

EXIM BANK: RESEARCH BRIEF

International Trade, Finance and Uneven Development



June 2009

EXPORT-IMPORT BANK OF INDIA

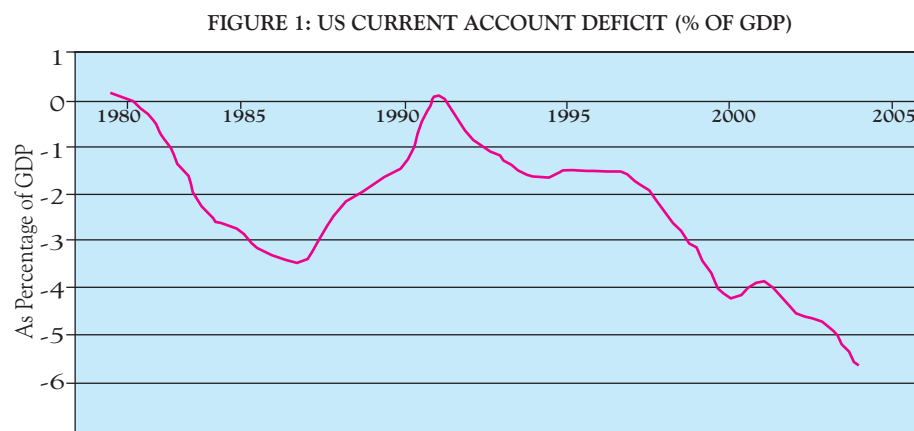
Visit us at www.eximbankindia.in

No. 48

In commemoration of Jawaharlal Nehru Birth Centenary (1889 – 1989), Export-Import Bank of India instituted the International Economic Development Research Annual (IEDRA) Award in 1989. The objective of the award is to promote research in international economics, trade and development and related financing, by Indian nationals at universities and academic institutions in India and abroad. The study titled 'International Trade, Finance and Uneven Development' is based on the IEDRA Award 2008 winning thesis by Dr. Ramaa Vasudevan.

THE CONTEXT

A peculiar feature of the present international economy is that the US, the leading 'hegemonic' country in the sense of the country whose currency enjoys the status of 'international money' has a large and mounting external deficit, which is financed by issuing debt in its own currency, while absorbing savings and capital from the rest of the world. Thus, the ability of the US to sustain a growing external deficit through the past three decades



Source: Bank of International Settlements (2005)

(Figure 1) has depended on its pivotal role in the triangular pattern of recycling surpluses from creditor countries (Japan and China), to the emerging markets in the periphery (Latin America, South East Asia). This deficit serves as the mechanism by which the US transmits the growth in its aggregate demand to the rest of the world.

A historical analysis of Britain's role during the gold standard, with particular focus on specific institutional mechanisms, yields interesting insights into the manner in which international liquidity was generated. It has been argued that Britain in the period of the international gold standard, and the US after the post war period in effect

acting as the international lender of last resort, injected liquidity through their central role in international financial intermediation. However, the mechanisms for liquidity creation and adjustment do not depend on the dominant country retaining a 'creditor' status. Rather, financial intermediation is made possible by the country's ability to borrow from surplus countries on one hand and pass the burden of deflationary adjustment shocks to the peripheral debtor countries on the other. Historically, specific institutional mechanisms, which relate both to imperial hegemony and international diplomacy, played a critical part in enabling the leading country to perform the role of financial

intermediation by extending its short term monetary liabilities.

The mechanisms of international finance that evolved during the International Gold Standard were based on London and the dominance of sterling as an international currency. The international monetary system in the 'gold standard' period was in general able to weather the crises that did erupt, relatively painlessly, and without impairing the overall mechanism or threatening 'convertibility' at the centre. The efficacy of this mechanism hinged on the ability of the London market to draw short-term capital flows and stem the outflow of capital in the face of growing trade deficits and dwindling reserves, in particular by drawing on the surpluses of India and Japan. The 'imperial system' played a critical role in sustaining the dominance of the pound in the gold standard period, by providing a critical source of surpluses which were recycled to London when core countries like France proved less willing to provide the necessary cushion.

The collapse of the Bretton Woods System in the 1970's could be compared to the dismantling of the 'gold standard' in the interwar years. The abandonment of gold convertibility by Britain in 1931 led, in some sense, to a collapse back to gold in international settlements, and set in motion a period of 'rolling deflation', and competitive devaluations, and ultimately the

erosion of the role of the sterling in international exchange. In contrast, the closing of the gold window in 1971, and the subsequent 'floating' of the dollar, did not result in the displacement of the dollar as the international reserve currency. Instead, developments in the international monetary arrangements in the past three decades enabled the preservation of the role of the dollar as an international reserve. The role of unregulated international capital markets, in enabling the absorption of savings by the US from the rest of the world and sustaining its large current account deficits is pivotal to this process. Specifically, the burgeoning off-shore euro-dollar market which was both liquid and unregulated, proved an important means for encouraging foreign investors to finance the US deficit.

Thus, liquidity in the post Bretton Woods dollar standard, derived from multilateral clearing mechanisms and financial intermediation similar to the sterling bill, financed triangular patterns of settlement of the British empire. During the earlier period, creditor countries like India and Japan placed sterling balances in London, while private capital flows to 'emerging markets' in Latin America and Australia bore the brunt of speculative attacks. The monetary arrangements after the collapse of the Bretton Woods system have, analogously, allowed the US to draw on the surpluses of the OPEC

Countries, Japan and more recently China (and Korea) while transmitting the burden of adjustment to the emerging markets in Latin America and South East Asia.

The historical development of the international monetary system in the last two decades is such that the cost in terms of increasing financial fragility and debt-deflation has to a significant degree been borne by the periphery. The privileged position of the currency of a single hegemonic country in the international monetary system imparts a degree of elasticity to adjustments in the developed core of the global economy. The mechanisms of adjustment, however, generate greater instability outside this core. Thus, the post Bretton Woods period has been marked not only by an increasing frequency of financial crises, but by a proportionately greater incidence of such crises in the emerging markets of the South.

The distinct asymmetric positions of the surplus creditor country and peripheral debtor country in relation to the US are central to the conclusion that global imbalances caused by the growing deficit of the US and concomitant growth of international liquidity leads to an inflow of capital to emerging markets in the debtor periphery. The peripheral debtor country, in a liberalised financial regime, faces destabilising dynamics precisely because of its asymmetric integration

into the international monetary system based on a floating dollar standard. The imbalance thus gets transmitted to the periphery in the form of an excess demand for its assets.

THE STUDY

The core of this research argues that the ability of the dominant country (i.e. which issues the currency that serves as an international reserve and vehicle currency) to sustain a growing external deficit is its role in the triangular pattern of recycling surpluses from creditor countries to the emerging markets in the periphery.

The study employs an analytical macro-model that highlights certain implications of financial intermediation and triangular adjustment patterns for the period after the collapse of the Bretton Woods system. It presents a stylised, open economy, stock-flow consistent, social accounting matrix of the world economy as a closed system with no 'black holes'. The international economy is represented as three interdependent blocs: the US with its trade deficit; 'trade account' countries in the periphery (Japan, China) which have a current account surplus that intervene to preserve their dollar exchange rate by buying up the US treasury bills; and debtor 'capital account countries' in the emerging markets in the periphery.

The unprecedented situation of a dominant debtor country and its

relative immunity from destabilising speculative attacks has been ascribed to the privileged position of the dollar internationally - 'the exorbitant privilege' that the US is able to exercise. A look at the financing of the US external deficit (**Figure 2**) suggests a pattern of intermediation where the US incurs liabilities largely in the form of private bonds and official holdings of dollar reserves and accrues assets through foreign investment outflows of both equity and foreign direct investment. After 1984 (when 38% of investment was in equity), US investors have favored equities over debt securities with its share rising to as much as 70% in 2001 before dipping to 66% in 2003.

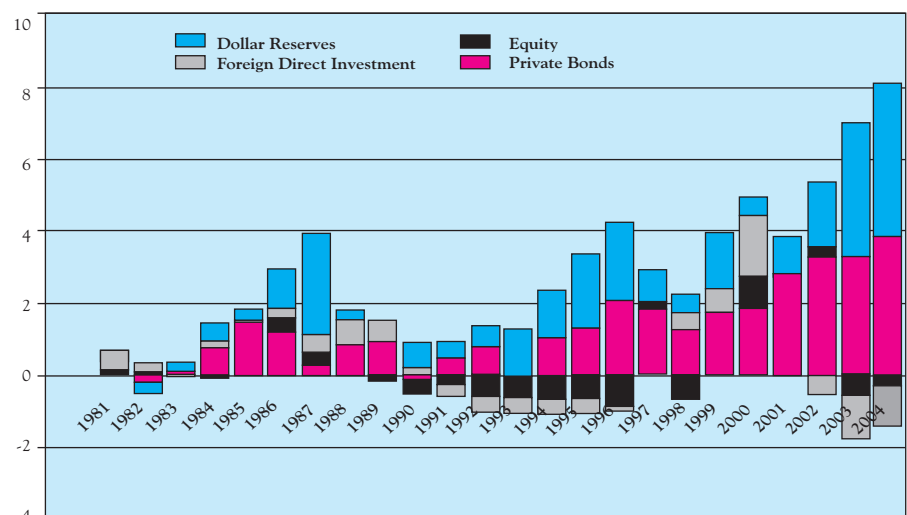
It is seen that while the dynamic adjustment pattern of the US with its creditors like China is relatively stable, the adjustment dynamic for the debtor emerging markets in the wake of dollar denominated capital inflows is likely to be destabilizing.

Capital flight from emerging markets acts like a safety valve for the international monetary system, hinged on the piling up of dollar liabilities, by precipitating a shift from assets denominated in domestic currency to those denominated in dollars. This is a critical channel and mechanism through which peripheral adjustment and instability might stabilise the core country.

Terms of Trade, Competitive Advantage, and Trade Patterns

The validity of the principle of comparative advantage, in the context of international capital immobility, rests on the specification of boundary conditions determining the relative scale of output in the two countries. It is seen that when one partner is technologically backward, a competitive trade outcome, with a higher than autarky profit rate, will emerge only if it is relatively large compared to its trading partner.

FIGURE 2: THE FINANCING OF THE US DEFICIT (% OF GDP)



Source: Bank of International Settlements, 2005

The analysis of trade in the context where one country has a technological disadvantage in both sectors has an interesting implication. No competitive trade outcome of specialisation based on comparative advantage emerges where the technologically backward country is small. However, size does matter, and a large developed country that has lost its competitive advantage could still 'gain from trade'. Analysis suggests that while 'headwind created by low wage competitors and technical imitators' attenuates the growth of the leading country, the dominance of the leader might still ensure that it continues to gain from trade despite losing its technical advantage. Thus the US, despite its loss of competitiveness, could still reap higher profit rate by trading with countries that produce the goods more cheaply. Developing countries, in contrast, can compete in the international market most effectively when they combine 'cheap labour' with more advanced technology.

CONCLUSION

The financial crisis that is engulfing the global economy has laid bare the contradictions of the international financial system where liquidity is generated through the growing debt of the key currency country – what

has been called the floating dollar standard. It has at the same time reopened the debate of the reform of the international financial architecture and the possibility of a new Bretton Woods negotiation.

This study draws the following lessons for the debate around the reform of the international financial architecture:

- The first relates to the asymmetry in adjustment between the core and the periphery in a international monetary system based on the dominance of the currency of a “hegemon”. The triangular pattern of recycling private capital flows provided an adjustment mechanism for the US deficit while precipitating financial fragility in the periphery. Any agenda for the overhaul of the international monetary system has to address the crucial core-periphery relationships that have underwritten and sustained the Post-Bretton Woods System.

- The second lesson that could be drawn is that financialisation has generated the parallel, unregulated private channels of liquidity creation of the floating dollar standard that helped pass the burden of adjustment to the periphery. While the collapse of finance in the current crisis might enable the reconstruction of a more regulated financial architecture,

better prudential regulation and controls is not a sufficient framework to deal with the dominance of finance. This remains the fundamental challenge for any agenda of reform.

- A third lesson, of particular relevance to the debates around financial reforms in India, is the need to insulate the financial sector from the shocks and structural vulnerabilities that arise from the pattern of integration with the international monetary system under an International Dollar Standard. In particular, it points to the critical importance of capital controls, and judicious management and diversification of reserve portfolios in protecting the financial sector from the fragility that international capital markets engender.

Note: Indian Rupee are referred in crore and lakhs:

1 crore : 10 million

1 lakh : 100 thousand

Publication is available with:
 Dharmendra Sachan
 Chief Knowledge Officer
 EXPORT-IMPORT BANK OF INDIA
 Centre One Building, Floor 21,
 World Trade Centre Complex,
 Cuffe Parade, Mumbai - 400 005, India.
 Phone : +91 22 2218 0379
 Fax : +91 22 2218 3070
 E-mail : dharmendra@eximbankindia.in
 Website : www.eximbankindia.in

Contact Numbers : Ahmedabad : 2657 6852, Bangalore : 2558 5755, Chennai : 2522 4714, Guwahati : 246 2951, Hyderabad : 2330 7816 , Kolkata: 2283 3419, Mumbai: 2282 3320, New Delhi: 2332 6625, Pune: 2645 8599

Dakar : (221) 338232849, Dubai : (971) 43637462, Durban: (2731) 5846118, London : (44) 2073538830, Singapore : (65) 653 26464, Washington D.C.: (1) 2022233238

