Many doubts about the post-crisis economic world

The huge US external current account deficit, with its counterpart in the large Chinese external surplus, has concerned economic analysts for years, long before the global financial crisis emerged. As early as 2000 Obstfeld and Rogoff stated that "The US current account deficit has been persistently large and has brought the country's foreign debt to GDP ratio to 20%, a figure that is high by historical standards."[1] They argued that "while US solvency is not a near-term constraint on ongoing deficits, the sheer size of the US economy makes it likely that its current account will have to approach balance in the next five to ten years, if not sooner".

Soft landing — At the beginning of the present decade many economists expressed similar views, opening a debate on whether the US economy adjustment would be a soft or hard landing. The "soft" hypothesis holds that economic authorities in the major countries would eventually take the reins of the adjustment: the US government would adopt measures to boost domestic savings, and China would promote increased domestic consumption and gradual appreciation of its currency. This came to be known as expenditure switching, a soft change in the pattern of expenditure in the US, with the reduction of domestic consumption offset by increased net exports. This scenario would not have much impact on production or employment, but increased public savings would be combined with currency devaluation and some degree of monetary tightening if controlling inflation should become necessary. In short, it advocated replacing domestic demand with foreign demand.

Hard landing — According to the hard landing hypothesis, failure to coordinate economic policies in the international sphere to counter the global imbalance would bring about an abrupt cut in US credit, forcing the country to suddenly reduce consumption. This would be achieved through expenditure reduction, and the need to speedily reduce domestic consumption would lead to a sharp drop in imports, which in turn would drastically affect production and employment.

In this scenario the US dollar would undergo a "rowdy" depreciation, and the economic authorities would be faced with a dilemma well known to emerging countries of raising interest rates — or holding them steady — in the midst of an economic downturn to avoid a weaker currency triggering inflation. In short, the US would then be forced to reduce domestic demand without the corresponding increase in foreign demand.

So far actual experience seems to invalidate the hard-landing theory as it had been formulated, because the driving force behind the global financial crisis was not the widely feared correction of imbalances between the US and Asia. Also, the crisis failed to produce the effects associated with that scenario, as pointed out by Brad DeLong: "We all, from Lawrence Summers to John Taylor, were expecting a very different financial crisis. We were expecting the 'Balance of Financial Terror' between Asia and America to collapse and produce chaos. We are not living that financial crisis. Instead we are having a very different financial crisis."[2]

Dark matter — It was the persistence of that supposed balance of financial terror that led some economists to formulate theories that, to a higher or lesser degree, question whether a balance is necessary at all. In 2006, Hausmann and Sturzenegger published a paper criticizing the methodology used to measure the US balance of payments.3 According to them, US GDP and exports are underestimated and the current account deficit is overestimated.

Hausmann and Sturzenegger argue that, despite the fact that official statistics may suggest that the US has been a net debtor since 1986, the country's revenue accounts show a surplus.[4] This could be explained by the fact that assets have appreciated faster than liabilities since 1976. To them, this dynamic has been maintained for quite a long time and could be attributed to the export of intangibles — "dark matter" — that have not been taken into account by the standard methodology for national accounts. Examples of intangibles are the net value of currency held by nonresidents that generate seignorage to the US Treasury; the US Treasury bonds that various nations have accumulated in their international reserves, and that represent a very-low-risk investment; and finally, the managerial development and the introduction of new technology that follows American direct investment in emerging countries.

The global crisis did not see a sudden halt of the financing of US foreign debt but rather a misalignment of the financial sector that suddenly put the brakes on credit and threw the country and the world into a recessional skid.

Hausmann and Sturzenegger propose measuring the intangibles, reassessing the US net foreign position, and marking assets and liabilities to market. According to their estimates, the US would never reach the position of net debtor because it would have been a creditor to the world by about US$100 billion in 2004. When the same methodology

is applied to other countries, the two economists conclude that there would be very minor changes; the totals calculated for the official current account deficit and the mark-to-market approach would be very similar. This confirms, somehow, the exceptional position of the US and reinforces the dark matter concept. Only two exceptions to the rule were identified: China has been an important importer of intangibles; and Great Britain, as well as the US, has been an exporter of services.

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Willem Buiter criticized the methodology Hausmann and Sturzenegger used for their calculations.[5] Although he does not discard the dark matter theory, he suggests that the difference between the yield on US assets and liabilities may be a temporary result of the significant capital gains in the 1990s, when the increased credibility of several emerging countries provided room for very profitable US investment there.

Bretton Woods II — An alternative explanation for the persistent imbalance in the economic and financial relations between the US and China is what has become known as the "Bretton Woods II" theory, introduced in a series of articles published from September 2003 through February 2009 by Michael Dooley, David Folkerts-Landau, and Peter Garber. Dooley and his coauthors build on the features of the Bretton Woods system, which dominated the global economy from the post-war period until the 1970s. At the time, the US posted deficits in its balance of payments while the periphery — then Europe and Japan, which were under reconstruction — accumulated foreign reserves. The Europeans and the Japanese experienced a period of robust growth. Today, the US is again recording balance of payment deficits while the developing countries accumulate foreign reserves and grow at accelerated rates. Thus, the concept of Bretton Woods II would refer to the similarities between the present economic world and that of the aftermath of World War II.

The research of Dooley, Folkerts-Landau, and Garber is based on the supposition that the developing countries, in particular the Asian countries, are rich in labor and capital and poor in terms of natural resources and technology. Therefore, they need foreign direct investment for acquiring technology and management innovations already dominated by the advanced countries, not for supplementing their savings. The problem, however, is that those countries suffer from institutional underdevelopment compared with the advanced countries and do not always offer the legal security foreign investors require.

Dooley and coauthors argue that the reserves accumulated by the emerging market countries in US treasury bills function as collateral for US investments in those

countries. Thus, if an emerging country expropriated American assets or those of a US ally, the US government would have the power to retaliate, blocking or expropriating assets (treasuries or other investments) of the government in question.

The idea may seem extravagant, but the authors provide several historical examples of this sort of retaliation. During World War II, assets of the Axis countries in Allied countries were frozen, as were those of East European countries after they fell under Soviet domination following the war. Similar occurrences were registered in countries like China, North Korea, Cuba, North Vietnam, the former Rhodesia (today Zimbabwe), Cambodia, Iran, Libya, and Panama.

Thus the Chinese development strategy would be based on exports and on the absorption of know-how through foreign investment, with the ensuing massive accumulation of reserves as collateral, which would guarantee the participation of the government and companies of the US (and other advanced countries) in the model. The Chinese advantages would be significant savings and an almost unlimited supply of low-cost labor, which is guaranteed by managing the exchange rate to keep the currency depreciated in real terms. This cycle and the ensuing accumulation of reserves would function until the process of transferring population masses from the countryside (the great reservoir of labor at almost zero cost) to the cities came to an end.[6]

Dark matter and Bretton Woods II are therefore attempts to justify the permanence of a situation that traditional theory sees as intrinsically imbalanced and that, sooner or later, would lead to a potentially painful adjustment.

US dollar as a reserve currency — Given the high pre-crisis US current transaction deficits and the behavior of the world during the crisis, what can be expected from now on? Even though the debacle triggered by the subprime credit market has not been a US current account crisis, it is still possible that the regulatory and institutional deficiencies that surfaced during the turbulence will accelerate the relative loss of importance of the US dollar as a reserve currency — particularly if the dollar continues to devaluate. This is not, however, an inevitable outcome. The markets look ahead: if there are significant and convincing changes in US financial regulation, investors may conclude that the US still offers the best governance for financial intermediation. Additionally, the fact that the European banking crisis has been as deep as the American crisis invalidates the argument that stricter European regulation has meant

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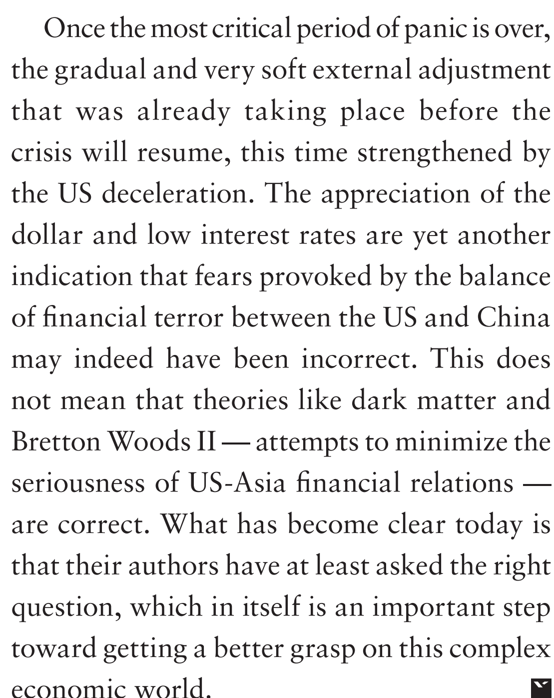
a safer financial environment: the failures were generalized. The speedy reactions that have been typical of the US in the crisis, such as the indictment of the megacrook Bernard Madoff, may help send a signal to investors that the US is still the best market for savings. Thus, Americans may well come out of the crisis even stronger than before.



Summing up, the theories and evidence examined tend to go against the view that a painful and rapid adjustment of the US foreign imbalance is inevitable. The global crisis did not see a sudden halt of the financing of US foreign debt but rather a misalignment of the financial sector that suddenly put the brakes on credit and threw the US and the world into a recessional skid.

Once the most critical period of panic is over, the gradual and very soft external adjustment that was already taking place before the crisis will resume, this time strengthened by the US deceleration. The appreciation of the dollar and low interest rates are yet another indication that fears provoked by the balance of financial terror between the US and China may indeed have been incorrect. This does not mean that theories like dark matter and Bretton Woods II — attempts to minimize the seriousness of US-Asia financial relations — are correct. What has become clear today is that their authors have at least asked the right question, which in itself is an important step toward getting a better grasp on this complex economic world.

[1] Maurice Obstfeld and Kenneth Rogoff (2000), "Perspective on OECD Capital Market Integration: Implications for U.S. Current Account Adjustment," in Federal Reserve Bank of Kansas City, *Global economic integration: Opportunities and challenges,* pages 169-208.

[2] DeLong, J. Bradford (2008), "The Wrong Financial Crisis," http://www.voxeu.org/index.php?q=node/2383.

[3] Ricardo Hausmann and Frederico Sturzenegger (2006), "Global Imbalances or Bad Accounting? The Missing Dark Matter in the Wealth of Nations," John F. Kennedy School of Government, Faculty Research Working Papers Series, RWP06-003; http://ksgnotes1.harvard.edu/Research/wpaper.nsf/rwp/RWP06-003.

[4] It must be recognized that measuring the US current account is not easy, as is evident in the procedures adopted by the Bureau of Economic Accounts (BEA), of the US Commerce Department, which is responsible for the official figures. For years the BEA has tried to find correct measurements of net foreign debt. According to the methodology that measures the debt at current value, US foreign debt for a year would be the sum of the deficits of current transactions accumulated up to the year in question. Thus, up to 1986 the US would have a net positive balance, but from 1986 onward, there is a shift in the position, and the country becomes a debtor.

[5] Willem Buiter, (2006), "Dark Matter or Cold Fusion?" Global Economic Paper 136, GS Global Economic Website, January 2006.

[6] According to projections in 2003, when the first article on Bretton Woods II was published, it was estimated that the process would carry on for another 10 to 20 years, that is, ending somewhere between 2013 and 2023.