrasekhar and Jayati Ghosh

It is now generally recognised that the very large macroeconomic imbalances between the US and the rest of the world, which are associated with very large capital inflows into the US, are unsustainable beyond a point. In a previous article,<sup>1</sup> we critiqued the recent argument of Ben Bernanke, a Governor of the US Federal Reserve, that this situation actually represents a “savings glut” in the rest of the world, as developing countries accumulate reserves to ward off possible financial crises related to capital flight. Instead of a “savings glut”, we argued that the role of the US dollar as international reserve currency, and the importance of US markets for the rest of the world’s exports, were important elements in the explanation for the current pattern of international capital flows.

We explore these issues further in this article. There is no doubt that the current situation with respect to international capital movements is absurd according to any perception of rational financial market behaviour, and certainly counter to the perceived role of international financial intermediation, which should encourage flows of financial resources from capital-poor to capital-rich economies.



Source for all charts: IMF World Economic Outlook September 2005

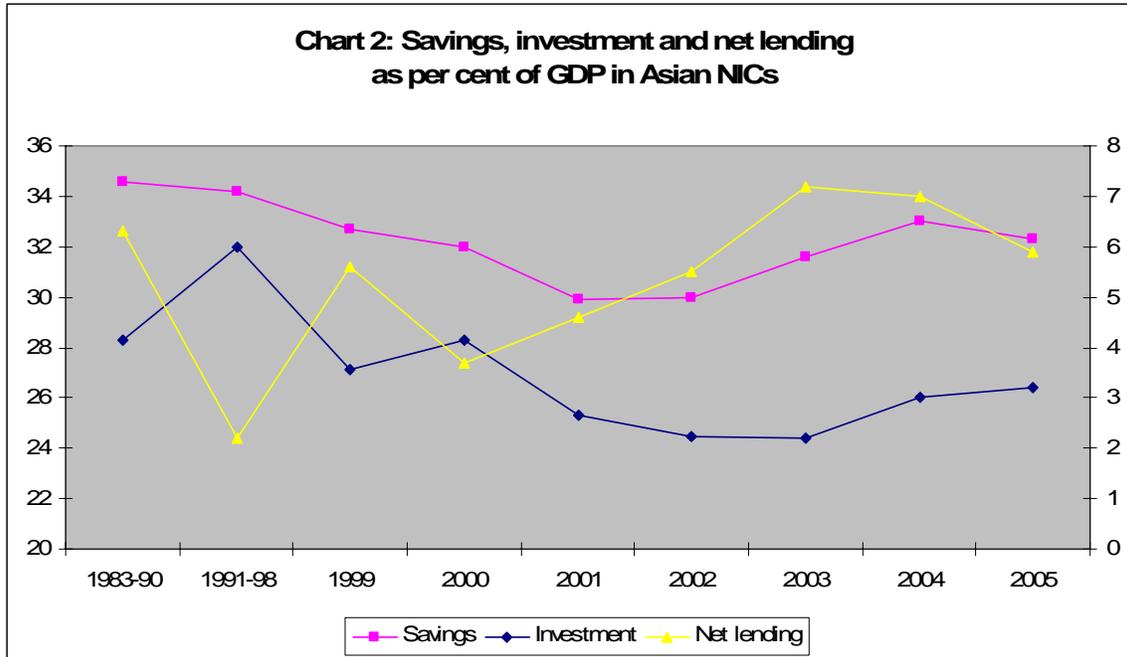
<sup>1</sup> See C.P. Chandrasekhar and Jayati Ghosh, 2005, “The Myth of a Global Savings Glut“ available at [www.networkideas.org/](http://www.networkideas.org/) or [www.macrosan.org/](http://www.macrosan.org/)

As Chart 1 indicates, net external lending is actually significantly negative for two of the richest large economies – the United States and the United Kingdom. The United States is obviously far more significant, currently receiving slightly more than 70 per cent of total world savings as capital inflows. The role of capital outflows from Japan and the Euro area in funding the US deficits was well known, but from around 2001, developing countries, especially in Asia, have become a significant source of such financing, and with larger resources in proportion to the size of the economy.

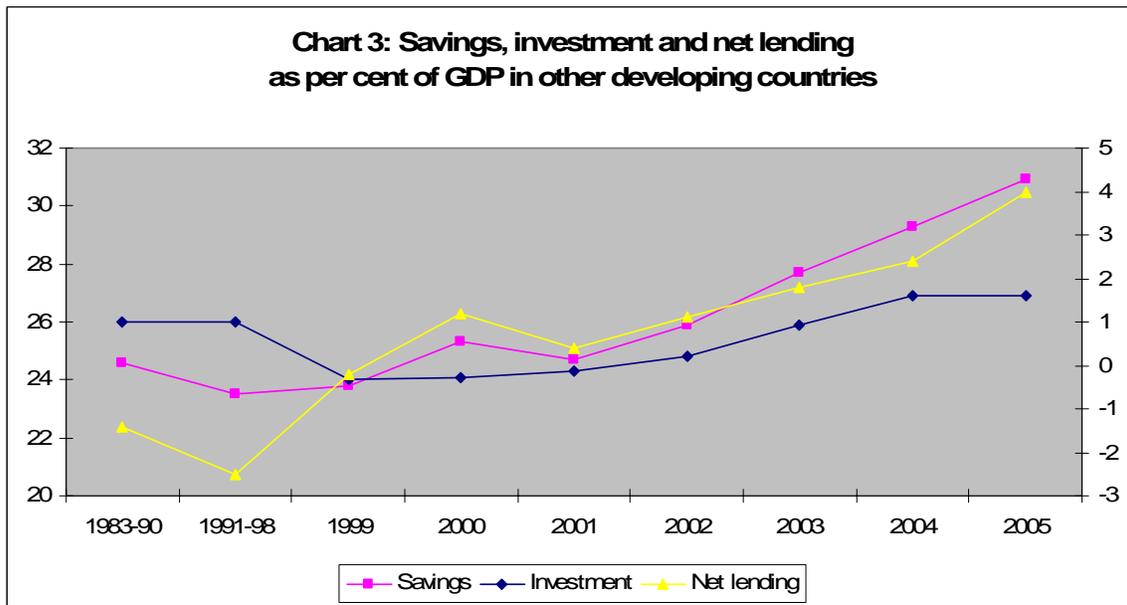
The newly industrialising countries of Asia (hereafter Asian NICs) have been sending out more than 6 per cent of GDP as capital outflow in the past three years. All other developing countries taken together (including China and India) are now exporting capital to the tune of 4 per cent of GDP. In a world in which the basic development project is far from complete, and where policy makers in developing countries still assume that they require inflows of capital to increase investment and economic growth, this is clearly a remarkable turn of events.

From the perspective of the United States, of course, it allows for economic expansion based on foreign capital inflows, and also involves a growing burden of foreign debt. Currently 52 per cent of US Treasury Bills are held by foreigners, up from 20 per cent only five years ago. But the consequences for developing country governments which are increasingly the holders of this debt may be even more significant.

This remarkable extent of outflow of capital from the developing world obviously reflects an excess of domestic savings over domestic investment, which is what led to the argument regarding a “savings glut”. However, as Charts 2 and 3 indicate, this excess came about not because of any real increase in savings rates in the aggregate, but because investment rates have not gone up commensurately.



It is true that in the Asian NICs (Chart 2), savings rates increased between 2002 and 2004 – but over this period, domestic investment rates also increased. Net lending abroad (on the right-hand scale) has actually declined slightly as share of GDP in 2004 up to this year, from the very high levels achieved in 2003. The period of most significant increase in net lending abroad was when domestic savings rates were actually falling, because investment rates were falling even faster.

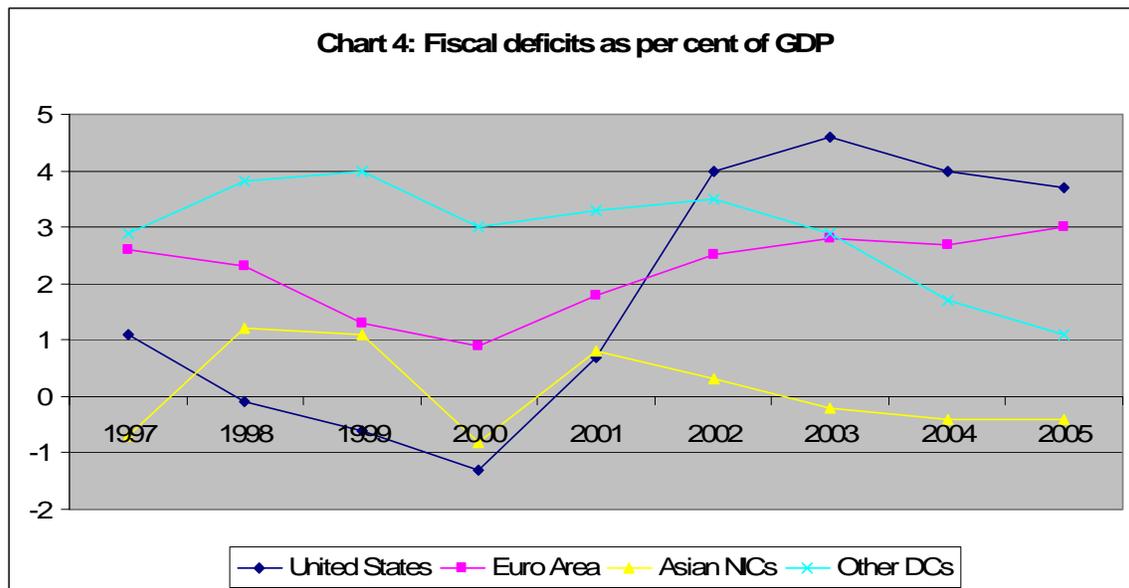


For all other developing countries (Chart 3), net lending has increased quite sharply in the recent past mainly because investment rates have not kept pace with higher savings.

Indeed, in the recent past, investment rates have stagnated even as savings rates have gone up. What is especially interesting is the source of savings in developing countries. Decomposition exercises suggest that in most developing countries, the savings increase has resulted from enhanced savings effort by the public sector, and not from household or private corporate savings. Therefore *increases in domestic savings rates in developing countries dominantly reflect fiscal consolidation and expenditure cutbacks by their governments.*

This is important not only because it suggests that Ricardian equivalence does not hold. (Indeed, estimates by IMF staff suggest that a 1 per cent increase in public saving increases the national savings rates by 0.85 per cent, as higher public saving is only partially offset by adjustments in private saving behaviour.) It points to the major reason for the apparent excess of capital which is then being exported to the US and other developed countries: deflationary policies on the part of governments, which suppress domestic consumption and investment.

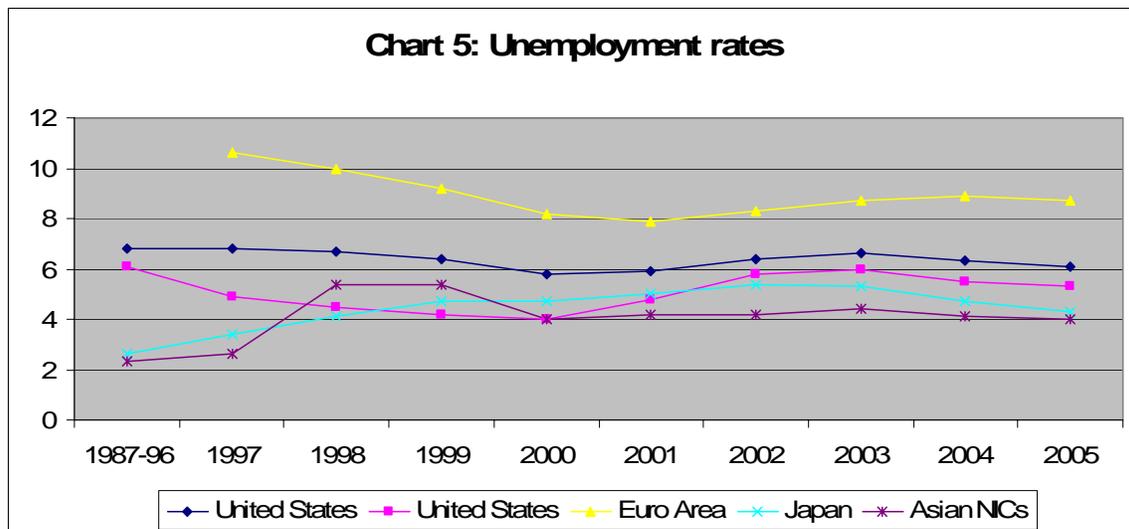
The excessive fiscal discipline imposed upon developing country governments, either by themselves or because of external pressure, is reflected in the fiscal patterns described in Chart 4. The large public deficits in the US are well known – and it should be noted that the IMF projection for 2005 which is presented in the chart is likely to be an underestimate, since unanticipated additional war and disaster-related expenditure in the US will add to expenditure substantially in the current year. But it is interesting to observe that public deficits in the Euro area have also been increasing, although they are still well below US levels, partly because of the constraints imposed by the Growth and Stability Pact.



But in developing countries, there has been apparently much more stringent fiscal discipline. The Asian NICs have mostly been in fiscal surplus since 2000, while the weighted average of fiscal deficits for all other developing countries was less than 2 per

cent of GDP last year and is projected to come down to only 1 per cent of GDP in 2005. Public sector savings have emerged as the most important marginal contributor to higher savings rates where they have been in evidence. In the majority of developing countries, where savings rates have not increased, the increase in net lending abroad has been generated by lower investment rates, driven by compression of public investment.

This obviously has effects on current levels of economic activity, but it also affects future growth prospects because of the long-term potential losses of inadequate infrastructure investment, etc. The deflationary effect of this fiscal strategy is reflected in lower levels of economic activity than could have been potentially achieved, as well as higher levels of unemployment. The increase in open unemployment rates in much of developing Asia, where there is hardly any unemployment benefit or social security system, points to a worrying convergence in rates of unemployment across developed and developing countries. (Chart 5)



The obvious question is: why are developing country governments pursuing such an apparently counterproductive policy which runs against the interests of their own current and future economic growth? The answer lies in a combination of international forces which have been unleashed by the collective adoption of certain national policies.

The first such force is the international domination of finance, which has resulted from national policies of financial deregulation, and created the possibility of large possibly destabilizing movements of speculative capital. It is certainly true that increasingly developing country governments all guard against the possibility of damaging capital flight by building up substantial foreign exchange reserves even when these may involve large seignourage losses.

But this is only part of the story. The second force which is dominant in development strategy today is the obsession with exports as the engine of growth. Across the developing world, the basic stimulus to growth is seen to come from increasing access to and getting larger shares of the international market, rather than building up the

domestic market. Even in countries which do not show large trade surpluses at present, such as China and much of East Asia, the stimulus to growth still is seen to come from exports.

Since all countries except the US are playing this particular game, it follows that the US economy remains the most important stimulus not only to world trade but to world economic activity generally. Even for countries like China, where exports to the US account for only around one-fifth of total exports, this remains the driving force for the accumulation which then generates such high rates of aggregate growth and in turn high aggregate savings.

In this context, domestic deflation in developing countries becomes almost necessary to perpetuate the system which provides the current pattern of growth. By fuelling the US economic expansion, it ensures a continuing market for exports by the rest of the world. And central bank intervention to mop up the dollars that are then invested in US securities ensures that exchange rates do not appreciate to levels whereby exports would be affected.

But this very obsession with export growth as the means to development creates its own contradictions. It leads to heightened competitive pressure (the famous race to the bottom) which reduces unit values of exports even as export volumes may increase. It prompts technological changes in export and import competing industries which mean that new production tends to generate less employment, and therefore have lower domestic multiplier effects. In any case, the fallacy of composition means that all developing countries together cannot really hope to increase their share of world markets unless they diversify their ultimate export destinations. And of course this strategy prevents more sustainable and equitable patterns of economic expansion based on the domestic market.

The peculiar paradoxes of the world economy today therefore reflect not only the political economy structures of international capitalism, but also policy choices by developing country governments with respect to both trade and finance. In such circumstances, financial liberalisation and trade promotion can become the means to undermine the development project in general.