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THE CHANGING DYNAMICS OF GLOBAL FINANCIAL POWER

"The world economy is increasingly integrated financially. What could be the unintended consequences of such an integration ? To what extent has global financial power shifted to the hands of surplus States ?"

Such are some of the questions this panel has been asked to comment upon.

I shall organize my remarks around two basic themes.

1. The existence of large surpluses in emerging economies is, to some extent, changing financial powers. But this shift is not, for the time being, entailing major direct unwanted consequences.

2. However, there are some more fundamental changes at work in the functioning of the international financial system that could create significant issues in the future.

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I. Emerging markets are accumulating large surpluses and foreign reserves whilst the US are getting more and more deeply into external indebtedness. What are the implications of this phenomenon for the international financial markets ?

1. The magnitude of change : the figures are staggering and well known : 869 billion $ for the current account deficit of the US in 2006 (6,6 % for GDP), 184 billion surplus for China (7,2 % of GDP). China's foreign reserves have now exceeded a trillion $.

Emerging and developing countries foreign reserves have grown fast. They amount to 3 trillion $ (from 800 billion in 2000) and represent 70 % of world international reserves[1].

[1] See : BIS annual report 2006

This makes the situation of the dollar -and more generally the stability of the international monetary system- very much dependent on the behaviour of surplus emerging economies particularly as regards their desire to continue to invest in US Treasury bonds and to avoid -through aggressive shifts in the composition of their reserves- marked perturbations in the functioning of the exchange rate system.

This also means that surplus -and fast growing- emerging economies have reduced their external liabilities, repayed most of their multilateral and official debt, and are in a better position to conduct their policies and withstand international shocks[2]. This amounts to a strengthening of the system.

So there is, in this respect, a shift of financial influence.

2. Is this shift about to lead, in the near future, to direct negative consequences ?

I don't believe so for the following reasons :

- Emerging surplus economies have no other choice as regards the way they invest their surpluses. As their local markets are still very much underdeveloped (as is their ability to directly harness their savings to local investments), they have to resort to the most liquid and safe international capital markets. Those are indeed -in particular the US equity market- very much concentrated in the US, Europe and Japan. Obviously, local financial markets of emerging countries are expanding and will further strengthen (they are already, to a significant extent, penetrated by foreign holders[3]). That trend should, in the event, help the financing by emerging economies of their local investment and therefore reduce their accumulation of reserves.

- Besides, it would not be in the interest of large holders of foreign reserves to engage in policies that could undermine the value of their main external assets, i.e. US dollar. Until now, Central Banks and government owned

[2] External debt service payments of emerging and developing countries (as a percentage of their exports of goods and services) have almost been halved since 1998 (from 25,4 % to 13,3 % in 2006). See : IMF –World Economic Outlook, September 2006.

[3] 13 % of emerging markets domestic debt issuances are now held by foreign investors (non residents) as compared to 5 % in 2000. See : IMF – Global Finance Stability Report, April 2006

institutional funds of emerging countries, have shown, in this respect, a clear sense of restraint and stability.[4]

- Besides, one can observe that emerging economies are still very much dependent on growth in advanced countries. Those industrial countries represent approximately 70 % of world GDP (50 % on a PPP basis). Thus, a severe contraction of the US economy -that would immediately affect Europe and Japan- would have significant negative effects on emerging economies exports and employment. We should not underestimate this macroeconomic relationship. It is not in the interest of emerging countries to act in a way that could destabilize and weaken the advanced economies.

  But, if the US slowdown were to be limited (i.e. growth rates in the 1,5 to 3 % consensus range) the effects on emerging economies would be modest, all the more so because the latter have the capacity to increase their domestic consumption and are less subject then they were some years ago to financial crises (healthier banking systems, sounder macroeconomic management, more moderate inflation, stronger fiscal positions, less credit bubbles….). The picture would be very different in case of a recession.

- I would add that in present circumstances -as compared with the two first oil shocks in the 70's, when oil surpluses were in large part placed in commercial banks and then recycled-, the external surpluses are mainly invested in US Treasury bonds acquired by Central Banks, and to a much more limited extent in equity portfolios and in foreign direct investment. The latter two forms -which are nonetheless growing- are not to be seen as "threat", but as a manifestation of the openness of capital markets and as the general desire of new players to acquire corporate strategic positions worldwide. Recent examples of Chinese, Indian or Middle-East investors going abroad are well known and will, in my view, become more frequent. They may well raise, in some cases, political problems, but they are the consequence of the workings of the free capital market system, not of a deviation.

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[4] One could refer to the words of a high official in China responsible for reserve management. To a question on reserve diversification which was asked a few years ago when the dollar was, at the time, on a weakening trend, the answer was :" We take a long term view of these matters, let us say fifty or a hundred years. What I know is that in half a century from now, there will still be the dollar and there will still be China".

All this is not to say that the situation is ideal and that it can last for ever. On the contrary, I am of the view that the persistence of very high US current account deficits and the corresponding increase of US foreign liabilities are dangerous, because they are not sustainable in the long run and because such massive concentrations of debt make the system more vulnerable to shocks. I therefore believe that the US have to adjust, rebuild a more normal level of domestic household savings and reduce their public deficits.

II. This leads me to my second point which concerns the possible "unexpected consequences" on the present functioning of the international system :

What are these, less visible and unintended, changes that might be raising long term consequences for the system at large ?

1. Firstly, it is clear that the massive acquisitions of US Treasury bonds by Central Banks of emerging countries are a major reason for the low levels of long term interest rates over the past years. A recent study[5] shows that such foreign flows have indeed an "economically large and statistically significant impact on long term US interest rates". Two thirds of the impact come from East Asian flows.

To the extent that such flows create an inertia in long term interest rates (this inertia has spread from the US to other international markets) they tend to undermine the effectiveness of monetary policy (and of its tightening moves) in industrial countries.

This is one of the explanations of the "conundrum" and also a significant factor behind the abundance of liquidity that is a main feature today's financial markets.

If one looks at M2 (broad money) over the last four years, one observes a steady but significant growth in advanced countries (+ 5,5 % median per year) and an explosive rate of growth in emerging countries (between 16 to 20 % per year) (see table I).

[5] "International Capital Flows and US Interest Rates" by Francis and Veronica Warnock (NBER Working Paper n° 12560), 2006. "In the hypothetical case of zero foreign accumulation of US government bonds over the course of an entire year, long rates would be almost 100 basis points higher », see NBER Digest, November 2006

This impressive growth of money aggregates and -more meaningfully- of all forms of credit in the world, is the result of different factors. Some have a direct relation with the “shift of financial power” :

- exchange rate pegging to the dollar by a number of surplus emerging economies that want to keep a competitive advantage for their exports through a week currency ;
- difficulty for emerging Central Banks to fully sterilize their dollar acquisitions, which leads to a “loose bias” in their monetary policy ;
- rapid increase of banking activities in emerging countries.

Of course, there are other factors at play which are not directly related to the issue examined today. I shall just mention the explosion of credit derivatives : to the extent banks are net buyers of protection (from less controlled entities like investment funds, pension funds, …), this frees regulatory capital for new lending[6] and therefore contributes to increasing net domestic assets.

Thus, one can assume that the magnitude of world imbalances is contributing to excess liquidity. This has not yet lead to a surge of consumer prices in part because of the emerging markets ability to sell cheap exports based on their low labour costs. But if the handsome growth of emerging countries is still accompanied by low inflation, it has also been leading to a rapid increase in commodity prices. In spite of the lower costs of manufactured exports from emerging countries, advanced economies have suffered from a net deterioration of their terms of trade since 2002. High energy and commodity costs are the main explaining factor. Inflation could eventually be affected by further increases in commodity prices.

2. My second point is related to the functioning of the international monetary system under present conditions:

Emerging economies are playing a more and more significant role in the world economy and this trend is likely to continue given demographic conditions. According to IMF estimates, Chinese GDP based on purchasing power parities amounted to 13,16 % of the world GDP in 2005 (against 20,7 % in the case of the US). China and India could well become the leading economies of the world in the decades to come.

And we will see those countries improving their domestic financial markets and developing more efficient banking and insurance institutions.

[6] In notional terms, the stock of credit derivatives has gone from 4000 Billion $ end 2003 to 27.000 Billions in June 2006. Of course, one should net these amounts and deduct pure trading positions in order to determine the “credit impact” of these instruments.

Therefore, the world should prepare for a growingly "multipolar" and harmoniously integrated international financial system.

Unfortunately this does not seem to be happening. Emerging countries are becoming more and more vocal and insistent on the need to redistribute IMF voting shares in order to better reflect the present economic realities. But when it comes to the role the IMF should play in the multilateral surveillance process, there seems to be no great interest neither from the advanced economies -an in particular from the US- nor from large emerging economies which seem satisfied to stay at a distance from the IMF.

How could we pretend that the IMF is fulfilling its "surveillance role" when we see massive and persistent deficits and surpluses, enormous indebtedness and foreign reserves piling up with no real consideration given to the appropriate underlying policies and to the functioning of the exchange rate system ? A large number of countries choose to peg their exchange rate to the dollar or to currency baskets in order to maintain a trade competitive advantage. Should the IMF and its membership continue to turn a blind eye to these issues ?

I do not think so. I know that some eminent economists argue that there is nothing fundamentally wrong with these imbalances. Emerging countries need to export in order to go on growing at a fast pace. As long as the US are wise enough to keep their markets open and their inflation under control, their current account deficits are only the consequence of the "excess savings" built up mostly by Japan and the emerging world. In this so called "Bretton Woods II" system, the US continue to act as the financial centre : they provide the international currency that is desired by the net surplus countries.

I personally disagree with this thesis for two basic reasons :

- at one point in time -as it happened in the past- the magnitude of US net liabilities will become a problem and could well trigger wide exchange rate perturbations that would have a negative impact on the stability of the system at large ;
- major trade imbalances eventually lead to protectionist reactions.

So, I believe that he more the global financial system becomes "multipolar", complex, and integrated, the more there is a need for international cooperation and consistency in economic policies and exchange rate behaviours. In this respect, I very much hope that the IMF discussions will not be limited to institutional refinements and quota reshufflings lest protectionism and disintegration should eventually prevail.

Table I.

(% annual growth)		2002	2003	2004	2005
United States					
	« Broad money » (M2)	6,3	4,9	5,7	4
Advaced economies (*)	M2	5,6	5,3	5,5	5,6
Emerging countries (*)	M2	15,9	16,2	17,1	19,9

Source : IMF, september 2006.
(*) Median progression.