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Global imbalances: a gathering storm

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1. Introduction

This article deals with global imbalances in the economic and financial areas. It follows two other articles: the first (Sacchetti, 1999) dealt with abnormal trends in the United States in four selected major economic areas, at a time when the U.S. economy was considered, in many quarters, as an exemplary paradigm. The second (Sacchetti, 2005) dealt mainly with the increasing deterioration of the U.S. negative balances in its external accounts. Inter alia, it reiterated the previously expressed opinion, shared by many other writers, that the U.S.'s financial relations with the rest of the world were on an unsustainable path.

This paper broadens the horizon, as it includes the position of other countries, often in opposition to that of the United States; and it also covers institutional and economic subjects, besides the financial aspects.

The problems which will be highlighted have two characteristics:

a) they simultaneously involve a number of countries (possibly many), which implies that the problems require, to the extent possible, negotiated solutions within the institutional international framework;

b) the solutions may be more complex than those of the problems, however serious, which have arisen during the ongoing credit crisis and which mainly require measures at the national level, even though, at times, they were internationally coordinated.

The problems dealt with in this article are not new. They have been building up over the years, even decades; but, except in academic and private professional circles, they have remained almost neglected, or sidestepped, insofar as the public authorities directly involved are

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concerned.[1] Lately, however, there have been a number of official pronouncements, and some international discussions have taken place over the subjects which have been raised on a technical/diplomatic level. These discussions, however, have mainly stated the problems without even hinting at solutions as they transpired, let alone at specific proposals.

This article covers, first, relevant geopolitical aspects which form the framework for the remainder. Then it deals, in sequence: (a) with some possible institutional changes in international financial agencies; (b) with the prospective financial problems of the United States and their implications for other, mainly surplus, countries; (c) with monetary developments in the United States in the near future; (d) with the external imbalances; and (e) with the international economic (i.e., non financial) problems, which, probably, will prove to be the most difficult to solve.

The problems mentioned in (b), (d) and (e) above have been gradually, but steadily, growing over a long period of time – two to three decades – but, for a variety of reasons, the agendas of periodic international meetings of public authorities have not included them as major subjects of discussion. There are now, however, indications that those problems are about to become the subjects of important debates, perhaps after the current financial internal crisis of a number of major countries appear to have been largely solved.

2. The geo-political framework

During the last two to three decades the relationships between the major countries in the world have gradually changed, notably with the ascent of the so-called BRIC countries (Brazil, Russia, India, China), and the decline of the United States. The latest UN *Report* (UN Department of Economic and Social Affairs, 2008) states that “[i]n terms of size,

[1] For example, the 2008 and 2009 *Economic Reports of the President* (of the United States) are silent about the international imbalances, except for one short paragraph. The same can be said about the *Annual Reports* of some Central Banks. The BIS 79th *Annual Report*, contains only a few descriptive paragraphs on the subject.

speed and directional flow, the transfer of global wealth and economic power now under way – roughly from West to East – is without precedents in recent history. This shift derives from two sources. First, increases in oil and commodities prices have generated windfall profits for the Gulf states and Russia. Second, low costs combined with government policies have shifted the focus of manufacturing and some service industries to Asia" (p. 6).

The economic and financial aspects referred to in the UN Report will be dealt with in detail in a few chapters which follow. There is, however, another major area, which can be described as the "shift of political power." To cover this, lacking personal expertise, reliance will be placed in what follows on some recent writings in the United States itself. Reliance on the writings of private experts is also due to the fact that normally (and in general) changes through time in a country's power do not emerge explicitly from official documents.

In a wide ranging-book, published recently, Fareed Zakaria[2] covers the above aspects, and using a metaphor, he states that we are experiencing the third "tectonic power shift" of the last five hundred years (Zakaria, 2008, p.1). The shift is epitomized by the expression in the book "the rise of the rest," as the author does not fully join the so-called "declinists" – a trend of opinion which probably started with the historian Paul Kennedy about twenty years earlier (Kennedy, 1987). Zakaria's position appears to be similar to the UN's, i.e., that by 2025 the U.S. will be one of a number of important actors in the world stage, albeit still the most powerful one (UN, p. 11). The facts and trends which will be presented later in this article raise some doubts about the certainty of that assertion. There have been and there are ongoing phenomena in the U.S., outside the economic, financial and political spheres, which may erode from inside the overall U.S. power over a number of years. Zakaria himself at one point raises some doubt. Referring to Americans' lack of awareness of the world beyond their borders, and to the limited knowledge of foreign cultures, he states that Americans in general are "sure that their way must be the best and most advanced." He adds:

[2] Fareed Zakaria, of Indian origin, is a United States citizen.

"There is a gap between America's worldly business elite and cosmopolitan class, on the one hand, and the majority of American people, on the other. Without real efforts to bridge it, this divide could destroy America's competitive hedge and its political future" (Ibid., p.46). In a similar vein, but on a different level, Mr. David Walker, the former Comptroller General of the United States, issued in 2007 an ominous warning. In a public address (Walker, 2007) he stated:

> "[...] if we want to keep America great, we have to recognize reality and make needed changes. As I mentioned earlier, there are striking similarities between America's current situation and that of another great power of the past: Rome. The Roman Empire lasted 1,000 years, but only about half that time as a Republic. The Roman Republic fell for many reasons, but three reasons are worth remembering: declining moral values and political civility at home, an overconfident and overextended military in foreign lands, and fiscal irresponsibility by the central government. Sounds familiar? In my view, it is time to learn from history. [...]"

One year later, Andrew J. Bacevich published a book which was highly critical of the policies pursued by the United States during the past decades (Bacevich, 2008). He also recommended changes in the direction of American policies. Three paragraphs in the introduction of the book put in a nutshell its contents.

> "The United States today finds itself threatened by three interlocking crises. The first of these crises is economic and cultural, the second political, and the third military. All three share this characteristic: They are of our own making" (p. 6).

And further:

> "Yet, as events have made plain, the United States is ill prepared to wage a global war of no exits and no deadlines. The sole superpower lacks the resources – economic, political and military – to support a large-scale, protracted conflict without, at very least, inflicting severe economic and political damage to itself. American power has limits and is inadequate to the ambitions to which hubris and sanctimony have given rise" (p. 11).

> "Rather than insisting that the world accommodate the United States, Americans need to reassert control over their own destiny, ending their

condition of dependency and abandoning their imperial delusions" (p.13).[3]

The assessments and opinions of the above quoted American foreign policy writers – though by no means universally shared – roughly define the present geo-political set-up in which China and Russia are the two other major players. The former has been building, and continues to build, in a steadily fashion its economic, financial and military power. Its revisionist strategy appears to be the achievement of important durable changes in the global system in a careful, prudent, and peaceful manner, including the skillful management of "state capitalism." Russia, on the other hand, appears to be vigorously pursuing a policy of building its sphere of influence, through peaceful pressures of various kinds – rather than by forceful conquest – over a number of former Soviet Union republics. That policy is supported, with regard to the United States, by the possession of a nuclear arsenal, by its strategic position in Central Asia, and by a vast energy base.

It is instinctive to anticipate that, in a not-too-distant future, there will be a (non-violent) clash, probably in international fora, between those two powers and the United States. India and Brazil, themselves emerging powers, could join the trio, especially in the trade area, on the basis of their own economic strength and as champions of the developing world.

The anticipation that a collision of conflicting interests of major powers could come out in the open in a not-too-distant future, has a factual basis in certain pronouncements and events involving individuals in official position. Until 2008, the discussion of imbalances in U.S. external accounts was confined to academic and professional circles, including articles in major magazines and dailies other than a number of

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[3] The reader may find it useful to consult the bibliography at the end of Mr. Bacevich's book. In addition, three other books, known to this writer only through reviews, have recently appeared and they advocate changes in policy direction for the United States. Whether, according to reviews, they advocate isolationism, or a realistic pragmatism, or deferment to a supernational political authority; all this implies an end of the hegemonic policy for the country: *The story of Ancient Empires, Modern States, and the Quest for a Global Nation*, by Strobe Talbot; *Common Sense can Rescue American Foreign Policy*, by Leslie Gelb; *The Rise and Fall (and Redeeming Promise) of our Country*, by William Greider.

meetings have taken place between high financial officials of the United States and China. No documentation exists, however, about the outcome of these meetings. Starting with the later part of 2008, and so far in 2009, there have been, however, a number of public statements, mainly, but not exclusively, by Chinese officials.

At the end of January 2009, at the Davos World Economic Forum, Mr. Wen Jiabao, the Chinese premier, called for the creation of one or more new reserve currencies. Mr. Vladimir Putin, the Russian premier, joined Mr. Jiabao, and also stated (reportedly) that the concept of a unipolar world revolving around the United States was “obsolete.” The suggestion about reserve currencies was echoed at a later Moscow meeting of the Presidents of the four BRIC countries.

The first target of a possible collision could be the international institutional set-up, particularly, but not confined to, financial institutions; also because of the frequent complaints, in a number of quarters, about the dominant position of the United States, by statute, in those institutions.

3. The institutional organizations

In the original statutes of the International Monetary Fund and of the International Bank for Reconstruction and Development (World Bank) – the Bretton Woods institutions – the voting power of the United States, based on participating quotas, was about 30 and 33 percent in the two institutions, respectively. These percentages changed over time, as is known, mainly due to: (a) the addition of other countries to the membership, including notably Japan, Germany, and Italy; and (b) the increase in total quotas, and changes in the quotas of member countries. The result of (a) and (b) was a reduction of the voting power of the United States. At present, that voting power is about 17 percent of the total. Since all the major decisions require an 85% majority of the total voting power, the United States has, implicitly, a veto power. One of these major decisions is the change in the quotas of members, which means that the veto power cannot be changed without the consent of the

United States.

Another item which is likely to come up for debate is the management of the above mentioned financial institutions. By unwritten, tacit agreement, the head of the IMF (the Managing Director) is a European, and the President of the World Bank is a U.S. citizen.

Both of the above features have been under attack, not only by China, Russia, and the two other BRIC countries, but also by many developing countries. The common major objective appears to be the termination of the dominant power of the United States, as embodied in the latter's percentages of voting power on major decisions. When these matters should be brought up for discussion in formal fora, the debate will inevitably be active and contentious. The road to solutions will be a long, drown out process. In particular, the determination of new quotas could present difficulties, including a possible replacement of the original Bretton Woods formula. And even without such a replacement, a technical obstacle will be the international non-comparability of national gross domestic products. This is because the U.S. GDP deflator is calculated differently from that of the European Union (and possibly of other countries) due to differences in computing the CPIs and the PPIs.

An enlarged agenda could include the reform of the structure of the international financial institutions. In this respect, the position of the International Monetary Fund could be particularly vulnerable. Its Articles of Agreement are, to a large extent (with the exception of the provisions concerning the SDR account) a reflection of the (undesirable) characteristics of the international currency markets of the 1930s (competitive devaluations, multiple currency practices, unsettling speculative capital movements, and so forth). The provisions concerning those features are, to a large extent, obsolete. In fact, even a new provision, i.e., the requirement that the IMF exercise firm surveillance on members' exchange rates, appears to have remained in abeyance since the time it was introduced – as an apparent alternative to a par value system. Even more importantly, certain recent developments have significantly affected the area of operation of the IMF. Reference is made to swap agreements made by the Federal Reserve System with a number of Western Hemisphere countries' central banks, to the more recent swap

agreements between the Central Bank of China and the Central Banks of South Korea, Hong Kong, Malaysia, Indonesia, Belarus and Argentina, as reported by the financial press (the reported amount is 650 billion renminbi). These add to the traditional potential financial assistance by the Bank for International Settlements to its member Central Banks. These financial arrangements, as long as they are effective, relegate the role of the IMF, largely, to providing assistance to developing countries. It follows that, in the context of discussions of the international financial structure, consideration could be given to the appropriateness of merging the IMF and the IBRD.[4] The creation of a single new institution would require the drawing up of new articles of agreement which would reflect the actual roles performed at present by the two institutions, and which could possibly include the provisions of the Statute of the International Development Association (IDA). The disposition of the SDR account would have to be dealt with separately.

Finally, a major contentious item on the agenda of a meeting, in the near future, at international level, on the global financial system, is likely to be the role of the U.S. dollar as the major reserve currency. This anticipation is based on the complaints reportedly made by China, Russia, and other major holders of reserve assets, and by their proposals to replace the dollar with another reserve asset. Besides what was mentioned at the end of the first section, a high Chinese official at the G8 meeting in L'Aquila (Italy), reportedly called for a new reserve currency. Later, at a news conference on March 13, 2009, Mr. Jiabao stated that he was "definitely a little worried" about the safety of Chinese investments of about $1 trillion in U.S. Government debt. And, early in September 2009, UNCTAD (the UN Conference on Trade and Development) reportedly urged the creation of a new world reserve system, using several currencies. None of these statements and proposals give, however, a clear indication of the nature of the desired alternatives, except that the thinking of the mentioned countries, or agencies, apparently exclude the

[4] It is noteworthy that: (a) since the mid-1960s the terms of financial assistance from the IMF have included a lengthening of the repayment periods (contrary to the initial provisions of a rapid reconstitution of resources); and (b) the IMF has recently adopted an instrument to obtain financial resources similar to the IBRD's.

SDR. This is, possibly, because this "composite" is not a transaction currency and it cannot be used for market intervention directly. Other possible reasons could be some shortcomings of the SDR mentioned years ago by this writer (Sacchetti, 1979).

4. The U.S. internal fiscal situation and prospects

One of the major reasons for the repeated challenges by China (and others) of the role of the dollar in the international monetary system can be found in the U.S. fiscal situation and prospects. The accumulation by China, during the past decades, of reserves of the equivalent of some U.S. $2.1 trillion (mostly in dollars) and some $800 billion of Treasury securities, would have, by itself, created uneasiness for the Chinese authorities even if the U.S. fiscal situation had suddenly improved, with prospects of declining annual deficits. The opposite, however, has taken place; causing Premier Wen Jiabao to express concern, as recalled in a previous paragraph. It is appropriate, therefore, to take stock of the situation, and to review the prospects on the basis of available estimates.

Starting in 1961, when the budget deficit was U.S. $3.5 billion, the annual deficit gradually increased, and, after 1980, the increase accelerated (only in 1999 and 2000 was there a small surplus). The estimated deficit for fiscal year 2008 was 574 billion dollars. At the end of that fiscal year, the total federal debt was about $10 trillion. Not all of this had, however, impacted the markets since the amount held by the public was about $5.3 trillion. The reminder, i.e., about $4.7 trillion, was held by the Federal Reserve System and by various Trust funds, including the Social Security Trust Fund, and the Medicare Trust Fund. Of the amount held by the public, "Foreign and International" (which includes Central Banks) had absorbed about $2.9 trillion. Most of this (about $1.7 trillion) was held by East Asian countries. Although the data are not precise, the amount held by China was close to $800 billion. Japan had a similar amount, with the remainder shared by Hong Kong, South Korea, Singapore, Taiwan and Thailand. Middle East oil exporting countries, Russia, other countries, and private entities held about $1.2 trillion.

This situation was already a matter of concern, especially for China. It became alarming, however, during the last quarter of 2008, and especially this year. The estimated deficit for the current fiscal year (ended in September 2009) is $1.4 trillion. For future years, there are various estimates, public and private. These estimates for the next ten years of cumulative deficits differ because they are based on ten different assumptions as to taxation, expenditures, and the future course of the economy. They are, however, all very significant, especially for large existing foreign creditors.

In a recent, comprehensive paper, Alan J. Auerbach and William G. Gale (2009), who have dealt with federal finances for a number of years, estimate that for the period 2009-2019, the total budget deficit will be $10.1 trillion. This compares with the most recent estimate of the deficit by the U.S. Administration, for the same period, of about $9.1 trillion(the Congressional Budget Office recently revised upward its earlier estimate of $4.4 trillion, but the authors of the above article noted that the CBO's estimates "incorporate a number of rules and assumptions that make it a poor guide for the underlying fiscal political trajectory"). Furthermore, under both the writers' projections and the administration's projections, the annual deficits will be in excess of $1 trillion after 2019, which prompts the authors to state that "the situation is unsustainable," adding that "all these estimates are based on assumptions which may prove optimistic – including a strong economic recovery."

Other, partial estimates for different categories of expenditures, have been made in the recent past. They include unfunded liabilities for Social Security and Medicare for a total ranging from $53 trillion to $70 trillion, depending on the assumptions. In addition, in 2005, the American Society of Civil Engineers estimated that the cost of repairing deteriorated infrastructures would be about $1.6 trillion. It is not known to this writer whether, and to what extent, these estimates overlap with those made by the mentioned writers and by the Administration.

Auerbach and Gale discuss at length various alternative scenarios and a number of policy changes – concerning taxation and expenditures – which, if introduced, would close "the fiscal gap." The reader is referred to that discussion for a better understanding of the problem and

projections.

In the remaining paragraphs of this section, the U.S. budget problems will be dealt with within the context of global imbalances. The starting point is an axiomatic proposition: for deficits of any kind to materialize it is required that there is a corresponding financing. This applies to individuals, business and governments – including the U.S. Government. In the case of the latter, the financing would consist of issues of Treasury bonds or notes, and, although I.O.U.'s may be issued to various government trust funds, (at least in the near future) the financing can be obtained from essentially three main sources: private domestic buyers, especially institutional investors; the Federal Reserve System; and foreign public and private entities. Any attempt at anticipating with some precision the proportions in which these sources of financing would participate would prove to be futile, especially because a number of unpredictable events and variables will influence each of them. One can only evaluate the broad directions in which each source would move, based on policies and economic objectives. Insofar as the institutional investors are concerned, a very important variable will be the rate of return on investment, in real terms, and this, in turn depends on the expected rate of inflation (see later). At any rate, substantial participation by this source would divert, pro tanto, the corresponding financial resources away from private investments in the domestic economy, thus adversely impacting economic growth.

The rate of change in economic activity – after a full recovery has started – both in the United States and abroad, is a crucial variable. A positive rate of change in GDP in the U.S., if anemic, will severely condition the capacity of the Federal Reserve System to finance government deficits, assuming – and this is a big assumption – that the System will continue to pursue its primary objective: to fight inflation. This assumption may have to be dropped; but keeping it for a moment, the System is expected, at least in initial years, to reabsorb the liquidity injected in the recent past into the market via purchases of bonds, i.e., to perform the reverse operation (the so-called exit strategy). The System's degree of freedom will be further reduced if the foreign countries, some of which have already de-coupled from the U.S. (China, India, Peru, and

to a certain extent Brazil, among others) will resume a normal rate of growth, causing, inter alia, increases in the prices of major raw materials. This would likely result in cost-push increases in the general price level in the whole developed world.

As to the size and terms of financing from the central banks and private entities abroad, this would depend on the policies of surplus countries. A major datum is (see above) that, given the present large holdings of assets in foreign currencies by some major countries, these would be reluctant, in principle, to engage in substantial financing. An important variable are the terms of which they would be prepared to accept additional U.S. Treasury obligations. At the same time, these countries, particularly those which export a large amount of manufactured goods, will face a dilemma of their own. As long as the thrust of their overall policy is to maintain sizable export surplus, they would have to be prepared to see further accumulations of financial resources in foreign currencies. They would, then, have to decide among basically three courses of action: diversify away from the U.S. dollar, thus causing its depreciation, which would adversely affect their own exports; invest the surplus in real assets anywhere in the world; or, as a last resort, to purchase U.S. securities. A combination of these three options is of course possible, even likely, and the outcome would be, inter alia, limiting the purchases of U.S. securities. It is important to point out why latter outcome is likely.[5]

By holding U.S. Treasury securities (and other dollar securities) the foreign Central Banks (and other investors) run the risk of loss of value due to three different factors. The assumed large amount of future required financing of the U.S. budget deficit would induce potential buyers anywhere in the world to condition their purchases to higher returns, which would reduce the market value of existing holdings of dollar bonds. Should there be, in addition, higher inflation in the United States, as expected, the market value of those holdings would be further negatively affected. Foreign investors, for their part, would face a third

[5] Available estimates show that in 2009, until November, China raised its holdings of U.S. Treasury securities by only $62 billion, or about 4.9 percent of total Treasury borrowings. This compares with 47.4 percent in 2006.

risk in the likely event that the U.S. dollar would depreciate in terms of other currencies, if a diversification is pursued, and if inflation in the United States were to be significantly higher than in their own countries. This possibility would be enhanced in the not unlikely event that the Federal Reserve System played a major role in financing persistent high negative domestic financial imbalances.

It is highly probable that, because of these risks, Premier Wen Jiabao, and other Chinese officials, have recently stated that they would need "guarantees" insofar as holdings of U.S. Securities are concerned. It is not clear, however, what the nature of those desired guarantees is. A minimal guarantee, i.e., that the U.S. would pay at maturity the face value of the securities, would be no problem for the United States; but this would not eliminate the three risks mentioned above. One possibility would be an indexation of the value of the bonds, either to cover the inflation risk or the dollar depreciation risk, or both. It is to be expected, however, that the United States would strenuously resist these requests, not only because of their effect on the liabilities of the Treasury, in monetary terms; but also because of their likely repercussion on the market valuation of non-indexed bonds, and thus, on their yields.

The above discussion of possible events and of relevant variables suggests that there is high uncertainty as to which will be the major sources of financing of the projected U.S. fiscal deficits. Whatever the sources, however, the preceding considerations lead to the expectation that the yields on U.S. securities will increase substantially from their present low levels,[6] and this could adversely affect a fragile recovery. Thus, despite the uncertainties, one should expect that the Federal Reserve System will have to be, willy nilly, a relatively important buyer of Treasury securities in order to prevent yields on the bond market from rising to levels which could be considered incompatible to the resumption of a reasonable economic growth. This may raise serious doubts about the feasibility of an "exit strategy," in which case the inflationary potentials would increase.

[6] About 3.6 percent for ten-year notes.

5. Prospective monetary developments

The expected role of the Federal Reserve System in financing part of the estimated $9-10 trillion deficit over ten years would lead to an increase in fears in external (and internal) creditors of a reduction, in real terms, of the value of their fixed income securities holdings, due to inflation. In recent months, there has been a lively debate among professional economists in the United States as to inflation prospects. It is appropriate, therefore, to evaluate these prospects. To start with, one has to bear in mind that in the recent past a so-called “quantitative easing,” to alleviate the credit crisis, has added about $2 trillion to the System’s balance sheet, and this means that the market has received an equivalent amount of money, which is now “sitting,” mainly, in the balance sheets of institutional investors (probably in the expectation of higher yields). Some notable economists (including Nobel Prize winner Paul Krugman) dismiss the inflationary danger by pointing out: (a) the unused capacity in the U.S. economy; (b) a slack in the labor market; and (c) possibly a hoped-for policy of monetary re-absorption by the Federal Reserve System. Apart from the fact that these arguments implicitly ignore the possible role of the System, as mentioned above, in deficit financing, they are of a dubious validity for the following reasons. During the four years following the 1973 oil shock, total industrial capacity utilization fell from an index of 88.4 to 75.6 in 1975, and only slowly recovered thereafter to reach 85 in 1979. During the same period, civilian unemployment (in thousands) rose from 4,365 to 6,137, with a peak of 7,929 in 1975 (i.e., there was a slack in the labor market). At the same time, the consumer price index rose (annually, December to December) by 8.7% in 1973; 12.3% in 1974; 6.9% in 1975; 4.9% in 1976; 6.7% in 1977; 9% in 1978; and 13.3% in 1979. As is known, this phenomenon was called “stagflation.” This is not to predict that the same phenomenon will repeat itself, but nobody can exclude by far that it will, and there are circumstances in its favor. As different from the 1970s, the global situation during the coming years will be different from that in the 1970s in two major aspects. As mentioned in an earlier paragraph, a number of fast growing emerging countries have de-coupled from the U.S., and the

demand from their manufacturing sectors will exert upward pressure on raw materials prices (possibly including agricultural products due to a shift of production from foodstuffs (i.e., grains, sugar) to substitute energy products). The second aspect is that, should prices in developed countries, for monetary reasons or scarcity reasons, rise, oil producing countries with surpluses in external balances will try to push upwards the price of crude oil. Under these circumstances, the Federal Reserve System would face a very serious dilemma.

The prospect of an anemic recovery in the United States has already been mentioned in a preceding paragraph, and as above pointed out, there are factors which make this a distinct possibility. Since the $800 billion stimulus program, enacted this year, is a single impulse to the economy, its effects, according to the familiar income multiplier sequence, will peter out in a relatively short time.[7] Furthermore, the usual pattern in a recession is for labor employment to improve with a lag after the economic recovery has started. As a result, total demand is bound to recover at a slow pace, also because consumers' confidence, which has been severely shaken, will also be slow in returning to normal. Under this scenario the System will be under pressure, on the one hand, to stimulate a near stagnant economy, as a part and parcel of a broad economic policy and pursuant to the Humphrey-Hawkings Act. On the other hand, the System would be under mandate to follow a restrictive policy to perform its traditional statutory function of restraining inflation. In this particular case, this would include the re-absorption of the $2 trillion "quantitative easing." Given the prevailing political climate, the former course of action is the more likely to be followed. Consequently, a rate of inflation could be medium-to-high by historical standards. This expected outcome will have an important bearing on the dollar valuation.

6. The external imbalances

In August 1987, the Joint Economic Committee of the U.S. Congress

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[7] In many quarters, there have already been proposals for a second stimulus.

issued a Report (U.S. Congress, 1987) bearing the title "The Economy at Midyear: a Legacy of Foreign Debt." This Report was prompted, apparently, by the fact that in 1985 the United States had become a net debtor to the rest of the world, after having been a net creditor for a long time. This excellent, well thought out and detailed Report is a useful reading for anyone, including policy makers, at this time. In a way, it was prescient. Even though in 1987 the problem, in quantitative terms, was minimal compared with the present situation, the warnings and recommendations in it were appropriate and sound. It is worth quoting a few passages:

> "The choice at this juncture is clear. To continue on the present course will risk either an enormous further run-up in our external debt obligations or a sharp recession. Either foreign investors will continue to lend us money, adding future obligations, or the foreign lending will stop, forcing a severe adjustment. Neither outcome is desirable for the long-term health of the U.S. economy. The country needs a change in direction in overall economic policy." (p.5)

and,

> "This Report has shown that the U.S. position as the world's largest debtor nation confronts us with an utterly new set of economic challenges. We cannot continue to go ever deeper into debt and still retain our status as a world leader." (p.37)

and,

> "A fundamental reorientation of policy is needed to met these new challenges. This will require hard choices and new directions. We will need to place a higher priority on production than on consumption, and to promote investment for the future rather than indulgence in the present" (p.37) (italics added).

The following year, Mr. M. A. Akhtar, Vice President of the Federal Reserve Bank of New York made a detailed review of the U.S. external imbalances and, inter alia, concluded:

> "[...] a continuation of large external imbalances poses a most serious threat to the medium- and long-term health of the U.S. and global economy. The international deficit, therefore, appears to us to be one of America's most

> pressing economic problems, which must be reduced much further or perhaps even eliminated, in coming years" (Akhtar, 1988, p.33).

These warnings and recommendations went unheeded. The same policies continued over the following decades; the current account deficits continued, and they grew (though with some fluctuations) at a rapid rate (only in 1999 – a recession year – there was a minor surplus). Data from the U.S. Department of Commerce show that at the end of 2007 the United States had a net international investment position of about minus $2.1 trillion. At the end of 2008 the debtor position had reached $3.5 trillion. This compares with a negative position of some $22 billion in 1986.

The cumulative deficits of the current account of the balance of payments were the principal cause of this financial deterioration. From 1982 (the first year of major deficits) to 2009 the total added up to $7.8 trillion; with about $5.4 trillion having occurred between 2000 and 2008. The available data show that the deterioration of the U.S. external financial position continued, though at a lesser pace, in 2009. The monthly trade deficits this year may average $30-36 billion, which is very high considering the severe recession which reduced total demand and demand for foreign goods at the consumption and production levels. In comparison, the monthly average deficits in 1991, when the recession was much shallower, was only about $6 billion. This hints at a deeper problem, i.e., a structural deficit at the production level, which will be discussed in a later section. At any rate, according to past experiences, the deficits are likely to return to almost their previous high levels, once the economy recovers, and the net international investment position is expected to deteriorate further.

At this juncture, the question should be raised, as in the case of projected U.S. deficits, i.e., for the external deficits to materialize there must be financing from some external sources. To provide an answer, an examination of a number of developments in the years past is instructive. The explanation which is frequently offered for the external deficits is based on the simplistic notion that excess savings in some countries are the counterpart of dis-savings in others. This is almost a tautology. The following may contain repetitions of parts of previous paragraphs. The phenomena and the sequence of events are rather complex, as their

determinants were economic, financial and political, and the following explanation contains the bare essentials.

From the early 1980s, the annual budget deficits in the United States were repeated single impulses, which together with an accommodative policy, produced an expansion of final demand. The foreign goods component of the final demand, possibly coupled with a process of de-industrialization (it could be argued that the phenomenon was, in part, the result of the maintenance of the dollar at an unduly high level), resulted in the often mentioned deficit in external accounts. As imports from many countries, especially from low labor cost, emerging countries, were invoiced in U.S. dollars, the payment for them produced two simultaneous results: (a) a contribution to the increase in deficits, and (b) an automatic capital inflow into the United States. These capital transfers appeared in the exporting countries, wholly or in part, as additions to the reserves of the monetary authorities. Since these financial claims on the U.S. were used, in part, to purchase Treasury securities, they financed, pro tanto, the U.S. budget deficits. At the same time, the purchase of ten-year Treasury bonds kept the interest rates on these securities at a low level, and as these interest rates had an important influence in determining the interest rate of the mortgage loans to finance home purchases and construction, the housing boom was facilitated in the process. Furthermore, the low prices of goods imported from low cost emerging countries (mainly China) helped maintaining a low rate of inflation, thus dispensing the Federal Reserve System from pursuing a restrictive monetary policy. This, in turn, stimulated consumption, investment and over-indebtedness.

No doubt, this is an oversimplified presentation, but it captures one sequence of past financial and economic developments in the United States. The main financial results were: in the United States, an increase in indebtedness to foreign financial (and non-financial) institutions, and a progressive loss of industrial capacity, and in foreign countries, a steady increase in claims vis-a-vis the United States. This was reflected in a striking improvement in the financial position of the rest of the world, which is detailed in the following.

From 1982 to the end of 2008, reserves (minus gold)[8] held by the rest of the world (i.e., outside the United States) rose from $364.3 billion to $6,722 billion in. By far the largest increase was registered by "Emerging and Developing Countries." Their combined reserves rose from $142.2 billion in 1982 to $4,287 billion in 2008. Of the latter amount, an estimated $2.1 trillion was held by China, compared with $11.8 billion in 1982. Moreover, $1.1 trillion was held by Japan, compared with $33.9 billion in 1982.

Until 2009, China, Japan, other Asian countries, and some Middle East countries invested a large proportion of their liquid foreign exchange holdings in U.S. Treasury and other U.S. Government securities. At the end of 2009, the category designed as "Foreign and International" held a total of about $3.5 trillion. Precise data for each country are not available, but various estimates place China's holdings at about $800 billion; and a similar amount is estimated for holdings by Japan.

In the prospective medium term, the above mentioned surplus countries are expected to continue to accumulate dollar liquid assets. The rate of accumulation is not expected, however, to be of the same order as in the recent past, before the onset of the credit crisis. Consistently with the expectation of a slow rate of growth in the United States and in the Western economies, the total surplus in the combined balance of payments of such countries in 2009 could be in order of $ 650-800 billion.

In the absence of unexpected developments (which, however, cannot be excluded, given the unsustainability of U.S. fiscal and external deficits), China is likely to continue to be the recipient of sizable inflows of dollars. Having expressed concerns about the safety of the existing stocks of dollar assets, these possible additions would create difficult policy dilemmas. Diversification of reserves into other currencies (e.g., euros, pounds, yens) could provide a limited relief, but the major problem will remain. To obviate further dollar accumulations, a possible technical device could be to require that all exports be invoiced in renminbi. This requirement will force importers in the U.S. to purchase renminbis in the

[8] The original figures (from IMF's statistics) are in the SDRs. They have been converted into US dollars at the average exchange rates in the respective years. A large proportion of the reserves was held in dollars, especially in 1982.

open market, but then the Central Bank of China would have the dilemma of either allowing the renminbi to appreciate substantially against the U.S. dollar, which could be contrary to their long-standing policy to assure continuing large export surpluses, or to intervene in the market by purchasing dollars. This would not substantially change what has taken place during the past decades.

This goes to the core of China's policy dilemma. The "price" of maintaining a large export surplus, as a factor of domestic economic growth, has been continuos reserve accumulation and so far, China appears to have been prepared to pay that "price." This is also because the country has been able to attain other objectives. To mention a few, one could point out the attainment of a higher political power in the geopolitical set-up, to the build up of large military capacities, to the securing of safe sources through acquisitions of raw materials in other countries in Africa and Latin America, and last but not the least, to the slow erosion of America's industrial power.

Recent events, however, appear to show that current and prospective developments in the financial areas in the United States, have convinced the Chinese authorities that the "price" is, or will be, too high. This is evidenced by the repeated statements of recent months as to the need of a new reserve currency, by increased investments in real assets in developed and developing countries, as well as by seeking a remedy, however limited, through invoicing in renminbi exports to a number of neighboring countries.

None of the above is likely, however, to refrain the Chinese authorities from exercising political pressures in international fora to reshape the economic and financial world order.

7. The economic problem

In a preceding paragraph it was pointed out that during the current recession, the U.S. trade deficit, estimated at an annual rate of roughly $400 billion, is much higher than that during 1991-1992 when the recession was much shallower. This denotes that the capacity of the U.S.

economy to provide goods for domestic use and/or exports had declined. In more general terms, there is evidence of a large shift in the balance between the U.S. economy and that of the rest of the world. This imbalance will prove more difficult to correct (than the financial imbalance) without resorting to extraordinary measures, including those affecting world trade. Some broad indicators are revealing: between 1992 (when the deficits started accelerating) and 2009, total non-petroleum imports rose from $485 billion to $1,664 billion. During the same period, industrial production in the United States rose by some 55 percent whereas in India it rose by 179 percent, in Korea by 212 percent, and in China by more than 600 percent. Moreover, in the United States capacity in manufacturing rose, between 2001 and 2007, by 4 percent which was less than the increase in population of 6.9 percent, and the increase in civilian labor force of 6.5 percent.

Some detailed figures are more informative. Between 1992 and 2009 iron and steel production decreased by 2.8 percent, as a number of steel plants were closed in the United States, and the textile industry suffered one of the largest declines, since in 2009 production of apparel was only slightly more than 36 percent of that in 1992. Imports in the above sectors rose sharply, and so did those of television sets, home appliances, and small electronic goods, the production of which either ceased or was minimal. This de-industrialization process began in the early 1980s with the so-called "hollow corporation" which involved the transfer by U.S. companies of production facilities to neighboring countries – particularly those with low wages and technical skills – while the corporation remained nominally and legally in the United States. In the decades which followed, especially after 1990, the process continued with the gradual shrinking of U.S. production facilities, especially for a large variety of consumer goods, and a corresponding increase in imports (and trade imbalances).[9]

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[9] A recent detailed survey by *Business Week* (September 21, 2009) lamented the insufficient assistance by public authorities in the United States to the development of innovations, and concluded that "[t]hinking like a developing nation may be a comedown for the world's greatest economic superpower. But that is the level to which America's

Since this international distribution of productive structures is at the root of financial imbalances between the United States and the rest of the world,[10] a correction of the situation is essential, but at the same time, it is a formidable undertaking. A hypothetical policy of re-industrialization in the United States will bring into the open contrasting interests which at the moment are latent. Those emerging countries which have gained large shares in international trade would naturally oppose any measure that would adversely affect their position. Likewise, other developing countries, with incipient industries, and those eager to receive transfers of technologies to start industrial activities, would consider such U.S. policy harmful to their objectives. The latter group would include countries where newly industrialized emerging countries (e.g., China) would relocate some of their labor intense activities.

The problems, and the conflicts of interest would not arise, of course, if global demand for consumption and production goods were to rise at a sufficiently high rate to absorb the presumed addition to supplies. Under foreseeable circumstances, however, and considering the prospective demographic dynamics of a number of Western developed countries and Japan, that development in demand is unlikely to materialize in the medium term. If this assessment is correct, a re-industrialization policy by the United States would require a set of un-orthodox measures.[11] They would include import tariffs and/or quotas, easy credit facilities for designated investments, accelerated depreciation provisions in the tax code for new plants, and export subsides. A sizable depreciation of the dollar – far from being excluded – would be a useful complement. A number of these measures would be the subject of litigation within the World Trade Organization. They could also instigate

manufacturing might has eroded. Unless it changes course, the U.S. not only won't be able to recapture industries it has lost - it may not be able to launch industries it invents.”

[10] The problem may become even more acute with, for instance, India and China developing automotive industrial capacities even for export purposes. Moreover, China's government is trying to restrain the expansion of six sectors already with excess capacity: steel, cement, flat glass, polisylicon, and chemically processed coal.

[11] A precondition would be the training of an adequate labor force, since new plants would incorporate modern technologies, and their location could be different from that of the closed facilities.

retaliatory measures elsewhere, which would be destructive for world trade and growth.

The above discussion of the requirements for establishing a measure of balance between the United States and the rest of the world is, inevitably, an imperfect and oversimplified presentation of more interlocking developments which may follow a mentioned U.S. policy change. Unforeseeable developments, as well as the varying degrees of reactions by all the parties involved may make matters more complicated. Its only purpose has been to emphasize the difficulty (and necessity) of the task, and to suggest, by implication, that an orderly solution of the problems would require a comprehensive international collaboration, however difficult this would be within the scope of the present geopolitical framework, with powerful contrasting political forces.

8. The U.S. dollar prospective developments

Any close observer of foreign exchange markets during the last twenty years or so, would be forced to come to a conclusion that anticipating with accuracy the exchange rate of the U.S. dollar in terms of other currencies for the near or distant future, is an exercise in futility. A few data are sufficient to support this statement.

During the early 1980s, and until March 1985, the dollar rose in value in foreign exchange markets to a high point (expressed in euros on the basis of the DM exchange rates) of €1.73 per U.S. $1. From this peak, the dollar declined, somewhat irregularly but steadily, to €0.69 per U.S. $1 in the Fall of 1995. No attempt made by economists and analysts to give a satisfactory explanation of the former ascent was successful. The same can be said of the, later, long decline.

These phenomena should be viewed within the background of the volume transactions in the foreign exchange markets. The latest figures available are those of the periodic BIS survey of 2007. According to this survey, the daily transactions of all kinds amounted to $3.2 trillion in

2007.[12] This figure by far dwarfs the value of the world trade and services transactions. Other factors to be born in mind are: the large influence on exchange rates of differentials in short term interest rates in various countries; the so-called "carry trade"; and, at least during the last year or so, the so-called "flight to safety," or vice versa.

Therefore, any attempt at anticipating the path of the U.S. dollar in the medium term may have to rely on more fundamental factors. In 1971, the then U.S. Secretary of Treasury made a celebrated statement at an international gathering: "The dollar is our currency, but it is your problem." There are reasons to believe, however, that Mr. Connolly's statement has lost much of its validity, because the "fundamentals" at this time are very different.

The figures reported in previous Sections for the U.S. economy show at least three developments and prospects which are relevant: (a) a projection of a budget deficit of some $9-10 trillion during the period 2009-19, and more deficits thereafter; (b) a persistent balance of payments deficit which, even with a shallower recovery in the United States could return to levels close to those in 2006-2007, possibly adding up to some $6 trillion in a ten years period; (c) a monetary expansion of some $2 trillion by the Federal Reserve System (the so-called quantitative easing) which, in principle, should be reabsorbed, but this prospect is doubtful. As mentioned in previous sections, assuming that the fiscal deficits will materialize, the System may have to purchase a certain percentage of annual issues of Treasury securities.

Taking the above three projections at their face value, they would lead to an expectation of a sizable reduction in the value of the dollar both internally (i.e., inflation) and in the foreign exchange markets. It could be validly argued, however, that the three projections are not consistent with other factors, also because of the already expressed uneasiness by surplus countries about their existing holdings of dollar assets, and consequently of their reluctance to increase substantially those assets.

[12] According to WTO statistics, total annual world trade and related services in 2007 amounted to $ 13.6 trillion.

The dollar problem has been increasingly recognized by professionals, with dire predictions for the valuation of the currency, even though the U.S. overt official position continues to be the mantra that "a strong dollar is in the best interest of the United States." In many quarters it is believed that an important measure which would substantially reduce the external deficits would be a sizable devaluation of the dollar. No doubt, this is a classic textbook prescription, but unfortunately, it does not seem to apply to the case of a reserve currency which is also a major trading currency. Besides, as was shown in the section 5, there are powerful underlying economic factors causing trade imbalances in the United States. At any rate, doubts about the effectiveness of a devaluation, per se, to eliminate or substantially correct imbalances, arise from the following facts.

Table 1 – *Dollar exchange rates – Annual averages*

	DM	Yen	Brit Pound	Swiss franc
1985	2.94	238	0.77	2,46
1995	1.43	94	0.55	1,18

The figures in the Table show that the average exchange rate of the dollar in 1995 was less than half that of 1985, except in the case of the British pound. During the same period, the balance of payments deficit changed from – $118.2 billion in 1985 to – $113.6 billion in 1995; showing that a very large depreciation produced only a very small reduction in the external annual deficits. This result is not attributable to changes in oil prices since the non-petroleum imports, during that period, rose from $286.7 billion to $693 billion.

Private reports, in recent months, of U.S. high officials prodding surplus countries to continue purchasing Treasury securities, and the open pronouncements asking for a replacement of the dollar as a reserve currency show that, contrary to Mr. Connolly's dictum, the dollar is also a problem for the United States.

Taking a medium term view, a dollar devaluation would have

widespread effects, especially if it were accompanied by: (a) a reduction of the role of the dollar as a reserve currency, and (b) a change in the pricing of the petroleum (and possibly of other materials now priced in dollars) into another currency or a "composite." The two above mentioned hypothetical changes would have inflationary effects in the United States since they would release for other uses the amounts now dormant in reserves and/or utilized in commodity transactions. Another possible effect on the United States external accounts could result from a shift of the financial transactions away from the U.S. capital markets to others around the world.

A study by the Federal Reserve Bank of New York in 2007 (Peristiani, 2007) concluded:

> "Concern is growing that the U.S. capital markets are losing market shares to overseas competitors. A decline in foreign initial public offerings indeed suggests that the U.S. equity market is becoming less attractive to certain issuers. However, evidence on the competitiveness of the U.S. equity market is mixed, since the trends affecting it are likewise shaping equity markets abroad. A less ambiguous decline in the share of global issuance can be seen in the U.S. corporate bond market, which is facing a growing challenge from the Eurobond market."

Should a dollar devaluation impact further the U.S. markets mentioned in the above quotation, the foreign exchange earnings of the financial institutions would be affected. It is not conceivable, of course, that even the combined markets of London, Tokyo, Frankfurt and Shanghai would replace New York and other U.S. financial centers, even in the medium term, but a shift would adversely affect the invisible earnings of the United States.

The balance of payments of the countries in the rest of the world with surpluses in their accounts, would, of course, be negatively affected by a dollar devaluation, as they would lose some of their competitiveness; and correspondingly, the positive effect on their economies from the export surplus would be reduced. Some would suffer larger trade deficits. The impact would depend on the magnitude of the devaluation, and it would not be uniform, particularly in the case of countries (e.g., China) which peg their currency to the dollar. Oil exporting countries would,

normally, not be affected.

The following conclusions appear warranted:

1. A dollar devaluation in the medium term appears inevitable (at the time of writing the euro exchange rate is $1.48 to €1).

2. A devaluation would not solve the external imbalances of the United States, unless accompanied by other measures; mainly a restructuring of the economy.

3. A devaluation could be accompanied by other changes in international transactions, initiated by other countries, singularly or jointly, which could have adverse effects on the U.S. economy.

4. Most of the countries in the rest of the world would also be significantly affected in their economies and external balances.

5. Because of the effects mentioned in 1 to 4 above, it is likely – at least it is hoped – that all the relevant matters will be dealt with in one or more international fora. Conflicts of interest are likely to result in heated and contentious debates, and it would be presumptuous to anticipate the outcomes.

Many writers on these matters have occasionally referred to the "benefits" which resulted from the "Plaza Accord" of 1985, and they have advocated a repetition of a similar gathering with, presumably, different participants. This could have the positive effect of coordinating the actions, where possible, by the major countries concerned, even though in many instances their interests may be in opposition. Such an approach would be far superior to unilateral actions leading to a currency and trade war. It would also have another beneficial effect: paraphrasing de Tallayrand, currency relations are "much too serious a thing to be left to" exchange traders.

Conclusions

While the United States and the rest of the world are intently making efforts to re-establish a durable economic growth, a storm – a large one, at that – is gathering across the global economy. In fact, this storm has been developing over two decades, or so. As different from crises in

individual countries, which require action by national governments – and possibly coordination across national borders – the problems discussed in this article are more complex and more difficult to solve. This is because of both their sheer dimensions, and of their deep seated determinants, but most of all, because their solution requires compromises of conflicting interests of the nations involved. The expected confrontations in the international arena arise within a new framework in which power – economic, political, and military – is shifting, as has been stated, from West to East – a phenomenon which, in and by itself, is bound to bring to the fore a play of raw political forces from all the parties concerned. A propitious aspect, in these historic circumstances, is that the thrust of the overall policies of the major players is different from the aggressive antagonisms of past conflicts, as, at least two of them are pursuing their objectives with determined but prudent perseverance, having a medium-to-long term horizon. And, at the same time, a new direction in international policy has emerged in the West – a collaborative orientation as different from the hegemonic drive of past decades. This is probably best epitomized by the following statements by U.S. President Barack Obama. In his address to the General Assembly of the United Nations on September 24, 2009, he said "[w]e have sought by words and deeds a new era of engagement with the world," and on November 14 he stated in Tokyo "[I] know there are many who question how the United States perceives China's emergence. But [...] in an interconnected world power does not need to be a zero-sum game, and nations need not to fear the success of another. Cultivating spheres of co-operation – not competing spheres of influence – will lead to progress in Asia-Pacific."

The discussion of problems and of possible solutions in this article have a time frame of five to ten years, which entails uncertainties due to the number and nature of unpredictable events, of economic variables, policy changes, which may be coming into play. There is more certainty, however, about the determinants of the problems, some of which go back at least two decades, during which time they have become deep rooted and, for that reason, difficult to correct in a short period of time.

In the economic and financial areas, two major events stand out: the policy which severe critics of the U.S. (see section 1) have branded as

fiscal "irresponsibility" in the United States, and a drastic change in general policy direction in China with the adoption of a pragmatic "state capitalism." At the same time, other Asian Countries started, years ago, pursuing vigorous policies of industrialization and modernization in the areas which had been the domain of the United States after the Second World War.

The advent of a major credit crisis in 2007 has produced policies in the United States which have exacerbated the problems which had been gradually building up in past years. Particularly in the fiscal and monetary areas the Administration's own projections are for very large budget deficits until 2019 and beyond – which has prompted scholars and analysts to describe the situation as unsustainable. And the Central Bank has engaged in an unprecedented monetary expansion, which has led to anticipations, in many quarters, of higher than normal inflation in years to come.

Furthermore, persistent deficits in external accounts, even with a falling demand due to a deep recession, and a substantial fall in oil prices from their previous peak – to mention only two major variables – have revealed underlying problems in the U.S. economy, more specifically the results of a process of de-industrialization, which started sometime in the 1980s. The expected diversion of financial resources from productive investments to the underwriting of part of the fiscal deficits, is bound to make the redressing of the industrial sector a harder problem than in normal circumstances, in view also of the understandable reluctance of foreign investors to inject resources into the U.S. economy.

With the expected resistance by surplus major emerging countries to relinquish, even in part, the achieved penetration in foreign market, and with the drive by lower income developing countries to industrialize, it is difficult not to anticipate, despite public proclamations and proddings to the contrary, that an era of protectionism (and likely retaliations) will be upon us in a not-too-distant future. To be sure, this is not an inevitable outcome, but it would only be avoided by exceptional circumstances, such as, inter alia, a rapid and sustained increase in effective demand throughout the world, coupled with a larger than normal increase in productivity. It would be very optimistic, however, to rely on these

factors, because investable resources will be absorbed, in part, not only by budget deficits in the U.S., but also by the undertaking of programs aimed at counteracting, or correcting, adverse circumstances, such as a deteriorating environment, both physical and social.

The usual upward push on prices, which would result from protectionism, added to the anticipated lax fiscal and monetary policies in the U.S., and the latter's persistent deficits in external accounts would increase the fears of a significant dollar depreciation. Incidentally, those fears may be enhanced by the advocation, in certain quarters, of a dollar depreciation as a remedy to external deficits, and as a somewhat cynical device to reduce the real burden of an increasing public debt.

One reason why until recently the problems mentioned above have not surfaced in international discussion, is that an unusual situation has prevailed, i.e., a co-dependency between the United States and the surplus countries, mainly China and the Middle East oil exporting countries. In the case of the latter, the quid-pro-quo has reportedly been the protection of the regional countries, particularly Saudi Arabia. In the case of China, and other Asian countries, the co-dependency has consisted in the advantage of surplus countries in the form of export-led growth and increasing financial power, and in the case of the United States, in the form of financing the fiscal deficits and of lower inflation.

The developments of the last two years or so, however, and the financial prospects in the United States for the medium term, appear to have brought that co-dependency to an end. It is probably reasonable to expect that the various "elements" of the co-dependency will become heavy topics for discussion. As already reported, explicit complaints have already been aired: China and the other BRIC countries have made known their dissatisfaction about the dollar as the major reserve currency, their desire to replace it, as well as their concern about the prospective value of the dollar. There is also a supposedly secret agreement among the oil countries, China, Japan, Russia and France to price oil exports in a currency different from the dollar.

What is not clear is which international forum will be most appropriate to tackle the various problems. The emergence of the G20 as a replacement of the G7 or G8, and as a main forum to discuss current

problems, is a promising development, but some problems, such as the interest of developing countries to receive transfer of technology for their enhancement, and in reducing the barriers to their primary products exports, can only be aired in a broader set-up. Furthermore, the change in the architecture of the international financial institutions, especially the thrust of the BRIC countries to bring to an end the dominant position of the United States (the veto power), as well as the insistence of developing countries to have a bigger voice in the decision making process; all of this would be appropriately dealt with within the financial institutions themselves.

Other weighty matters, which include the solution or reduction of imbalances in world trade, with a correlated "management" of a sizable decline of the US dollar in international markets, and a correction of economic maladjustment underlying those imbalances; would have to be more appropriately dealt with in a separate forum, with the possible participation of the WTO.

All of the above problems involve conflicting interests, even at a geopolitical power level. There is no assurance that all of them will be solved, even partially. In some cases, the solutions could involve a drawn-out process over a period of years. It is to be hoped, in any case, that in a new collaborative orientation among the major powers, constructive compromises, even after heated debates, will prevail for the benefit of all concerned.

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