CAPITAL FLOWS, GLOBAL LIQUIDITY AND EMERGING MARKET ECONOMIES (1990-2015): REVISITING THE BRETTON WOODS II POSTULATE

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DOCTOR OF PHILOSOPHY

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DECLARATION

This is to certify that thesis entitled, **"CAPITAL FLOWS, GLOBAL LIQUIDITY AND EMERGING MARKET ECONOMIES (1990-2015): REVISITING THE BRETTON WOODS II POSTULATE"**, submitted by **Krishnakumar S**, to the Centre for Economic Studies and Planning, School of Social Sciences, Jawaharlal Nehru University, New Delhi, India, in partial fulfilment of the requirements for the award of the degree of the Doctor of Philosophy has not been previously submitted for any other degree of this university or of any other university and is my original work.

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We recommend that this dissertation may be placed before examiners for evaluation.

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Dedicated to South Campus Library, Delhi University
For that great space for working,
the wonderful treasure of books and
the great environment for learning

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Abbreviations

ABS	Asset-backed securities
ADV	Advanced economies
AMF	Arab Monetary Fund
ARG	Argentina
ASEAN	Association of Southeast Asian Nations
AZER	Azerbaijan
BAN	Bangladesh
BCA	Balance on current account
BEL	Belgium
BGK	Bank Gospodarstwa Krajowego
BIS	Bank for International Settlements
BNP	Banque Nationale de Paris
BOPS	Balance of Payments Statistics
BOS	Balance on services
BRA	Brazil
BRI	Belt and Road Initiative
BRICS	Brazil, Russia, India, China, South Africa
BUBOR	Budapest Interbank Money Market Rate
BW	Bretton Woods
BWII	Bretton Woods II
CA	Current Account
CAD	Current Account Deficit
CAMB	Cambodia
CAS	Current Account Surplus
CBS	Consolidated Banking Statistics
CEC	Casa de Economii și Consemnațiuni
CEE	Central and Eastern Europe
CHF	Swiss Franc
CHL	Chile
CHN	China
CIC	China Investment Corporation
CIS	Commonwealth of Independent States
CMIM	Chiang Mai Initiative Multilateralization
COL	Colombia
CZEC	Czech Republic
DOTS	Direction of Trade Statistics
EC	European Commission
ECB	European Central Bank
EGY	Egypt
EMA	Emerging Asia
EMDA	Emerging and Developing Asia
EMDE	Emerging and Developing Economies
EME	Emerging Europe
EPW	Economic and Political Weekly

ESI	Employee State Insurance
ESIF	European Structural and Investment Funds
EU	European Union
EWN	External Wealth of Nations
FDI	Foreign Direct Investment
FHB	FHB Mortgage Bank
FINACC	Financial Account
FLAR	Latin American Reserve Fund
FSR	Financial Stability Report
GIC	Government of Singapore Investment Corporation
GDP	Gross Domestic Product
GDS	Gross Domestic Savings
GE	General Electric
GER	Germany
GFC	Global Financial Crisis
GIIPS	Greece, Ireland, Italy, Portugal and Spain
GPO	Government Printing Office, USA
GVA	Gross Value Added
HK	Hong Kong
HSBC	Hongkong and Shanghai Banking Corporation
HUF	Hungarian Forint
HUN	Hungary
IDEAS	International Development Economics Associates
IDN	Indonesia
IDS	International Debt Securities
IFI	International Financial Integration Ratio
IFS	International Financial Statistics
ILO	International Labour Office
IMF	International Monetary Fund
IND	India
INDO	Indonesia
INV	Investment
IRE	Ireland
JAP	Japan
KAZHA	Kazhakstan
KOR	Korea
LATAM	Latin America
LBS	Locational Banking Statistics
LSDV	Least Squares Dummy Variable
MAL	Malaysia
MAS	Monetary Authority of Singapore
MBS	Mortgage backed securities
MENA	Middle East and North Africa
MENAP	Middle East, North Africa and Pakistan
MEX	Mexico
MKB	Magyar Külkereskedelmi Bank
MNB	Magyar Nemzeti Bank

NBER	National Bureau of Economic Research
NBP	National Bank of Poland
NBR	National Bank of Romania
NETH	Netherlands
NFA	Net Foreign Assets
NIIP	Net International Investment Position
NOR	Norway
NRT	Net Resource Transfers
OCBC	Overseas Chinese Banking Corporation
OECD	Organisation of Economic Co-operation and Development
OFI	Other Foreign Investment
OTP	Országos Takarék Pénztár
PER	Peru
PFI	Porfolio Foreign Investment
PHI	Philippines
PLN	Polish zloty
PNG	Private non guaranteed
POL	Poland
PUB	Public
RBI	Reserve Bank of India
RFED	Russian Federation
ROM	Romania
RON	Romanian leu
SAFE	State Administration of Foreign Exchange
SARAB	Saudi Arabia
SLO	Slovenia
SLOVAK	Slovak Republic
SNG	Singapore
SSA	Sub Saharan Africa
SWITZ	Switzerland
SWF	Sovereign Wealth Fund
THA	Thailand
TUR	Turkey
UAE	United Arab Emirates
UK	United Kingdom
ULC	Unit Labour Cost
VIET	Vietnam
WB	World Bank
WBK	Bank Zachodni
WEO	World Economic Outlook
WTO	World Trade Organization
ZAF	South Africa

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Introduction

After the collapse of the Bretton Woods system in the early seventies, the global economy was witness to an unprecedented level of volatility. International financial markets experienced large fluctuations in exchange rates and asset prices. With financial globalization gathering momentum through the nineties, there was a steep increase in the external assets and liabilities of economies. The emerging market economies in particular were caught in the boom-bust cycles resulting from volatile capital flows. Diaz-Alejandro (1985) had rightly prophesied the movement of developing economies from an era of financial repression to an epoch of financial crash. Concerns were also expressed about the untrammelled mobility of capital as far back as in the eighties and nineties, and there was scepticism with respect to the ability of capital to flow downhill to the developing economies, contrary to the prognostications of the proponents of financial liberalisation.

This study intends to undertake a critical appraisal of the argument put forward by Dooley, Folkerts-Landau and Garber, known in economic literature as the Bretton Woods II postulate, which indirectly tries to make a virtue of the international monetary (non) system of sorts which has evolved over the years.

Dooley, Folkerts-Landau and Garber (2003) in their series of articles tried to conceptualise the contemporary international monetary system as Bretton Woods II. In their model, the economies are largely classified under three functional groups: centre, trade account economies and capital account economies. The objectives of the different groups of economies vary. The main objective of the centre country, United States, is to maintain the value of its reserve currency intact, irrespective of the unfavourable performance in the trade account. The trade account economies would like to maximise their access to external markets like the United States. In return for the trade surpluses, these economies, through the purchase of official Treasury securities of the United States government, maintain their exchange rates pegged to the dollar. Low yield on the official securities doesn't matter for them, trade surpluses matter. In fact, in the period from 2002 to 2007, the official holdings of Treasury securities increased from $700 bn to $1.6 trillion, literally doubling in a short span of time (Bertaut & Pounder, 2009). The capital account economies, on the other hand,

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would invest in the United States only for a higher return, i.e., through largely private capital inflows. In case their private investors (say, in Europe) nurture a fear that public debt in the United States is rising, and become reluctant to invest in US securities, then their currency (the euro) would appreciate. This too works ultimately in favour of the trade account economies, for they could now even export at the cost of the capital account economies. Thus, Dooley and others argue that the trade account economies would underwrite the Bretton Woods II order.

Bretton Woods II does not merely ignore the large welfare costs incurred in the process of accumulation of foreign exchange reserves on the part of the emerging economies, but also is blissfully unaware of the development concerns of the least developed economies and the problems they face in financing development. Rather than making a case for the reform of the international monetary system, this configuration which has evolved in the process of financial globalization, has been celebrated by Dooley and others as a panacea for the development problems of economies with large labour reserves.

This work is divided into five chapters. The first chapter attempts a critical overview of the Bretton Woods II postulate, as put forward by its proponents, in the light of the changing contours of global imbalances. As per this understanding, in return for access to export markets, the labour surplus economies would resort to the accumulation of foreign exchange reserves, thus keeping intact the strength of the dollar, even when the centre country, i.e., the USA, is recording rising current account deficits. The foreign exchange reserves accumulated by the emerging economies would also serve as collateral of sorts for the stock of capital invested by the advanced economies.

The second chapter tries to make sense of the growth process that has given rise to this configuration in eighteen emerging market and developing economies, which account for a substantial share of the emerging market universe. It examines the links between rates of growth and current account balances of these economies over a long period from 1989 to 2014, to bring out the volatility endemic to the kind of growth recorded. The chapter critically examines the process of foreign reserve accumulation, which according to the proponents of B W II, has been an important pillar of the international monetary system that has evolved through the nineties. It

further examines as to whether the exorbitant privilege enjoyed by the United States, in the form of the difference in the return on its external assets over its liabilities continues to hold in the aftermath of the global financial crisis. This is pertinent because, the period after the global financial crisis has been witness to a steady decrease in the current account surpluses of the emerging and developing economies.

Interestingly while the Bretton Woods II postulate focuses attention on the current account surpluses outside US and capital inflows from these economies to the US, the period has been one in which cross border flows to economies outside the US have also risen to new highs, both in the form of banking flows as well as those mediated through international debt securities. The third chapter tries to explore the vulnerabilities to which emerging economies are subjected on this account through an examination of the Locational and Consolidated Banking Statistics of the Bank for International Settlements (BIS), as well as other data. It draws attention to the faster pace at which dollar credit to the non-financial sector outside United States has been on the increase, accounting for almost $11.34 trillion (60 % of US GDP), as per BIS 2017 figures. Given that at least 30% of the same flowed to the emerging market economies, the risks associated with interest rate hikes in United States are too important to ignore. Using the BIS data, the chapter explores the *global liquidity paradox* to which emerging market economies are exposed in the   B W II phase.

For geographical and historical reasons, the economies of emerging Europe were major targets of capital flows. In fact, they had benefited substantially in the form of higher rates of growth during the period marked by a favourable tide of global liquidity between 2003 and 2008. This financialisation induced growth is under reversal in the context of the developments after the global financial crisis. Its associated effects in the form of lower rates of growth and improvement in current account is the subject of investigation in the fourth chapter. The region's economies were subordinated to the effects of cross-border capital flows and a substantive portion of the banking assets were owned by the foreign banks, with an increasing share of foreign currency denominated liabilities. The controls this has necessitated to address the attendant vulnerabilities, it is argued, could possibly make the economies of emerging Europe a surplus region in the evolving B W II system.

Within this configuration, supported with policies that enhance labour market flexibility, Germany has emerged as a leading exporter in the global economy. By keeping relative unit labour costs from improving in tandem with productivity improvements, it has managed to squeeze out a large current account surplus. This deflationary strategy of Germany has consequences not just for the stability of the eurozone itself, but for the world economy. In the next chapter, we explore the bilateral trade balance of Germany as against Greece, Ireland, Italy, Portugal and Spain as a function of relative unit labour costs. Contrary to the claims of advocates of B W II that with the exhaustion of labour reserves in China, other developing economies would graduate into being the new trade account economies, this chapter underscores the possibility of the advanced economies themselves emerging as export performers, by keeping relative costs from rising.

We end with some concluding observations bringing out the interrelationships between the B W II postulate and the contemporary international economy characterised by cross-border mobility of capital.

Chapter 1

Global Imbalances and Bretton Woods II Postulate

Introduction

The international monetary arrangement which evolved in the course of financial globalization, under which the leader country US was able to keep the value of its currency stable, despite its burgeoning current account deficits and worsening net international investment position, is referred to as Bretton Woods II.   This was made possible by the readiness with which the   developing, emerging-market countries were willing to buy Treasury securities of the United States, in return for the access to the large market in that country. Inasmuch as the exports resulting from that access underlay the growth success of some of the emerging market economies, the proponents of the Bretton Woods II postulate argue that it has been purportedly working in favour of growth and development in the emerging economies, referred to here as the periphery.

The stability of the arrangement has always been under a shadow of doubt, given that it was underwritten by the low-interest rate fed, bubble-economy of the United States, on the one hand, and a consumption squeeze in Asia, on the other. With the global financial crisis, the limits to this model have come to the fore. In the aftermath of the global financial crisis, the current account balances in the world economy have been through three important changes. There has been a reduction of both the current account deficit of the United States as well as the current account surplus of China. Whereas the emerging economies (other than China and oil producers) have moved from a current account surplus to a current account deficit, advanced economies (other than the United States) have moved from a deficit to surplus in the current account. Moreover, Germany, an advanced economy, has emerged as one with a large and dominant current account surplus. In fact, contrary to the claims of the proponents of the Bretton Woods II postulate that international financing for the developing economies had become easier under that arrangement, surpluses are now once again centred around advanced economies. Notwithstanding the increase in net private capital inflows to the emerging and developing economies, 80% or more of the stocks of foreign owned financial assets is located in the

developed countries.[1] In fact, the very premises underlying the postulate that the benefit of US current account deficits accrue to the developing periphery is under challenge, with the transformation of Germany into a major exporter. This chapter tries to explore the same in the light of the literature in this regard.

The chapter is divided into four sections. The first section attempts to provide an overview of contemporary trends in the international economy, with some focus on the issue of capital flows to emerging markets. The global imbalances which emerged in the backdrop of the low interest rate regime of the Greenspan years coupled with a series of financial innovations gave rise to an international monetary arrangement of sorts referred to as Bretton Woods II. Attempts have been made to draw similarities between this system and the Bretton Woods arrangements of the immediate post-war period, ignoring the extant institutions and macroeconomic policies which went into the making of the Golden Age of Capitalism during the 1950-70 period. The second section would try to shed light on the post-war international financial system with a brief retrospective examination of the Bretton Woods system and the circumstances which led to its collapse in 1970s. An overview of the literature relating to Bretton Woods II is attempted with a critique of the same in the third section. The next section discusses the Bretton Woods II postulate in the light of the changing trends in global imbalances. This is followed with some concluding observations.

I

Trends in the contemporary world economy

The last two decades of financial globalization have been characterized by large increases in the external liabilities and assets of countries across the world. The index of international financial integration (IFI), or the ratio of the sum of international assets and liabilities of a country to its GDP, has been on the increase across the world, with the ratio registering faster increases in the advanced economies as compared with emerging   market economies[2]. Even though this study on global

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[1](UNCTAD, 2012)

[2]For more on this see Lane(2012). See for data on the international financial integration ratios (i.e. assets plus liabilities to GDP)(Lane and Milesi-Ferretti,2007) and an updated database of 2010

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imbalances is particularly concerned about the shifts in current account or trade balances, the steep pace of accumulation of external liabilities in the period of financial globalization and the risks which that poses to the stability of world economy requires drawing attention to the IFI ratios. Particularly pronounced has been the increase in the case of the advanced economies, for which the index of international financial integration (IFI) has risen from 0.684 in 1980 to 4.382 in 2007. The period has also been witness to an increasing participation of emerging and developing economies in world trade, and a rise in the IFI ratios of the emerging markets, though to a much smaller degree, from 0.349 to 0.733.

Figure 1.1 provides figures on the IFIs of a number of countries based on data available in the Lane and Milessi-Ferretti (2010) database. It emerges that there are significant differences in the timing and pace of movement of the IFIs for individual advanced countries. In the case of the USA the IFI ratio rose steeply only from 2003, literally doubling from 1.5 (2003) to 3.12 in 2010, or to 312% of GDP. On the other hand, the IFI for Germany had touched 3.25 by 2003, and it rose to 4.69 by 2010. Meanwhile, the figure for Japan had not crossed 2 throughout that period.

The experience in emerging markets was even more varied. The IFI for Brazil in 1984 was 1, which was where it stood for Germany as well in that year. But, over the years, contrary to the steep increase in the value of the index for Germany and other countries, Brazil experienced large volatile changes in the figure, which however remained around 1 even in 2010. On the other hand, though the IFI ratio for Malaysia was characterized by large fluctuations in the context of various crises, it has been showing a persistent upward trend, with its value in 2010 standing at 2.34. Of interest is the experience of the fast growing economies, India and China. In India's case, the value of the IFI had registered a small rise from 0.43 (1999) to 0.84 (2007).

IFI ratio(United States)

IFI (Germany)

IFI(Japan)

IFI (Brazil)

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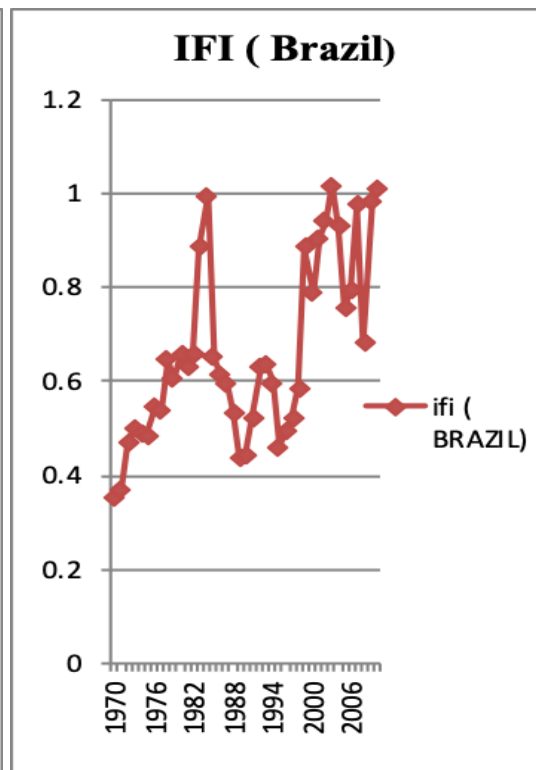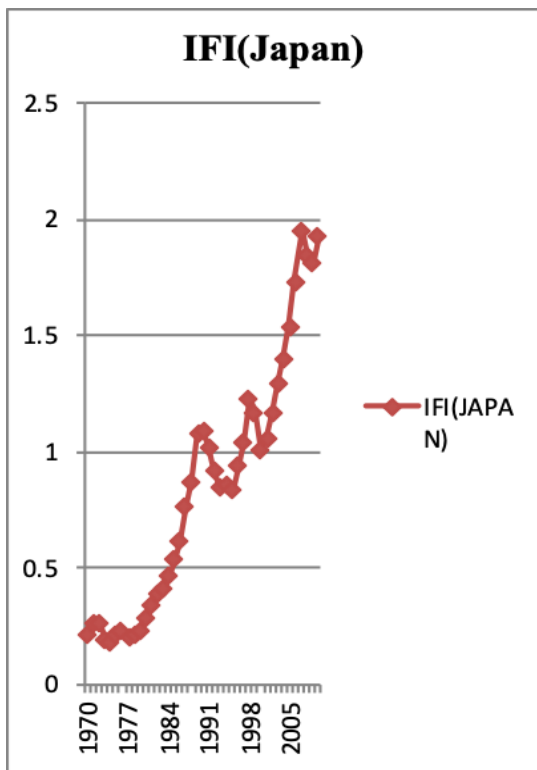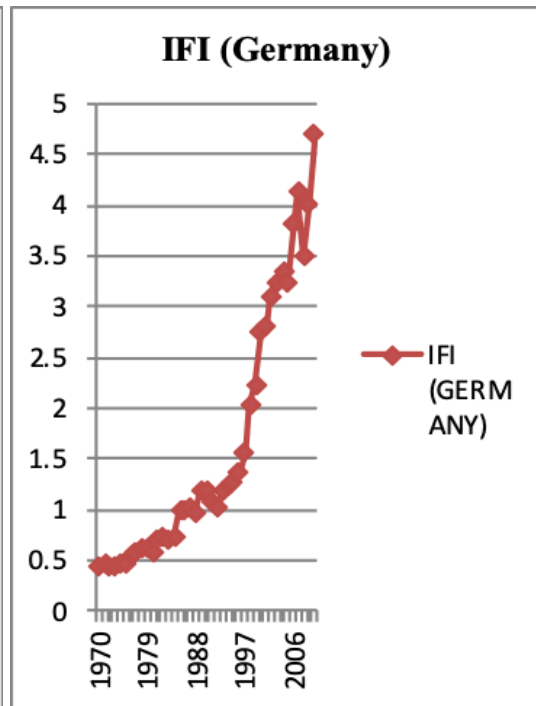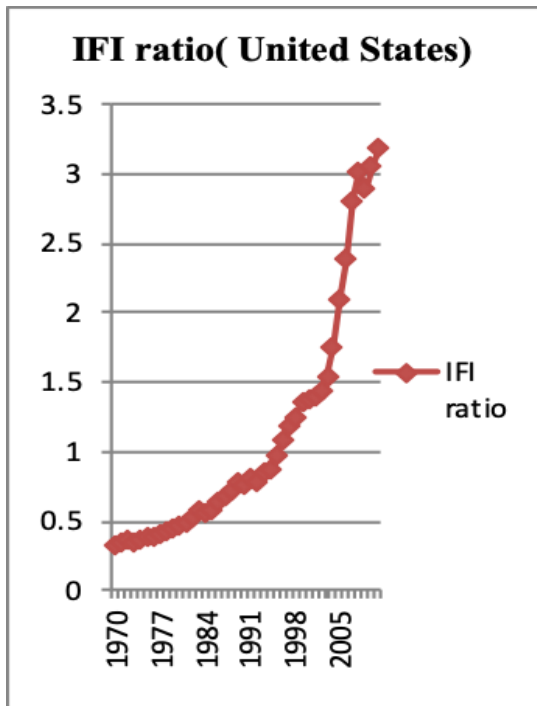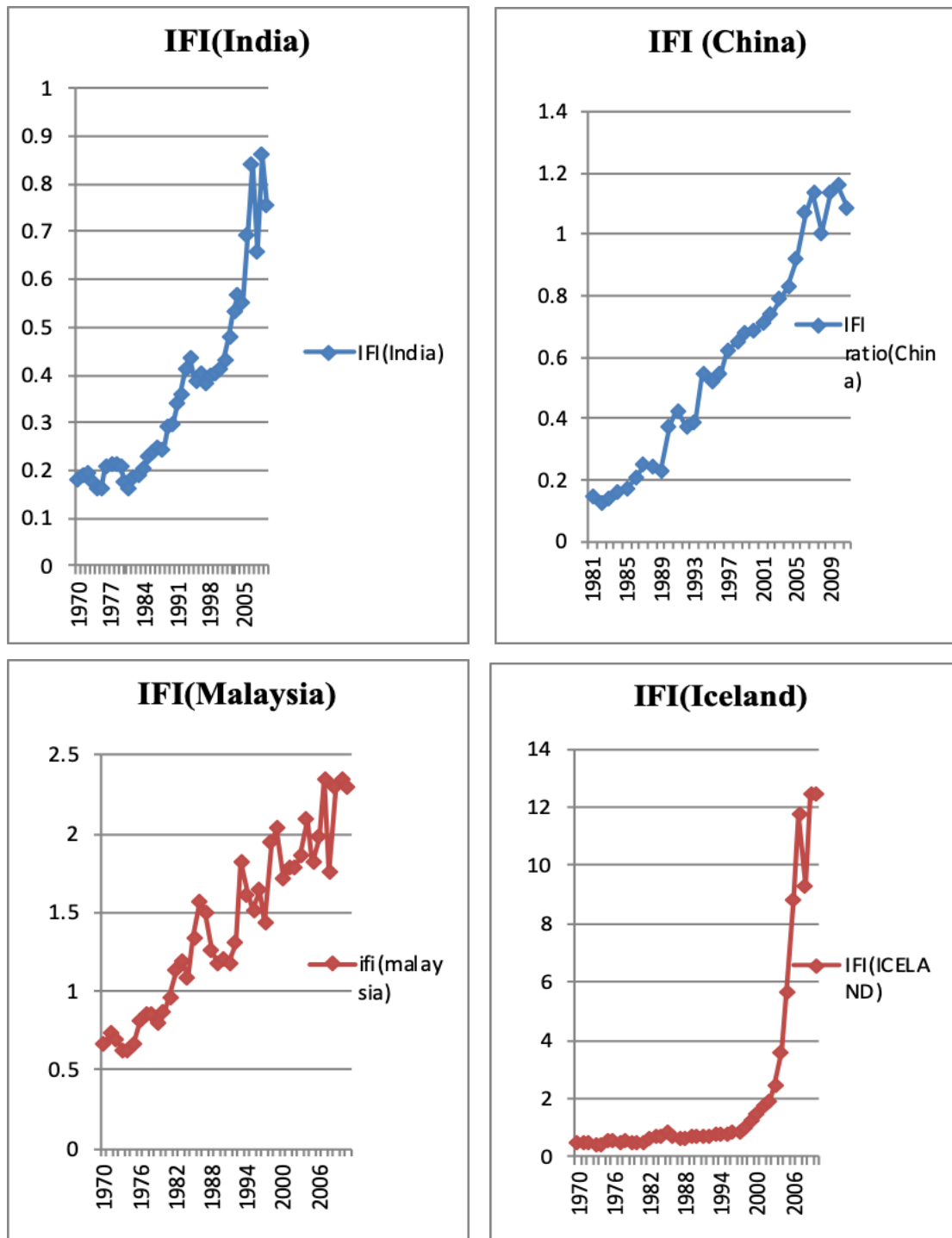
Figure 1.1: Change in IFI ratios of economies (1970-2010) *Source:Lane & Milessi-Ferreti,2010)*

In the course of the crisis, the IFI ratio dipped by 0.2 (i.e., from 0.84 to 0.65). Overall, compared to other economies, the IFI ratio of India has been low. So too is the case of China, which also registered an IFI ratio of just 1.2 by 2011. There are many countries serving as international financial centres, which by virtue of their

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large two-way capital flows, have very high IFIs, even as many countries with high levels of trade openness ratios have low IFI ratios. In so far as an economy like Iceland is concerned, which is among those serving as a banking and financial hub, prior to the global financial crisis in 2007, it had external assets amounting to 524% of its annual GDP, while it owed foreigners something to the tune of 636% of its GDP. It is pertinent to note here that even as the share of the developed economies in world trade had declined from 80% to 60% and that of the emerging and developing economies had increased from 20% to 40% in the period 1990 to 2015, the index of international financial integration of the advanced economies had increased at a much faster pace compared to their developing country counterparts. Financial integration in their case was rising far more rapidly than the level of integration through trade.

Even as the IFI ratios of different emerging market economies have been far lower than of their developed country counterparts, the data from World Economic Outlook Database of the IMF reveals that the net financial account flows to the emerging and developing economies increased from $92.86 bn (1.3% of EMDE GDP) in 2002 to $608.03 bn (4.5% of the EMDE GDP) in 2006, before it declined steeply in 2009 to 0.33% of the EMDE GDP. Even during the period from 2003 to 2008, the net inflows under other investment[3] constituted the larger share of the net financial inflows to the emerging market economies, bringing again to the fore the fact that a substantial share of the inflows to the developing economies are guided by the search for yield, given the large interest rate differentials. (Figure 1.2)

Except a small set of east Asian economies as well as the oil exporters, which had current account surpluses, much of what was showing up in the form of increase in foreign exchange reserves of the EMDEs has been on account of the net flows in the financial account. Contrary to the argument of the protagonists of Bretton Woods II that the accumulation of foreign exchange reserves was recorded in the EMDEs because of their improving export competitiveness (or pursuit of a mercantilist strategy), this accumulation was the result of capital inflows in excess of their current account financing requirements. The accumulation also reflected the self-insurance motive that overwhelmed the EMDEs, as a response to the volatile nature of flows on

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[3] According to the Balance of Payments Manual of the IMF, other investment is a residual category that includes all financial transactions not covered under direct investment, portfolio investment or reserve assets. The classification includes mainly loans and currency and deposits, apart from which it includes trade credits also. https://www.imf.org/external/np/sta/bop/bopman.pdf

the financial account. The view of the proponents of Bretton Woods II that this is a benign trend favourable to the developing economies, does not recognize the fact that this is more the fall-out of the predicament facing emerging economies in the context of the policies of capital account liberalisation that they chose to or were forced to adopt, coupled with the expansionary monetary policies pursued by developed country central banks since the global financial crisis.

Source: World Economic Outlook Database . October 2018

Source: World Economic Outlook Database . October 2018
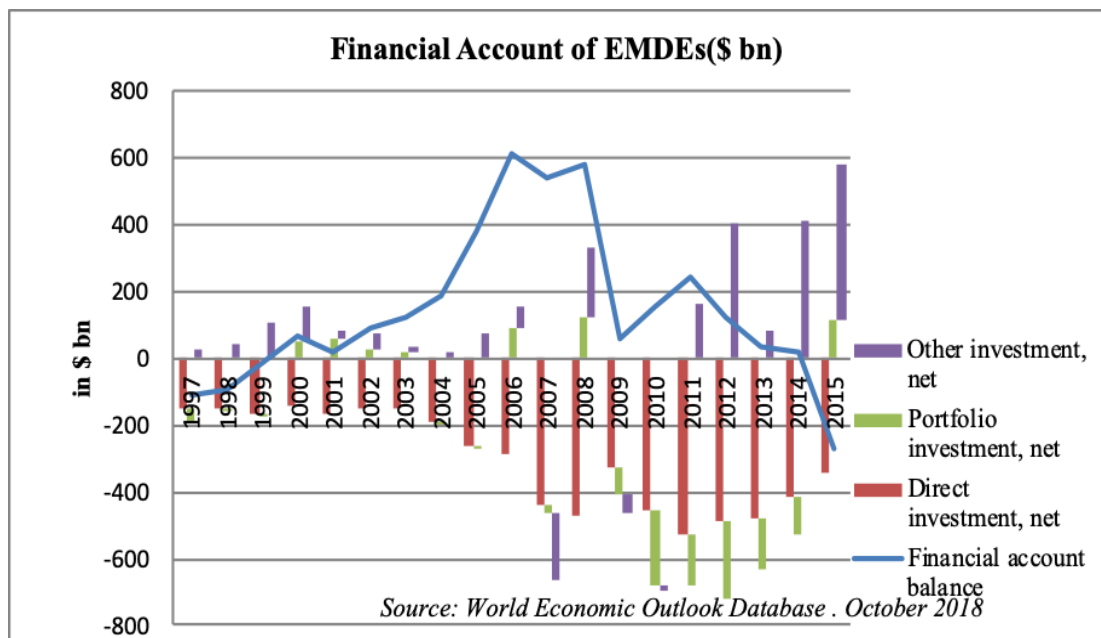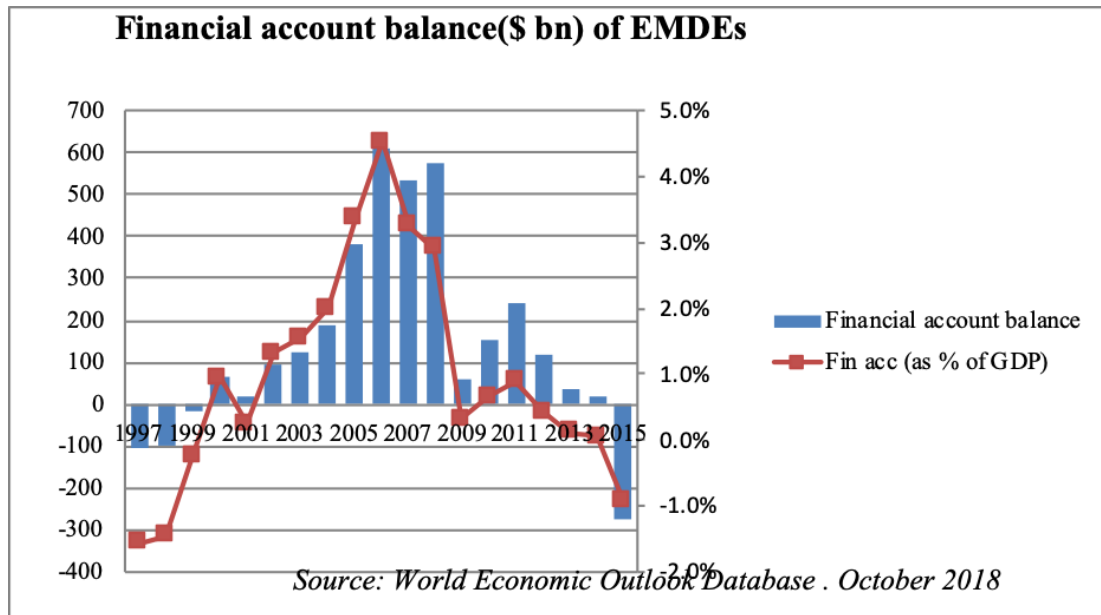
Figure 1.2: Financial Account of EMDEs

Two factors underlie this sharp increase in capital flows to and from developing countries. One is capital account liberalization in the developing countries themselves that has been underway for some time, making it possible for financial agents from the metropolitan centres to choose selected "emerging markets" as targets for their investment, as and when they want to. The second, is the push factor encouraging emerging market investments by these operatives, that resulted from the massive infusion of liquidity into the world system consequent to the adoption of easy money policies by some developed country central banks prior to the 2008 crisis, and the subsequent policy of 'quantitative easing' (bond purchases by the Fed Reserve as well as the European Central Bank as a means of infusing liquidity) adopted after the crisis. The availability of cheap liquidity resulted in a surge of capital flows to the emerging markets, where returns were high, encouraging investors to ignore exchange rate risk. Studies have drawn attention to the heavy costs incurred in terms of the social costs of the resultant accumulation of foreign exchange reserves[4] (Rodrik, 2006).

Large capital inflows have also meant that the emerging market and developing economies have been subject to volatility of various kinds, and the associated boom-bust cycles[5]. Moreover, over the last two decades, the international financial landscape has been witness to the growing importance of other kinds of financial institutions, apart from banks, like hedge funds, sovereign wealth funds, pension funds as well as private wealth funds, which have been massive purveyors of liquidity.

As per the data of the Sovereign Wealth Fund Institute, the assets worldwide under management of SWFs has reached close to $ 8 trillion, based on surpluses accruing from commodity price increases, apart from the surpluses of the economies in East Asia. In the period post-2000, different surplus economies with huge foreign exchange reserves have set apart a portion of the same as capital for SWFs, so that the returns are maximized by undertaking investments with reasonable risk. Contrary to

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[4] It remains a puzzle as to why developing economies could not resort to restrictions on short-term external liabilities as an alternative strategy. Different economies like Chile have successfully experimented with such measures.

[5] For more on this see the submission by UNCTAD Secretariat Subgroup on Capital Flows Management to G 20 Working Group on Reform of the International Monetary System titled *Capital flows and capital floods: The new curse of a globalised economy?* A summary of the same is included in (UNCTAD, 2012).In fact, this report goes on to suggest that apart from a regime of capital controls, the countries should peg exchange rates at constant real exchange rates.

the popular misperception that most of the SWFs are based in the developing economies, a substantial number of these is either from advanced economies or resource-rich ones (Norway, Canada, and the oil-producing economies). Leading among them, to name a few, are Norway's Global Pension Fund, China Investment Corporation, and SAFE Investment Company (China), Abu Dhabi Investment Authority Fund (U.A.E) and   General Investment Corporation and Temasek Holdings (Singapore). As per the recent data, the combined assets under CIC and SAFE of China outstrip that of Norway Global Pension Fund. This is also reflective of the changing trends in the composition of the external balance sheet of China, from being risk-averse to risk-loving. Even as efforts are underway towards regulating these entities through Santiago Principles, as purveyors of large funds, SWFs pose significant risks to the global economy.[6]

Since gross financial inflows and outflows across countries have grown far more since the seventies, in comparison to the trade flows, the shocks transmitted from one country to another through the financial channel has turned out to be far more important than the ones that are conveyed through the trade channel.[7]

Indeed, the low interest rates in Japan since the nineties, as well as the low rates in US and Europe in the past few years, as a result of the pursuit of unconventional monetary policies, has resulted in the these financial institutions borrowing in yen, euro and dollar at low interest rates, and buying assets in emerging and developing economies, in order to exploit the interest rate and financial return differences across these countries. This form of global 'carry trade' is not for facilitating trade, but is explicitly aimed at capitalizing on differentials in financial returns and interest rates. In the process, these investors also tend to benefit from the associated appreciation of the currency of the receiving country. In this context, the management of capital flows through foreign exchange market intervention has been an important pre-occupation of the central banks of the developing and emerging economies. To stem the tide of appreciation during phases of surges in capital

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[6] The Santiago Principles refer to 24 general principles enunciated with an intent to promote transparency, good governance and prudent investment practices among SWFs. For more information relating to the same, (Willett & Rajan, 2009). See also (Truman, 2010)for details on Santiago Principles. For recent data relating to the assets under management of SWFs, see https://www.swfinstitute.org/fund-rankings/sovereign-wealth-fund.It is also pertinent to note that one of the major investments undertaken by China Investment Corporation of $ 3 billion has been in the US-based Blackstone private equity group.

[7] This is captured through a simple model of the international finance multiplier, with the public as well as leveraged institutions as agents seeking domestic as well as foreign assets. See (Krugman,2009)

inflows, to prevent loss of competitiveness of their exports, central banks are forced to accumulate foreign exchange reserves, with associated costs to the central banks as well as government.

In certain instances, despite their best efforts, not only do the currencies appreciate, but, given the higher levels of inflation in the country *vis-à-vis* counterparts in the developed world, the currencies are witness to real exchange rate appreciation, thus undermining their competitiveness in international markets. In fact, there are cases where deterioration of the current account is the result of the flows occurring in the financial/capital account.[8]

When compared with movements in current account balances (surpluses and deficits) and net capital flows, gross capital inflows into and gross capital outflows from developing countries as a proportion of their national incomes have been far more volatile in the period 1990 to 2015. Figure 1.3 reveals the high level of volatility of gross capital inflows and gross capital outflows of Brazil and India, as against their current account figures during the period 1990 to 2011.The net result of such tendencies in the external account of countries has been the huge accumulation of gross external assets and liabilities across countries over the course of the last two decades. Because of that, even valuation changes in the measure of the stocks of liabilities and assets are found to have a much larger effect on the net international investment position (NIIP) or net foreign assets of countries, than changes in the current account. Obstfeld (2012) observes that even when the current account continued to be an important indicator of macroeconomic performance and financial stability of economies, the valuation change occurring through the change in the relative value of currencies, and its impact on the NIIP of these countries was turning out to be even more important.[9]

Associated with the large inflow of capital were recurrent financial crises, which started in the mid-1990s but gathered intensity after the 1997 Southeast Asian financial crisis, proving that the concerns raised by Diaz Alejandro and others much earlier, were well founded.[10]. When individual economies experience a bust because the capital flow spiral unwinds, a collapse of its currency value is often the result. The

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[8]For more on this as well as the turmoil in the emerging market economies in the backdrop of the retraction from the unconventional monetary policies, see (Akyuz, 2013)

[9] Attention is drawn here to his Richard T Ely lecture.(Obstfeld, 2012)

[10]See (Diaz-Alejandro, 1985)in this regard. And, for specific details relating to Asian crisis, see (Chandrasekhar and Ghosh, 2013)

impact of the exchange rate variations on the balance sheets of corporates, due to the structure of their assets and liabilities, currency of their denomination as well as their period of maturity can subject the economies concerned to a balance sheet recession.[11] The composition of capital flows, the currency of denomination as well as the length of the maturity of the inflows and outflows, which can lead to liquidity imbalances, have therefore assumed much importance in this period.[12]
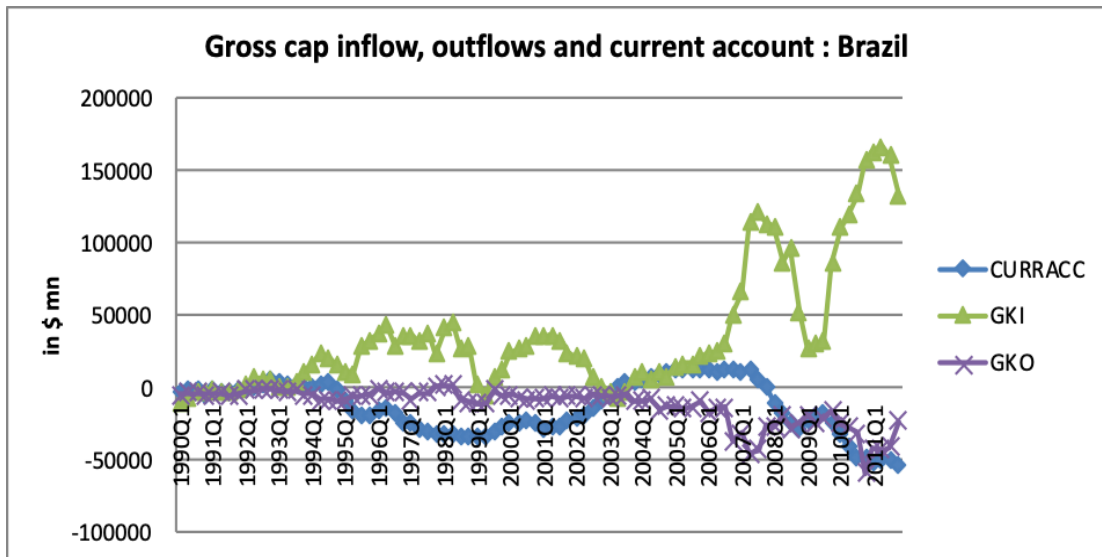
Source: IMF(2016)
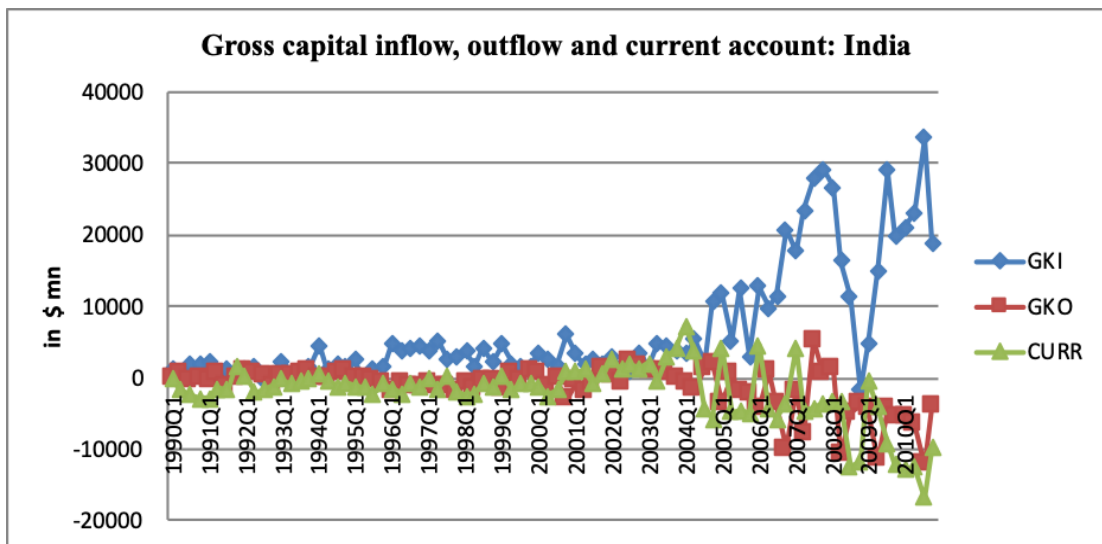
Source: IMF(2016)

Figure 1.3: Gross capital inflow, outflow and current account of India and Brazil

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[11]For a model based on the same, see(Krugman and Eggertson,2012)
[12](Gourinchas,2012)

Even as financial globalization picked up momentum, the policy discourse with respect to capital mobility and controls has undergone a drastic change. Contrary to the earlier optimism of the early nineties reflected in the Washington Consensus postulates, capital was found to flow uphill, i.e., from the poor to the rich economies[13]. One reason for this was that when faced with balance of payments difficulties, developing countries found it difficult to obtain resources from the international financial system, forcing them to turn to unpalatable, conditional financing from the International Monetary Fund (IMF). That required adoption of contractionary policies to reduce current account deficits. The asymmetry in access to financial resources from the international monetary system and the proneness to crises, driven home in particular by the Asian crisis of 1997-98, also encouraged precautionary reserve accumulation as insurance in times of crisis. The result was an unprecedented accumulation of large foreign exchange reserves by the central banks of Asia which were then invested in safe and liquid instruments like US Treasury bills, that accelerated the reverse flow of capital from the South to the North.

The response to crises also took the form of experiments with regional monetary co-operation like the Chiang Mai Initiative and the BRICS Bank. The basic rationale which guides the development of pooling arrangements like Chiang Mai Initiative, which was later replaced by Chiang Mai Initiative Multilateralization (CMIM), has been that member countries would tend to use reserves at different times . This would occur only if their international transactions are staggered and macroeconomic shocks are less than perfectly correlated, which is far from true during times when currency contagion afflicts a region.[14] Moreover, since the 2008-09 crisis, the precautionary line facility of the CMIM has rarely been used. This is due to the fact that the extent of dollar liquidity that could be drawn from the facility was too small to constitute a credible challenge to the reversal of international capital flows. But studies by Ocampo have drawn attention to the successful sharing of

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[13]Notwithstanding the net private capital inflow into the emerging market economies, there have been large official reserve transfers from the developing and emerging market economies to the developed world in the form of the investments in Treasury securities, that provoked Gourinchas (among others) to refer to the United States as the venture capitalist, which borrows short at low rates of interest and lends/invests long abroad.

[14]In the backdrop of the self-fulfilling currency crisis models, which tends to affect a region as a whole, or a set of countries, Eichengreen, among others, is sceptical of the utility of regional monetary co-operation.(Eichengreen, 2012)

reserves benefiting the participants of FLAR (Latin American Reserve Fund) and AMF (Arab Monetary Fund).[15]

Meanwhile, even international financial institutions and think tanks, which had been advocating full capital account convertibility began favouring some form of capital controls, even if not so much after the currency crisis in east Asia in 1997-98, but definitely after the global financial crisis, which exposed the different advanced economies in Europe to the risks raised by the unregulated two-way capital flows.[16]

The accumulation of reserves and regional arrangements do not, however, guarantee stability, especially for countries (such as India) where reserves are "borrowed" and not built with current account surpluses. Transitions from periods of a surge in global liquidity (such as 2003-08) to ones characterized by a sudden squeeze of liquidity (of the kind seen during the course of the 2008 global financial crisis), make growth in the period of financial globalization highly volatile. In fact, Chandrasekhar and Ghosh (2008) draw attention to the endogenous forces generated by the high tide of liquidity, which themselves sow the seeds of its destruction, giving rise to what they refer to as the 'global liquidity paradox'.

II

Post-war Bretton Woods international financial system and its collapse[17]

There have been attempts to trace similarities between the international payments mechanism which evolved in the course of the first decade of the current century, with the Bretton Woods system which came into being in the post-war

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[15] See (Ocampo, 2017)

[16] For the recent changes in the perspectives of the IMF in this regard, see (Arcand, Berkes, & Panizza, 2012). They are sceptical about any purpose served by financial development beyond a particular threshold. In fact, in the aftermath of Asian financial crisis itself, Bhagwati had taken exception to the then prevalent IMF argument favouring untrammelled capital mobility .(Bhagwati, 1998)

[17] This survey of literature relating to different events that led to the emergence of the post-war Bretton Woods international monetary system, and its collapse in the course of two decades relies on various works including(Bordo, 1993),(Eichengreen,2007), (Eichengreen,2008), (Marglin & Schor, 1990) and (Rakshit, 2001).

period. So, a historical analysis of the global payments system would help understand whether too much is being read into elements of similarity between these two periods.

It is in the backdrop of the beggar-thy-neighbour policies pursued by different countries in the context of the interwar years, which were characterized by floating exchange rates, destabilizing speculation, as well as high unemployment, that the world political and economic leadership met at Bretton Woods, New Hampshire to agree on a new international monetary arrangement for the post-war period. The international financial system that was in place for nearly the first nearly two decades of the second half of the twentieth century, was based on the Articles of Agreement of the International Monetary Fund signed into force in New Hampshire Bretton Woods in July 1944, and arrived at after heated interchanges between John Maynard Keynes and Harry Dexter White over the finer details.[18] They were able to come to an agreement on an exchange rate arrangement based on fixed rates, which could be changed only under conditions of fundamental disequilibrium. Under the Agreement, the exchange rates of currencies were fixed in terms of the dollar, and the dollar was convertible into gold at the rate of $35 for an ounce of gold. Given that US held three-fourths of the world's monetary gold stock after the war, the promise of convertibility of the dollar into gold appeared to be credible. The national currency of the United States was now the reserve currency of the international economy.

The system was distinct for the stability which it offered economies faced with short-term liquidity constraints, as well as those in fundamental disequilibrium. Countries faced with random or cyclical shocks, which could be addressed with expansionary fiscal and monetary policies, were provided temporary access to the gold they had contributed to the IMF's reserve pool and were also eligible to avail short term loans up to a limit. There was an escape clause that permitted countries to devalue their currencies, in case of an adverse permanent shift in the international situation, leading to a fundamental disequilibrium in the balance of payments of a country. This was crucial, because adjustments in prices and wages that could restore equilibrium would take time. It marked a fundamental departure from the Gold Standard regime of the nineteenth century. Further, to rescue countries from the ravages of international capital movements, they were free to institute capital controls.

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[18]For an engaging account of the details of the Bretton Woods deliberations and the differences of opinion which were aired, see (Steil, 2014)

Both in the pre-world war I as well as the interwar period, speculative capital flows impaired the abilities of countries to maintain internal and external balance under the Gold Standard.

To write about the Bretton Woods system in the post-war period sans the Marshall Plan would be like Hamlet without the Prince of Denmark. Since the global dollar shortage implied difficulties for the US as import restrictions elsewhere threatened its own activity levels, it recognized the importance of international aid for maintaining export levels. This perspective provided the background for the Marshall Plan, which involved large reconstruction expenditures in Europe to stimulate economies of the region.[19] Moreover, under the Bretton Woods system developed country governments adopted Keynesian-style aggregate demand management policies, with the government playing a far bigger role. The resulting buoyancy, coupled with productivity increases, contributed to a rise in the level of wages. Distributive disparities in the developed economies were on the decline, and even as external demand was increasing with the end of the disruption of the inter-war years, the role of the domestic market in driving growth was crucial. In contrast, during the period characterised as Bretton Woods II, i.e., the period with large increases in global liquidity and increasing financial globalization, there have been no concrete initiatives comparable to the Marshall Plan, the peripheral economies have pursued growth trajectories based on export orientation and a consumption squeeze, and there is evidence of widening inequalities, especially in the post-nineties period, across the world. It would only be opportune to mention here that in the aftermath of the global financial crisis, there has been an effort in the form of The Belt And Road Initiative (BRI) on the part of China, even while the advanced economies have been restricting their efforts to mere quantitative easing. Again, here, the initiative is not from the leader country, i.e., United States.[20]

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[19]Block(1977)noted that the Marshall Plan was far more than an effort to finance the export surplus , it simultaneously attacked all forces which were moving western Europe away from the liberal, capitalist , multilateral, international economic order desired by US: strength of European left, relative weaknesses of European economies, and most importantly, the pull of the Soviet Union. All this led to the passage of the Marshall Plan in the US Congress. (Marglin & Schor, 1990)p.67 . A detailed exposition of the period is given in article by Glyn and others "The Rise and Fall of the Golden Age" in (Marglin & Schor, 1990)

[20] The study by Centre for Global Development on Belt and Road Initiative argues that it is unlikely to cause a systemic debt problem, as is generally argued, but could have adverse effects on particular economies. (Hurley, Morris, & Portelance, 2018)

Apart from the initial devaluation of a number of currencies vis-à-vis the dollar, exchange rate adjustments became less frequent under the regime. Indeed, the world economy was relieved of the uncertainties regarding exchange rates of the inter-war years. During most of the 1950s and 1960s, Japan and many European countries used capital controls to maintain stable real exchange rates against the US dollar. Under the system, through the fifties and sixties, US recorded current account surpluses, but ran a balance of payments deficit with the rest of the world, thus providing the world with dollar liquidity. It played the role of a world banker, engaging in maturity transformation, by providing short term liquidity services (i.e., borrowing short-term) and lending long term to the rest of the world.[21]

The Bretton Woods period started with a phase of dollar shortage, due to the huge current account surpluses of the United States, but, in due course, the current account surplus fell to reasonable levels, and there were large capital outflows to the rest of the world from United States. However, towards the end of sixties, the fact that capital outflows from the US were far larger than the current account surpluses, led to fears, in France for example, that the promise of gold backing for the dollar liabilities of the US may not be sustained. Indeed the world was moving from a period of "dollar shortage" to one of "dollar glut", with the US over-exploiting the exorbitant privilege of being home to the reserve currency, and running large fiscal deficits to finance among other ventures the Good Society programme of President Johnson and the Vietnam War.

Inasmuch as countries were ready to pick up the dollar liabilities, and arrangements like the Gold Pool[22] were in place to take care of the price of dollar, there was no threat to the dollar. But, once the dollar liabilities were found to be far outstripping the gold reserves of US, the credibility of the assurance of convertibility of dollars into gold at $35 per oz came under a shadow. Central banks started clamouring for conversion of their dollar holdings into gold. The US government, if

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[21](Despres, Kindleberger, & Salant, 1966)

[22]The Gold Pool refers to the co-operative arrangement among eight central banks of pooling gold reserves as part of maintaining the stable functioning of the Bretton Woods institutions. Initiated in November 1961, it worked towards stabilising the gold price at $35 per oz through intervention in the London money market. Though it was successful in meeting this objective till 1968, with France withdrawing, the Gold Pool collapsed in March 1968

needed, could have met its commitments through purchases of gold from the market. But its entry would have resulted in a huge increase in the price of gold.

The latter part of the Bretton Woods period was witness to significant productivity improvements in Japan and Germany, which reduced their unit costs of production, vis-à-vis the United States, which, on the other hand, was experiencing high rates of inflation. The balance of payments weakness in the US that this led to made the dollar an object of a speculative attack. With rising federal deficits, dollar liabilities were piling up in the rest of the world. Together with the rising current account deficit, this led to gold claims and a decline in the holdings of gold of the United States compared to the 1950s. To address that problem, the US had to resort to a two–tier gold market mechanism, wherein only intra-central bank dollar holdings were convertible to gold. But, ultimately, the convertibility of dollar into gold had to come to an end. So, finally, in 1971 it announced the closure of the gold window. The Bretton Woods system was brought to an end, heralding an era of flexible exchange rates.

In the immediate aftermath of the war, only the currencies of the US and Canada were fully convertible in the current account, but by the late 1950s and 1960s, not only had all the currencies of the developed countries become fully convertible on the current account, but there were some relaxations of capital controls as well. This resulted in a growing integration of international financial centres across the world, an increase in currency trading as a financial activity, and a search for private gains through speculative attacks on currencies, in case there was an expectation that a country would devalue in the wake of persistent current account deficits. With the frequent recurrence of balance of payments crises in Europe, countries found it difficult to maintain external and internal balance under the Bretton Woods system. Though institutional arrangements like the Gold Pool were used to maintain the dollar's value vis-à-vis gold, ultimately, central banks had to stop intervening in private markets. The eventual collapse of the system occurred when it was clear that the external payments of the United States were in a state of disequilibrium. With the massive speculative attacks against the dollar in March 1973, the world entered an era of floating exchange rates.

Right from its inception, the risk associated with a national currency serving as an international reserve was a matter of contention. For such a system to be stable there ought to be enough availability of the currency which serves as reserve. To facilitate that, balance of payments deficits had to be incurred by United States, leading to an outflow of dollars. But simultaneously, the promise of backing the currency with gold reserves needs to be assured. In Triffin's view, the expansion of international liquidity in tandem with the growth in the volume of international trade requires the reserve currency country to incur balance of payment deficits. But if the extent of the deficit crosses some limit, it would result in a confidence problem, with the currency being ultimately forced to suspend its convertibility to gold. When there is a dollar glut, while dollar liquidity is available, the confidence in the currency comes under a shadow. On the other hand, if there is a dollar shortage, there would be a shortage of international liquidity. (Triffin,1961)

<div align="center">III</div>

Bretton Woods II Postulate and its critics

One of the major economic paradoxes of the period starting in the late 1990s has been the large and rising net export of capital from poorer economies to the capital rich North, including the US. A rationalization of sorts has been provided for this in Dooley, Landau and Garber, who argued in the early 2000s that the international monetary regime has metamorphosed into a new Bretton Woods of sorts.[23] In the international monetary system prevalent since 2000s, while the major currencies such as the euro, pound, dollar and yen float against each other, the currencies of many Asian and emerging market economies remained pegged to the US dollar. It is in this background that Dooley et. al. have characterised the present set of exchange rate arrangements as a revised Bretton Woods system. As part of that, beginning in the 2000s, there has been an enormous increase in global liquidity, with global reserves almost doubling over the 2003-07 period, compared to the increase of just over 30% in the 1997-2003 period, and the ratio of accumulated

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[23] This section attempts a review of literature on Bretton Woods II postulate through the writings of its main exponents: (Dooley, Folkerts-Landau & Garber; 2003, 2004a, 2004b, 2009)

reserves to GDP rising significantly. Much of the reserve accumulation has been in the Asian emerging market economies, which invested those reserves in US securities and financed the American current account deficits.

Because of this demand for US securities, the nominal yields on Treasury securities declined from 1999 to the mid-2000s (Dooley, Folkerts-Landau and Garber,2004a). This, it is argued, occurred because, despite the collapse of the old Bretton Woods system, the structure of the international monetary system returned full circle to its essential Bretton Woods era form, with deficits being financed even as nominal interest rates as well as spreads on US financial instruments fell (Figure 1.4).

Source: Federal Reserve Board
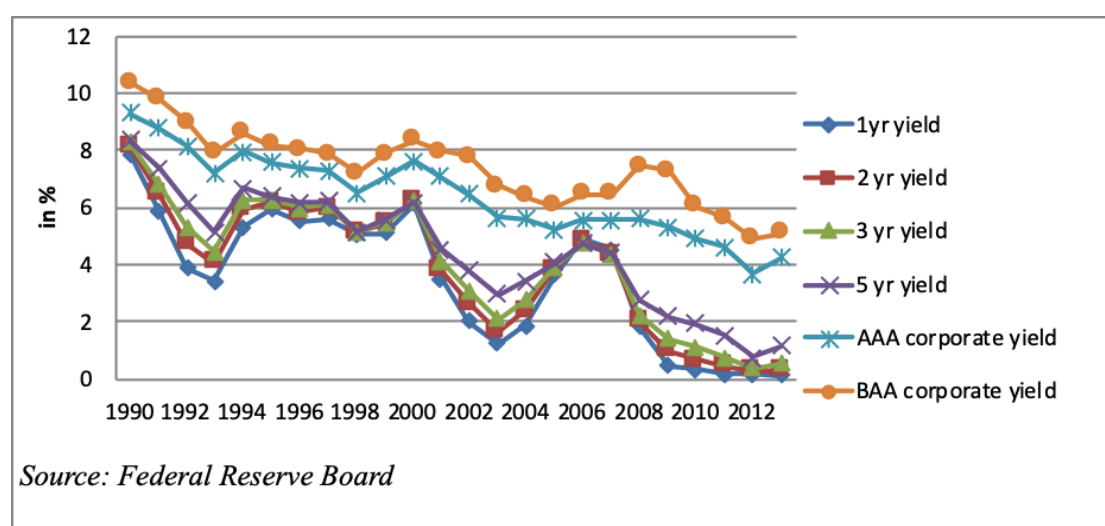
Figure 1.4: Market yield of US Treasuries of different tenures and corporate bonds

In fact, Bernanke in his Sandridge lecture, takes issue with the argument that the US current account is primarily a consequence of the economic policies and other developments in the United States. Rather, he argues, a combination of diverse forces led to a significant increase in the global supply of savings --- a global savings glut--- which explains both the US current account deficit and the low long term rates of interest. Certain others have even found in this an explanation for the global financial crisis.[24] Contrary to this, De Cecco (2012) argues that perhaps reserve building by emerging market economies took away a lot of the timber from the bonfire that

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[24]For a critique of Bernanke's global savings glut, which traces its fallacy to its pre-Keynesian method of reasoning, (Patnaik, 2009)

leading financial institutions lit up in the advanced countries. In fact, as against the Asian economies which were subscribing to the US treasuries, it was the bankers of Germany and UK, who were massively buying up US toxic assets in the run-up to the financial crisis. Further, De Cecco concludes that the non-liberalised large financial system in Asia played the part of a keel to stabilize the markets of the advanced countries. In fact, it could safely be argued that the sub-prime bubble was caused by the low interest rates produced by the lax monetary policy of advanced country central banks and by the 'financial innovation' unleashed by liberalisation, and not by official inflows of Asian capital from surplus economies.

Dooley et al argue that in the course of the eighties and nineties, with the collapse of the planned economies, the supply of labour to the world economy increased. The paper argues that given the stock of capital in the world economy and its potential increase, the marginal product of capital, and, therefore, the interest rate was expected to increase. But through the processes of real wage squeeze in peripheral east Asian economies, the supply of savings too increased along with the supply of labour. The East Asian economies were transformed into major accumulators of US treasuries, or, in other words, net savers. All of this resulted in high rates of growth of employment in these economies. The United States could serve as an export market of last resort for these countries, for it could now set aside external considerations in the conduct of its monetary policy, for financing balance of payments deficits was no more a concern. The favourable rate of growth of east Asian economies also gave a fillip to oil prices, contributing to the external surpluses in the Middle East. Almost all of the increase in savings that was happening in east Asia as well as the surpluses in the Middle East were matched by an equivalent decrease in the level of savings of United States, reflected in its widening current account deficit (Dooley, Folkerts-Landau and Garber, 2004a). Indeed, the increased savings in these regions was invested in dollar securities as part of the growth strategies led by exports supported with competitive exchange rates in these economies.

The role of China prominently figures in most of the writings of Dooley relating to BW II. The country took up the challenge of mobilizing an enormous pool of domestic savings for investment in internationally competitive capacities. Reserve accumulation on the part of China and other east Asian countries is characterised as a

collateral held against the stock of foreign direct investment. While foreign direct investment generates an asymmetric risk for the core countries since the periphery is less creditworthy compared to the centre, these reserves serve as a collateral. Logically it follows that for the system to work, USA must be willing to run a current account deficit (Dooley et al 2004b p.3), which alone would permit the Asian economies to garner dollars with which they could buy securities, that could serve as collateral. In this return swap, China gets the returns on dollar denominated financial instruments including Treasury securities and foreign investors get the returns on their equity.[25] Thus, as under Bretton Woods I, USA engages in maturity transformation, borrowing short term, on net, from the periphery, and lending long term on net, mainly in the form of FDI, to the periphery. The old periphery (i.e., Japan, Europe and others), in the Dooley model of BWII, now constitute the group called the capital account economies, which would invest in dollar assets provided they yield a return, failing which they would move to the assets of other countries.[26]

Most importantly, under the Bretton Woods II, the current account of the US supplies the wherewithal to generate the international collateral provided by the periphery, which through two-way trade in assets liberates capital formation in the poor countries from inefficient domestic financial markets. This provides an explanation as to why capital flows from the poor to the rich countries. Indeed, this logic has its genesis in the international debt crisis of the eighties, where loan default had to be negotiated. Under this regime, any threat whatsoever to foreign investment in the periphery would be more than compensated for with the securities in United States, owned by the Asian economies. It tries to put forward an impression that "collateral trumps the traditional model". Here the periphery's current account surplus provides the collateral to support the financial intermediation that is at the heart of development strategies. But, this serves the purpose of only the export-led successes among emerging market economies, i.e., those who have managed to cross a threshold level of income by pursuing that strategy. In practice, there are few examples of such success. Moreover, this approach of Dooley and others gives an impression that the

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[25] See (Dooley, Folkerts-Landau and Garber, 2003)p.3

[26] They are clubbed as capital account economies, not because they do not have any significant role in the world of trade (which they definitely have), but because their transactions on the capital account are important enough to influence their incomes on the current account, particularly, through the investment income inflows, and through the accumulated stock of their external assets and liabilities.

exports of the developing economies have been on account of export-oriented foreign investment, which is mainly true of China and the second-tier Asian industrialisers. A study by Manova, Wei, & Zhiwei (2011) reveals that at least 50% of exports from China was produced by foreign owned firms, a further 23% by joint venture companies, and only the rest by domestic firms.

And it altogether rules out the possibility of development for economies with current account deficits. Here, the model of Chenery and Strout (1966) which makes a case for foreign assistance to tide over current account deficits proves to be of relevance.[27] That said, the dual gap or three- gap model also turned out to be highly problematic. History has been witness to several Latin American economies getting onto a trajectory of debt-driven growth, only to be followed by a crash. The so-called middle-income trap is inextricably linked to this boom-bust cycle of capital flows.[28] The Dooley model hardly takes account of such experiences. Moreover; it ignores the fact that in most of the economies that were witness to higher growth along with investment ratios, there was a simultaneous rise in the savings ratios too.

Indeed, during the debt crisis of the eighties, the Japanese reaction had traces of the Dooley et. al. model. Japan, which was a current account surplus country in the eighties, had very little stake in third world debt. This was despite the fact that the balance sheets of the Japanese banks were strong following the Plaza Accord, which resulted in the relative appreciation of the yen against the dollar at the end of eighties. Japanese Prime Minister Takeshita in 1988 had suggested that a global approach to third world debt could be initiated. In his proposal, he argued that the debtor countries should deposit their official reserves with the creditor country, thus absolving the latter of the risk of debt default.[29] Takeshita's suggestions did not gain much acceptance from the advanced economies, in particular, United States, for it did not want to forego its dominance in the market for third world debt. It should be noted that the Takeshita proposal has a similarity with the "reserves as collateral" argument of Bretton Woods II floated by Dooley and others.

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[27](Chenery and Strout,1966)
[28]For details relating to this argument, see (Ros, 2013)
[29]Quoted in (Sen, 2004)

Further the Bretton Woods II argument ignores the process through which the debt of the developing world got transformed from speculative debt to Ponzi debt, as a result of the Volcker disinflation strategy as well as the deterioration in the terms of trade of primary commodities in the eighties.[30] Seen in that light, the Bretton Woods II model of international finance seems to at best protect rentier interests, limiting this method of re-routing of capital as a model of economic transformation only to a small group within the emerging market economies, to the total exclusion of the development needs of the least developed countries, for which official development assistance, which has been on the decline, continues to be of immense importance.

On the whole, we can see that there are three blocks under the Bretton Woods II system: the core country, trade account economies, and capital account economies. The most important objective of the core/centre country is to see to it that the supremacy of its currency remains unchallenged. To the extent that is possible, by diverting the surpluses of the surplus generating economies into dollar denominated assets, it ignores the loss of competitiveness of domestic industries resulting from a strong currency that renders imports cheap to the benefit of the domestic consumer, while allowing the currency to rule the roost in international financial markets. The trade account countries know very well the limitations of the scope of the domestic market, and would like to sell cheap in the international markets. That is possible, so long as they keep their currencies "competitive". Given that their surplus labour reserve is not anywhere near exhaustion, since it runs to millions, and technological change has made employment highly inelastic with respect to output growth, it need not even be bothered about the real exchange rate, for the same would also remain depreciated given low wages and prices. As it is, they peg against the dollar, and through intervention in the foreign exchange market, they see to it that the currency does not appreciate. Under the logic of this system, it pays off for the trade account countries to resort to the strategy of reserve accumulation. The group of capital account countries (i.e. Europe, Japan etc) are the floaters in the system, since they bother only about the returns which accrue to them when they subscribe to securities of one country as against that of another.

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[30] See (Kregel, 2004) in this regard.

Ever since the global financial crisis, there has been some rethinking about the Bretton Woods II postulate. The debate around the sustainability of the American current account deficit was put to test in the course of the global financial crisis. Contrary to the predictions, similar to that of Obstfeld and Rogoff (2004), that these deficits would result in a crash of the dollar and a global slowdown, in the wake of the global financial crisis, with imbalances starting to unravel, there was a massive flight to safety and liquidity into dollar assets, resulting in large inflow into Treasury assets, particularly those of short term nature, from different central banks across the world, thus even leading to the appreciation of the dollar. Though the crisis was linked to the imbalances in the world economy, Dooley, Folkerts-Landau &Garber (2009) argued that the global financial crisis was not due to global imbalances, since the crisis did not result in the sudden stoppage of capital flows to US, which could have resulted in the depreciation of the dollar. On the contrary, the dollar appreciated. This, it is argued, validated the nature of the international monetary arrangement postulated under BWII. But this ignored the fact that the inflows to the US were almost all into Treasury securities, with frenzied central bankers seeking safe haven. And the shift from equity securities to debt securities was continuing, with a reallocation in favour of short term Treasury securities in the course of the financial crisis. This intensified when it was revealed that some part of the risks associated with the American housing markets were passed on to the European banks, and there was no scope for diversification into other currency assets, as some of the commentators pointed out. The possibility of diversifying to the euro was fully ruled out as risks were transmitted from the US to Europe, resulting in the European Sovereign Debt crisis.

Two distinct strands of literature have emerged in response to the Bretton Woods II postulate. One accepts the validity of the postulate, but points to substantial differences with the earlier regime and argues that these differences question the sustainability of the regime. The other challenges some of the key underlying assumptions of the postulate.

Eichengreen (2011) and Roubini (2006), through their contributions, drew attention to the differences between the current and earlier regimes, and identified seeds of instability in the latter. Under the earlier regime, other than for a few years, the United States had a current account surplus and it was a net investor always,

implying that it had a positive net international investment position. As against this, during the Bretton Woods II era not only is the US continually recording current account deficits, but it also experiences a fall in its net international investment position. Further, argues Roubini, the US shows a persisting fiscal deficit under the current dispensation, contrary to the earlier one. Hence, both Eichengreen and Roubini feel the regime would be short-lived due to the unsustainable current account and fiscal deficits.[31] Given the size of the external liabilities of the US, the extent of capital inflows which would be required to finance them would grow at a far faster rate than the willingness of central bankers and private agents to accumulate reserve assets, given the possibility of dollar devaluation.

The sustainability of BW II also requires accelerated growth in US domestic demand to absorb exports from the periphery. This phase of growth of the United States was heavily dependent on asset price bubbles, especially, the housing price bubble, which encouraged debt-financed spending. By 2007, that bubble had collapsed, bringing down demand. Moreover, ever since then there has been no effort on the part of United States to counter the decline in demand in the US economy with expansionary fiscal strategies, which is what is warranted during times of recession. The large current account deficits were unsustainable because the domestic counterpart of those deficits was private debt, in particular, household debt, which was financing the growth in consumption. Yet, ever since the property bubble burst, there has not been any significant effort to bolster demand by expanding government expenditure.

Further in the earlier dispensation, there was no substitute reserve currency anywhere in sight, but under BWII, an alternative currency such as the euro was also available, giving central banks an option of sorts to shift their asset portfolio, in case they lost trust in the capacity of the dollar to maintain its value. Though the euro could barely pose any challenge to the dollar as Europe and its bankers became a victim of volatile capital flows during the global financial crisis, the current pre-occupation of the United States with restraining current account deficits and reining in fiscal deficits is to be seen also in the context of their perceiving long run challenges to reserve currency status from currencies like the euro. Given that the debt-fuelled

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[31] See (Eichengreen,2006), (Eichengreen,2007) and (Roubini,2006)

absorption by the US, which spilt over in the form of its growing current account deficit, had contributed to the increase in current account surpluses of the emerging market economies, the policies of a protectionist nature pursued by the US since 2008 have had a fallout in the form of a large reduction in the surpluses of the EMDEs.[32]

There is also a matter of a stable institutional arrangement like the Gold Pool under Bretton Woods, wherein a group of countries intervened to preserve the dollar value of gold. Under the current dispensation, though there is reserve accumulation being undertaken by a number of economies, Eichengreen (2007) doubts the stability of this "coalition" of heterogeneous and conflicting interests, which could derail the arrangement. As against this, we should also note that there is a growing demand for reserve dollar assets post the crisis, even on the part of the advanced economies, though the demand for securities is far more tilted towards Treasuries as against private-labelled securities like mortgage-backed securities (MBSs) or asset-backed securities (ABSs).

There has been yet another set of arguments around the key pivot of the system: the American current account deficit. Providing market access to different economies which were geographically proximate to the erstwhile Soviet Union was a part of the geo-economic strategy of the United States, one fallout of which was the east Asian miracle, since it benefited a set of economies in east Asia. Indeed, it is the responsibility of the leader country to provide market access to facilitate the growth process in different economies in the lower to middle income levels, and this is required for the stability and sustainability of the global economic system. So, a reasonable current account deficit for the United States is warranted. However, there have been differences of opinion with regard to the sustainability of the deficit. The differences of opinion aired by Cooper (2008) and Feldstein (2008) are representative of such arguments. Cooper (2008) argues that given the highly flexible nature of the American economy and the permanent increase in productivity and profitability of investment, foreigners would continue to direct substantial amounts of capital towards the US. Feldstein (2008) doubts whether, given the growing current account deficits

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[32] As we see in the next section, in the aftermath of the crisis, the EMDEs sans China & MENAP have moved from the category registering current account surpluses to one having current account deficits. And the problem of the financing the current account, that too, when monetary easing in advanced economies is being reversed, would pose new risks to the international economy.

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of the USA, countries like China would consider maintaining their portfolio of dollar assets at the current level, for this would entail risks for them.

Kitchen (2006), on the other hand, argues that the US's external position is sustainable because its foreign investments earn far more than the foreign investment made by others in the United States. It is on the basis of this assessment that even when the whole world was expressing concern over the declining net international investment position of the United States and its growing current account deficit, Haussmann and Sturzenegger (2006) were expressing doubts about the veracity of the numbers, to the extent of arguing that there was some sort of underreporting or under-recording of the exports of United States, on account of the liquidity services (seigniorage), insurance services (secure investments) and knowledge services (organisational knowledge and brand recognition) it provides. These they argued, were bundled with three types of financial instruments: US currency held by foreigners, US treasury bonds held by foreigners and US originated FDI. However, in an investigation based on the numbers provided by Hausmann and Sturzenegger, Buiter (2006) argues that other than with respect to liquidity services, the calculation with respect to dark matter does not hold merit.[33]

The Bretton Woods II model is based on a world economy characterized by the two-way flow of capital and a substantive increase in gross capital inflows and outflows, which consists of equity and debt of different levels of maturity. It is argued that through reserve accumulation and real exchange rate depreciation, countries would be able to graduate to higher levels of income, and therefore, Bretton Woods II is even portrayed as a tool in the development policy kit. But, this is restricted to those countries which have crossed a threshold. In other words, it does not offer anything to those economies which are in a low-level equilibrium trap. Moreover, these models rely heavily on external markets at the expense of processes that contribute to the creation of an internal market, which means they rely on a consumption squeeze as a method to generate an export surplus which is required as international collateral in the system. Further, given that this option of real exchange rate depreciation has resulted in some transformation in certain economies of Asia, what should stop the other countries, even those of the erstwhile periphery (i.e., even

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[33]For an argument as to why the dark matter as well as savvy investor would not hold simultaneously see (Eichengreen, 2006).

today's capital account economies in the Dooley et. al. model) from resorting to deflationary strategies that reduce unit costs to facilitate exports to international markets? The next section tries to explore these issues in the context of the shift in global imbalances.

IV

Bretton Woods II Postulate and Global Imbalances

How has the composition of global imbalances changed ever since the global financial crisis? Have there been countries which have moved from surplus to deficit categories or from deficit to surplus categories? Or has there only been a reduction of deficits and surpluses ever since the crisis? What does the data in this regard reveal? Based on the data from the World Economic Outlook Database of the International Monetary Fund, we examine the changes over the period 1997 to 2015. We present the figures of the major deficit economy, USA, and, of China, Germany, Japan and the Middle East, North Africa, Afghanistan and Pakistan (MENAP) region which were the surplus economies as per data from the WEO Database. Thereafter, we take the total current account of the advanced economies and deduct from the figure the current account balances of USA, Japan and Germany to generate the current account position of other advanced economies or ADV(Others). [34]Similarly, the figure of the category EMDE (Others) is generated by deducting the current account balances of China and MENAP from that of all EMDEs. Figure 1.5 gives us a sense as to how the current account balances changed across countries and groups during this time period.

We find that the deficit in the case of the USA, after increasing to $806.73 bn in 2006, had declined till 2013, and registered some marginal increases thereafter. An economy with deficits till 2002, Germany, has its current account surplus continually increasing with a minor dip during 2009-10. After continually being in surplus since 2000, with a record surplus of $411bn in 2012, the MENAP region entered into deficit territory, due to the slump in global oil prices, till 2015. Though the magnitude of the surpluses recorded by Japan kept changing, it remained consistently in the surplus

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[34]The list of the advanced economies is as per the WEO Database of the IMF.

category, though its relative share in the aggregate surplus of all surplus countries has dwindled. The dramatic increase in the surpluses of China from 1997, in particular, since 2004, made it one of the developing economies (non-resource based) falling in the surplus category. But, of particular significance is the fact that whereas the EMDEs (sans China and MENAP) had begun to record larger deficits, the other advanced economies have moved to the current account surplus category. This also implies that the current account problems of the EMDEs at large are back in the reckoning. That too, when policy decisions by advanced economy central bankers could have an unfavourable impact on global liquidity.
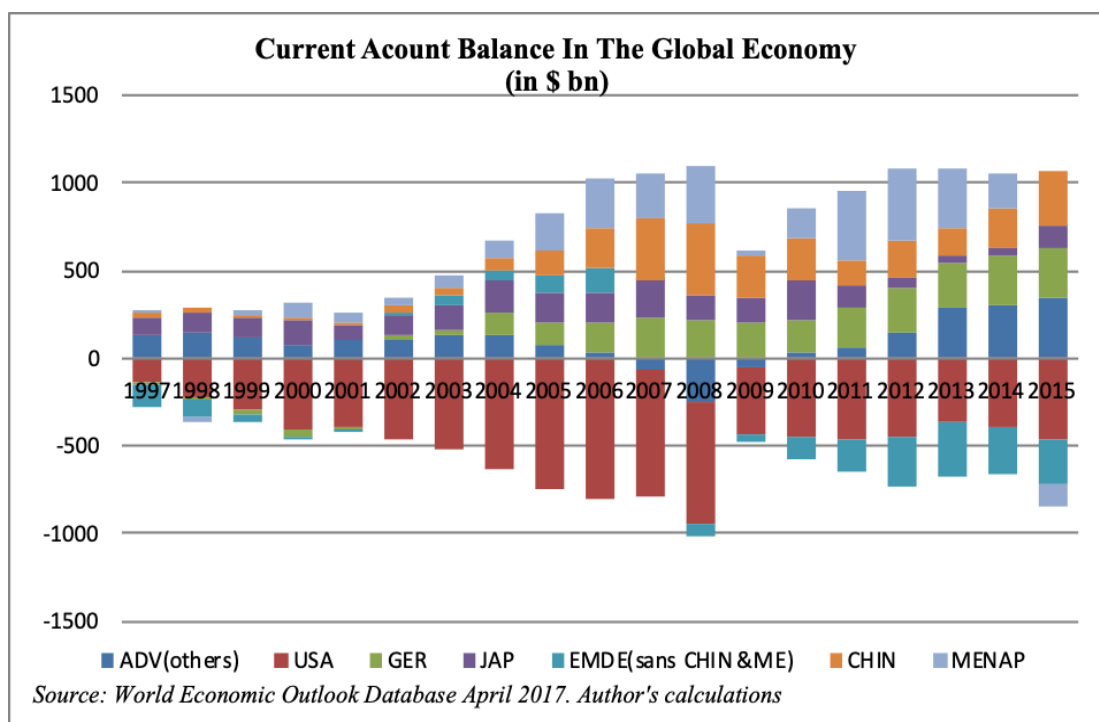
Figure 1.5: Current Account Balances in the Global Economy(in $ bn)

To return, the current account deficit of the United States increased from $140.72 bn (1.64% of GDP) in 1997 to $806.73bn (5.82% of GDP) in 2006, prior to the global financial crisis. In fact in all but one of the years, i.e., 1991, when it had a small surplus of $2.895 bn, the United States has had a current account deficit since 1990. In fact, the current account deficit of the United States in 2006 was the highest ever, at 1.57% of the world GDP, which was unprecedented and made possible purely through the process of financialisation of the global economy (Figure 1.6). As a reserve currency country, it could afford to run such deficits, but when the current

account deficit rose sharply to over 5% of its GDP, questions relating to the sustainability of the deficit were raised among others by Feldstein.[35]
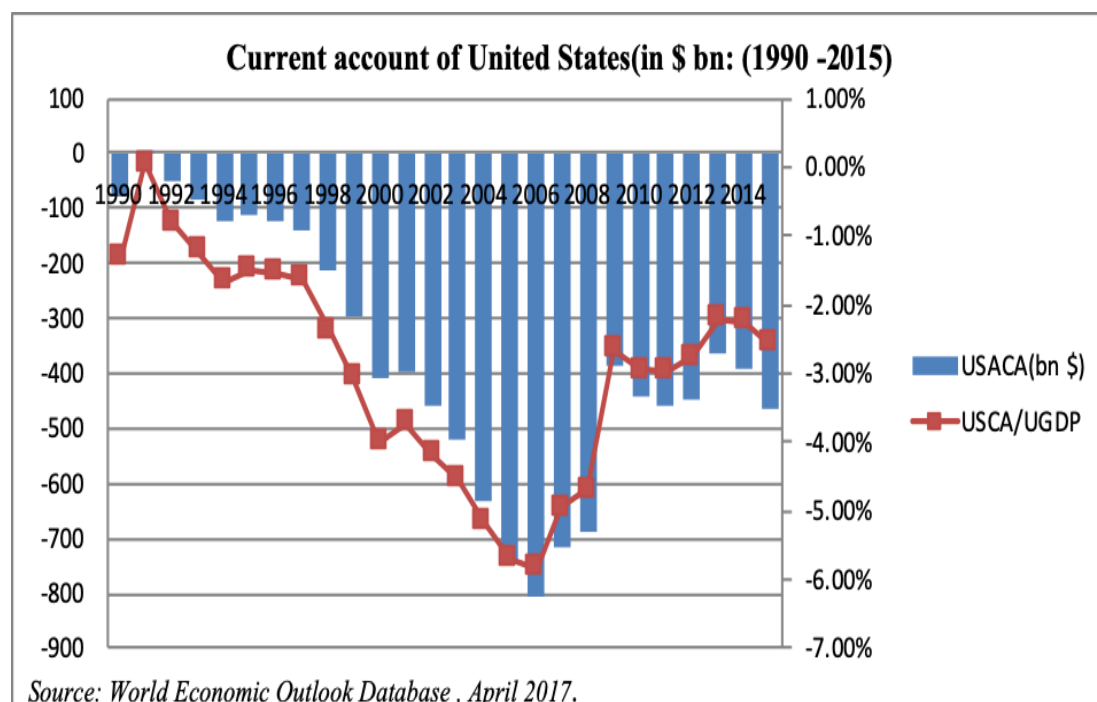
Figure 1.6: Current Account of United States($ bn): 1990-2015

US deficits rose sharply in the phase of debt driven growth. The ultra-loose monetary policies pursued by the Federal Reserve in the context of the collapse of the dot com bubble played an important role in the shift in the trajectory of growth of the US economy to one characterized as consumption-led (De Cecco, 2012). But, given the stagnant level of real wages in the United States since the nineties, it was the credit instruments floated by the financial system that were instrumental in giving a big fillip to autonomous consumption, which further received a big boost because of the "wealth effects" generated in the phase of rising share values and rising residential property prices.

Between 2002 and 2007 even as the current account deficits rose, and the borrowings towards financing those deficits increased, we find that the NIIP of the US improved (Figure 1.7); the reason being that in this phase there occurred a sustained depreciation of the trade weighted index of the dollar (Figure 1.8). In fact valuation changes intermediated through the exchange rate, more than changes in the current

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[35]This debate continues even to date. For, given lower rates of growth of United States, would it be able to provide for the rising demand for safe assets from the rest of the world. For diverse viewpoints in this regard, see (Feldstein, 2008) as well as (Cooper, 2008)

account, turn out to be an important influence on movements of the NIIP.[36] The two-way capital flows and large increase in gross capital inflows and outflows have resulted in the accumulation of assets and liabilities to such an extent, in the case of the US, that assets rose to 143% of the GDP and liabilities to 176% of the GDP. With the depreciation of the dollar, given that most of the liabilities are denominated in dollars, the NIIP is found to increase, and the reverse occurs with the appreciation of the dollar. As can be seen, a large proportion of the liabilities are in short term debt and assets are in long term equity, i.e., United States has over the years been borrowing short and lending long. Gourinchas and Rey (2007) characterise this as the transformation of the USA from being a world-banker to serving as a world-venture capitalist.[37]
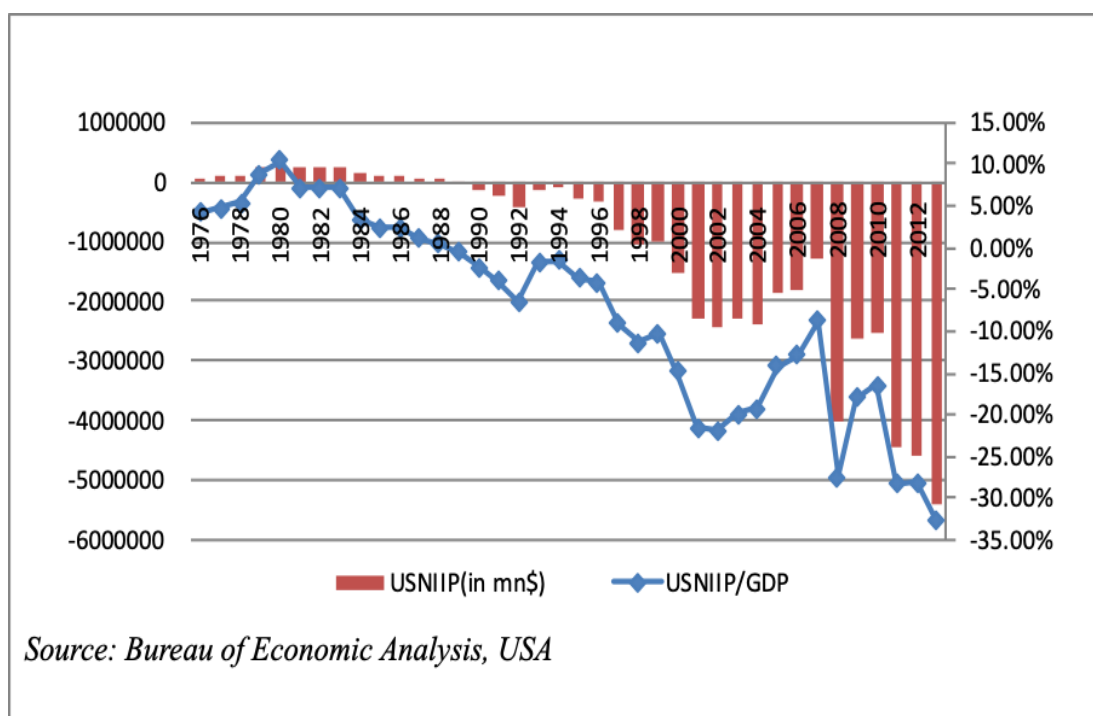
Figure 1.7: US Net International Investment Position (NIIP) ($ mn)

The disaggregates of the US current account reveal that a large share of that deficit is contributed by the merchandise trade deficit. Even as the other constituents are found to fluctuate, there is a positive balance on income account which contributed around 1.34% of the GDP in 2013 (Figure 1.9).

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[36]Lane & Milessi-Ferreti (2009) draws attention to this valuation change intermediated change in NIIP.

[37](Gourinchas& Rey,2007)
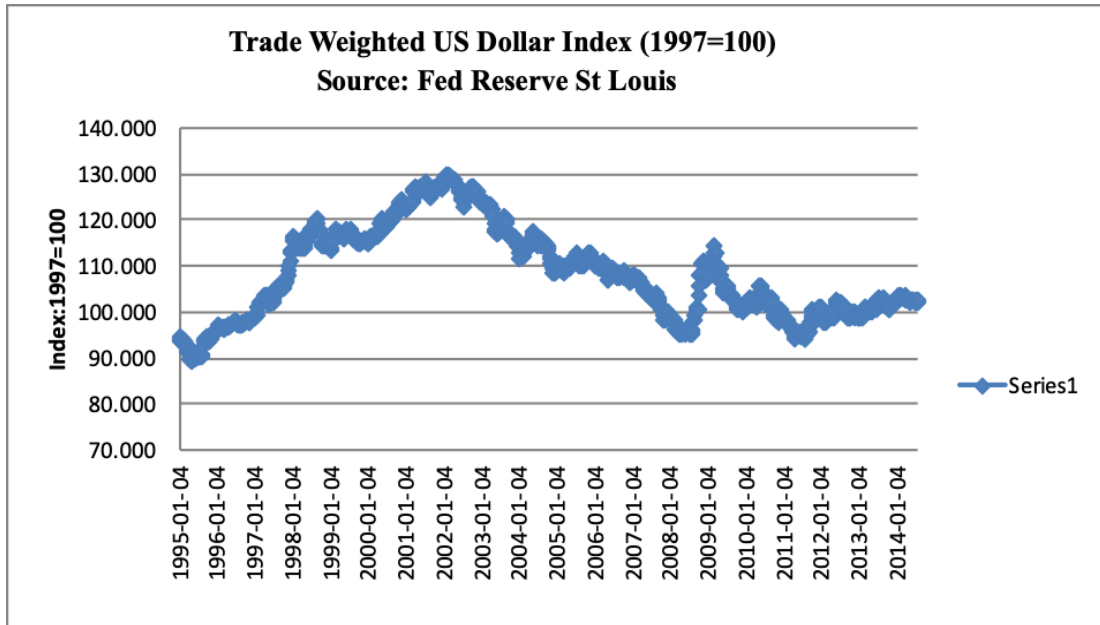
Figure 1.8: Trade Weighted US Dollar Index
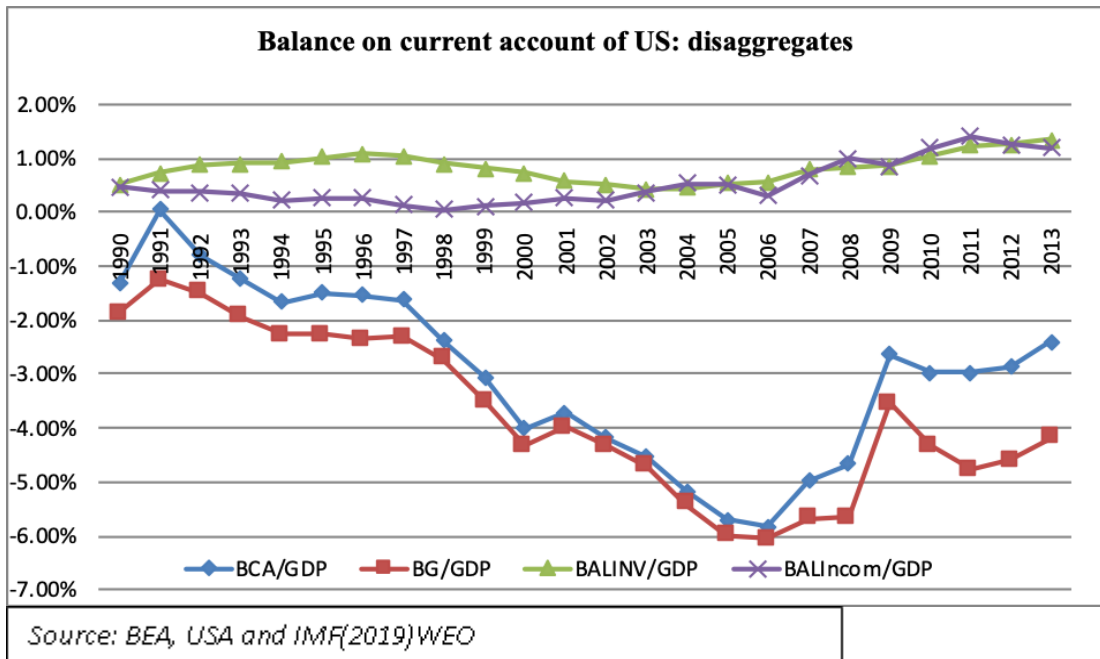
Figure 1.9: Balance on current account of US: disaggregates

Ever since 2007-08, there has been a decrease in the current account deficit of the United States from 4.96% (2007) to 2.57% (2015) of GDP, which amounts to a large squeeze of world demand. A back-of- the-envelope calculation puts the reduction of demand at almost 1% of the world GDP. As can be seen, with lower rates of growth in the post financial crisis period, the demand for goods from the United States has not picked up momentum yet. Though the current account deficit of the US

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has started showing signs of increase, the trends are not very clear. The protectionist policies, of late, pose new problems too.

Nonetheless, the growth of different east Asian economies including China in the first decade of the century benefited from the fillip provided by the growth of the US economy as well as its autonomous consumption, which rode the tide of credit finance. If the US was the single largest deficit country, China and the east Asian region were major surplus regions, igniting a debate on competitiveness based on low wages prevalent in Asia, ignoring the very fact that the wage advantage which accrued to China was purely on account of its huge labour reserves.[38] Figure 1.10 shows that the current account surplus of China reached an all time high of $420.569 bn in 2008, accounting for 9.13% of its GDP.
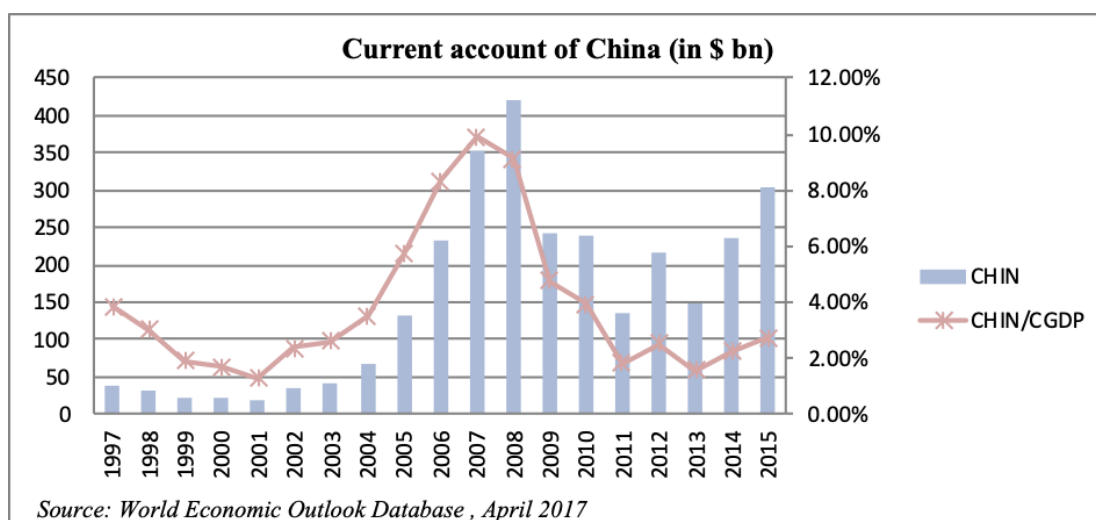
Figure 1.10: Current account of China (in $ bn)

The intervention by China to keep its exchange rate competitive played an important role in facilitating the rise. Moreover, many multinational corporations exploited the opportunity of an export platform in China, with the country becoming an important part of the global production value chain. In fact, the decade witnessed a large increase in the global value chain participation rate of China. But it should be noted that the current account surplus of China declined from its high of $ 420.58bn (9.13% of GDP) in 2008 to as low as $148.20 bn (1.54% of GDP) in 2014, before

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[38] See (Patnaik,2011) in this regard.

increasing to \$304.16bn (2.71% of GDP) in 2015, which could very well be characterized as being of a reasonable level.[40]

Though Japan does not command the importance it did earlier with respect to current account surpluses, it continues to be a current account surplus country, but the disaggregated figures provided by the 2016 Balance Of Payments Yearbook of the IMF reveal that it is primary income which contributes substantially to the positive current account of Japan, and the surplus on merchandise trade has been fluctuating as well as declining. In fact, it is huge net primary income earnings from a combination of direct and portfolio investment abroad which enabled Japan to have a current account surplus of 3% of the GDP in 2015. In that year, the country had a deficit on all fronts other than primary income. (Figure 1.11)

In fact, while the current account surplus of China has been on the decline, which could possibly be attributed to the large expenditure programmes being initiated within the country, and also to an increase in wages in tandem with productivity improvements, the experience of Germany has been very different. We find that the German surplus of \$282.44 bn in 2014 was higher when compared with the past. Moreover, the current account surplus as a percentage of GDP had increased to 8.33% in 2015 from 6.75% in 2007. Earlier, from a level of \$35.44bn in 2003 , i.e.,1.41% of the GDP, the current account surplus of Germany increased to \$232.5 bn in 2007 or 6.75% of its GDP, pointing to a structural break of sorts in 2003. We shall be dealing with the question of the German current surplus vis-a-vis the world economy as well as with the GIIPS (Greece, Ireland, Italy, Portugal and Spain) in a later chapter. Suffice it to say here that restrictions on increases in real wages in tandem with productivity improvements have played an important role in the transformation of Germany into a major exporter.

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[40]In its recent report on countries indulging in unfair currency intervention and associated steps, the document of the federal government of United States does not consider Chinese trade to be unfair, arguing that the intervention in the foreign exchange market done by the PBC was with an intent of preventing the depreciation of the yuan after a limit. and that cannot be considered a case of protectionism. (US Department of Treasury International Affairs, 2018)
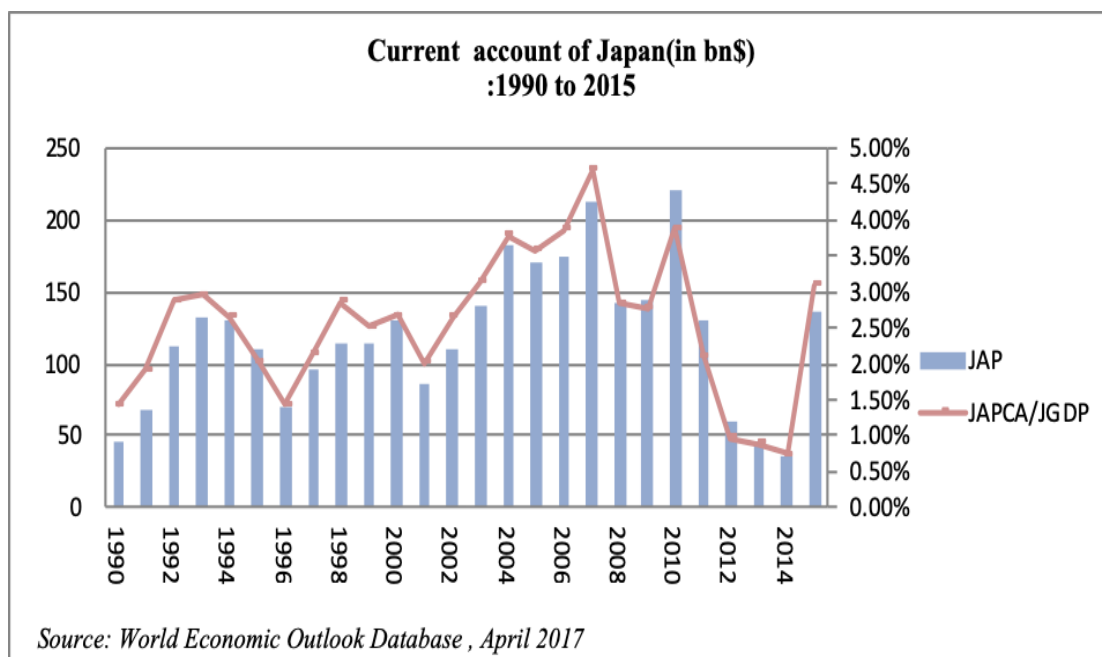
Figure 1.11: Current Account of Japan:1990-2015

Comparison of the current account to world GDP ratios of economies.

In Figure 1.12 , we observe how the surpluses and deficits of countries as a proportion of world GDP have moved over the years. We had observed earlier that the current account deficit of the US declined from1.56% of world output in 2006 to 0.6% of the world output. The current account of the Middle Eastern region was positive during the high tide of global liquidity, i.e., the 2003-07 period. In the period from 2010 to 2013, the surpluses of the MENA region were more than 90% of the absolute current account deficit of United States. In 2015, that deficit stood at of 0.17% of world GDP, due to the decline in the price of oil, which has however reversed since end 2017. While the surpluses of Japan in the early nineties were even higher than the deficits of the United States, in the post-2010 period it had come down to just 0.05-0.08% of world output. By 2016, it had shot up to 0.25% of world output. Though the prominent surplus economy of the 2000-09 period was China, its surplus has declined in the post 2009 period, from 0.66% of world output in 2008 to 0.27% in 2016, with Germany emerging as the leading exporter. The latter has moved from recording a current deficit of 0.10% of world output in 2000 to a current account surplus of 0.39% of world output in 2016.

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Whereas the Bretton Woods II sort of arrangement is built upon the premises that a set of emerging economies (labour surplus economies) would begin earning a surplus and the centre, i.e. the United States, would record deficits, the data in the aftermath of the crisis, reveals that the current account surplus of Germany at 0.39% of world GDP is even higher that of China. While the proponents of the Bretton Woods II postulate had speculated about the possibilities of other emerging economies emerging as the new periphery in the system, we find one of the advanced economies (in the group of capital account economies) making its entry as a leading surplus economy. Moreover, the EMDEs (excluding China and MENAP), which had a marginal surplus in the pre 2009 period, have now become deficit economies.
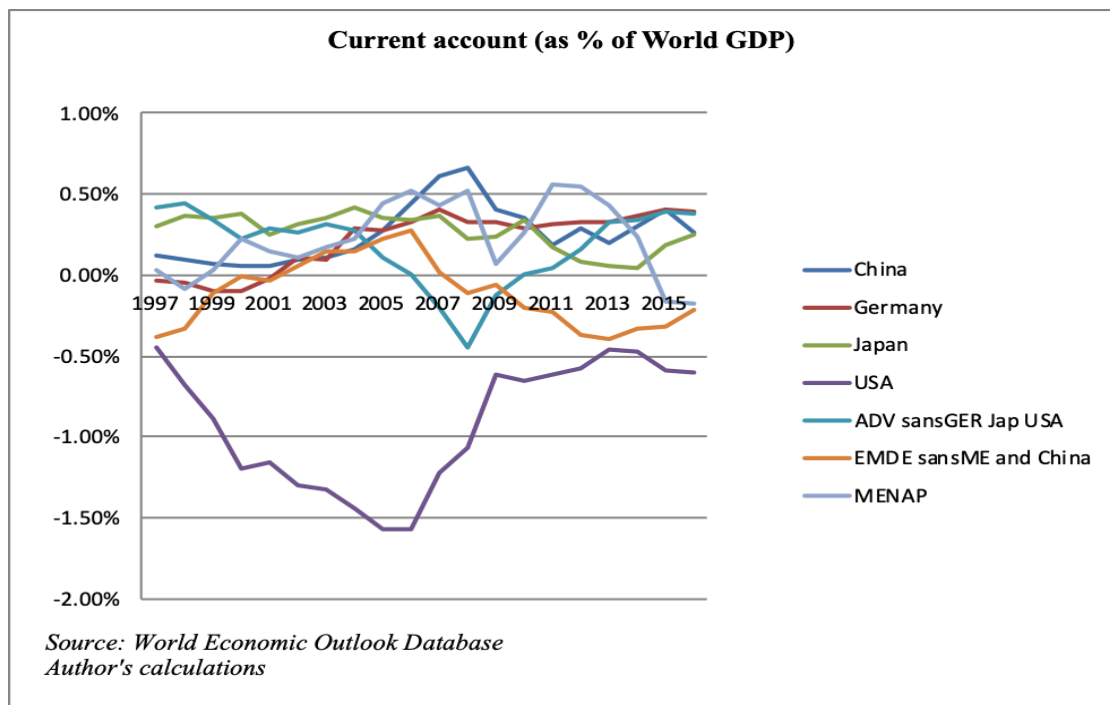
Figure 1.12: Current Account (as % of World GDP)

IV

Some concluding observations

In the various discussions on Bretton Woods II, it is suggested that no sooner the current economies who serve as the periphery of the system transform over time,

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some other countries would be able to serve as the periphery. But, examples like that of Germany seem to suggest that some of the early "capital account" countries under BW II could take over the export market, by keeping price levels suppressed, or with flexibility on the downside. In other words, through wage deflation, or through methods by which they disallow transfer of productivity gains to labour, a larger share of world trade could be cornered hypothetically by a developed country, while another, i.e., the centre country enjoys the benefit of the reserve currency, and rides the tide of what De Cecco (2012) characterises as import-led growth. This would alternatively mean restoration of the old poles of the previous Bretton Woods I. This is one of the possible scenarios.

So at the end of the day, rather than a "new developing" country graduating into the periphery, one of the developed countries serves as the exporter once again, denying the chance of export-led growth to the current periphery. Given the low elasticity of employment characterising new technologies, labour supply need not be a constraint. And, if at all it hits the ceiling of labour supply, immigration would do the task. If such a pattern emerges, it would even exclude the chances of the current periphery.

The second is a situation where cautious about sentiments of the larger European periphery that Germany was dominating the region, the crisis affected GIIPS as well as emerging Europe emerges as the periphery, and some others like Germany deploy their technology and capital in the region and transform it into an export platform. In this case too, more or less, the old order would be restored. In the period after the Asian crisis, not only did the currencies of economies in the region depreciate, but also the price levels decreased, and, most importantly, there was a tendency amidst these economies to pile up foreign exchange reserves as a buffer against potential crises and attacks on their exchange rate peg. Along with the labour reserves, this added to their ability to boost exports. Though in the case of the GIIPS, they do not have a currency of their own, the trends of deflation in the region have resulted in lower price levels for a relatively long period. So it is possible these European economies could end up sharing the spoils of exports to the international economy, with the Asian economies. This would amount to one set of countries being forced to give way to another, restricting this kind of growth path to a span of time.

Most importantly, whoever graduates to being the periphery would have to follow the path of resorting to a consumption squeeze to export to the world.

The emergence of the Bretton Woods system in the post-war period was a response to the problems associated with the destabilizing speculation of the inter-war period on the one hand, and the burden of adjustment under the Gold Standard being on the level of prices or wages, on the other. It allowed for readjustment of exchange rates under conditions of fundamental disequilibrium. The German case seems to bring the system back to its original form, by requiring labour to bear the pain of adjustment needed to generate a current account surplus, through a consumption squeeze and wage deflation. It is indeed paradoxical that the arrangement under Bretton Woods II, which heavily counts upon a consumption squeeze, rather than generation of mass markets, is christened as a sequel!

It has been argued that given that Japan and Germany depend on the US for their defence and security, they have an incentive to invest in US treasuries. But would they be as aggressive in investing in Treasury securities as a developing economy like China? In such a scenario, wherein the demand for securities from Japan and Germany could not possibly make up for the reduced demand from China, it would have an impact on long term bond prices, and therefore, result in the firming up of interest rates   posing risks to the sustainability of the Bretton Woods II arrangement. Given this eventuality, the likelihood of emerging Europe being a large part of the reserve accumulating current account economies cannot be ruled out.

If it cannot garner surpluses through the prevailing international system, would China think of expanding its trade network with emerging economies and promoting the use of its own currency in bilateral trade, playing in the process the role of a centre country? But this would impact China at least in the short to medium term through capital loss from the effects of dollar depreciation on its large holdings of US treasuries. But, increasingly, there is a shift in the composition of capital outflows from China, from risk averse Treasuries to risk loving investments abroad. There could possibly be a hypothetical situation in which China ceases to be a trade account country, and become a capital account country. However, given the overwhelming share of the dollar in the foreign exchange market, and the far lower share of

renminbi, it would not be realistic to speculate on the emergence of China as the centre country.[41]

It should also be noted that, while the United States has been a net capital importer since 1982 and has been increasingly financed by emerging economies in most of the years since, the situation is being reversed recently with the surpluses of Japan and Germany proving sufficient to finance the US deficit. During the same period, there has been a transition of the EMDEs (sans Middle East and China) from surplus category to deficit category post financial crisis. This is sure to reignite issues relating to the financing of the current account deficits of this group. It would compound risks in the world economy, if the monetary tightening of the advanced country central banks picks up momentum. This hike in interest rates could result in an eighties sort of situation re-emerging.

But most importantly, the fact that unless one crosses a threshold level of saving, one cannot serve as the periphery, keeps the BW II periphery option restricted to the emerging market economies to the exclusion of the less developed countries, which would continue to depend on official development assistance and the logic provided for the same through the dual gap models. In fact, BW II ends up rationalizing the logic of growth taking for granted the process of the financialisation of the global economy, that discussions about autonomous models of development based on mass domestic markets had challenged.

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[41]Though arguments of a different genre, with a number of reserve currency issuing economies, have been made by Eichengreen (2012), making a case that the growing demand for liquidity from a multipolar world could only be fulfilled by a group of leading economies, i.e., through multiple reserve currencies.

Chapter 2

EMDEs in the "Bretton Woods II" period: Foreign Exchange Accumulation and Net Resource Flows

Introduction

In the   Bretton Woods II   model, the newly industrializing economies accumulate foreign exchange reserves, which are invested in safe assets abroad, largely in US Treasuries. While this serves as a "collateral of sorts" shielding the foreign investors from any sort of risk on their stock of assets in developing economies, it also serves to keep the value of the dollar stable, inspite of growing external deficits. Given that the centre country, USA, is more concerned about the stability of its currency that acts as the reserve currency, and, the late industrialisers are concerned about their access to export markets abroad, this provided the justification for continuing with the *ad hoc* nature of the international monetary arrangement which had evolved after the collapse of the Bretton Woods system in the seventies. This has pushed economies to accumulate forex reserves as a hedge against liquidity risks.   That process picked up momentum in the first decade of the current century, a few years after the Asian financial crisis. This strategy has been pursued by EMDEs as insurance against the volatility of financial flows. Bretton Woods II has been put forward as a model catering to the growth aspirations of the emerging and developing economies, even though that underplayed the inequitable net resource transfer happening from the developing world to the United States (the centre).

This chapter is concerned with analysing the relationship between growth performance and current account developments in emerging market economies during the Bretton Woods II period. The first section gives an overview of the context in which the process of financial globalization gathered momentum in emerging market economies in the eighties, and sketches a brief outline of the shift in the composition of global imbalances. In the next section, we undertake an investigation, comparing the shifts in growth performance of the emerging economies in relation to the changes

in the current account balances during the 1998 to 2007 period and the 2008 to 2014 period, i.e., largely during the Bretton Woods II years.[1]

In the third section, we focus on the accumulation of foreign exchange reserves, which is an important pillar of the Bretton Woods II postulate and addresses concerns aired in this regard.

In the final section, we try to explore whether the exorbitant privilege of the United States, through which it has managed net resource flows from the rest of the world, is under challenge in the period after the global financial crisis. The chapter ends with some concluding observations.

I

Growth Cycles in the World Economy

With financial globalisation gathering momentum in the course of the nineties, an environment of deregulation or self-regulation (a la Alan Greenspan) pervaded the financial sector with legislations across countries taking the process of financial globalisation to new heights in the post-2000 period.[2] The resulting surge in the two-way gross flows of capital and the expansion of the external balance sheets of countries had resulted in global liquidity reaching a new high prior to the global financial crisis and the Great Recession. The expansion of global liquidity and its impact on growth was associated with increased downside risks, including increased volatility of growth in the emerging market economies. We explore the links between the rates of growth of these economies with shifts in the nature of their current account. This is done with the objective of bringing out the fragility associated with growth in different emerging market economies. The period was also witness to an

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[1]For this we use the sample set of economies studied by Boratav (2009) for the period from 1989 to 2007 and extend it till 2014.

[2] Alan Greenspan as Fed Chair not only permitted 25% of the revenues of banks to accrue from investment banking activities, but was also highly sympathetic to the lobbyists arguing for the repeal of the Glass Steagall Act. It was repealed and later replaced by the Gramm-Leach-Bliley Act, which did away with even the residual restrictions on combining commercial banking, investment banking and insurance underwriting (Eichengreen, 2015). After the global financial crisis, Alan Greenspan admitted: "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief" (Financial Crisis Inquiry Commission, 2011).

increase in the influence of the Federal Reserve's actions, not just in the United States, but also in the rest of the world. This could be traced back to the contractionary monetary policy of the late seventies. The deflationary strategy aggressively pursued by Volcker, in the name of containing the threat of inflation from the oil price shocks, resulted in interest rates rising to unprecedented highs. From 6.37% in 1978, the discount rate per annum increased to 13.87% in 1981 (Figure 2.1). The money market rate shot up to 16.38% in 1981. The Fed's success in reining in price levels in the United States, which had risen inter alia because of the quadrupling of oil prices, appeared to validate the idea that central banks can be independent, giving them pre-eminence of sorts.[3] Even as the contractionary monetary policies involving higher interest rates were able to reign in prices in the US economy, it had extremely adverse consequences for the international economy, leading to the Latin American debt crisis.

It is in this phase of the eighties that the policies of liberalizing the capital account to benefit from financial globalization were adopted by many developing countries, in the belief that capital would flow downhill from the advanced to the less developed. Some capital did flow, but after the sudden stops in capital inflows as happened in 1994 in Mexico, 1997 in East Asia, and 2001 in Argentina, the risks associated with an open capital account were brought to the fore. Even while policies inspired by the Washington Consensus were being pursued by governments, there were critiques which emerged based on experiences of different developing economies that were not paid any heed to. But the collapse of the two way gross capital flows, in the immediate aftermath of the global financial crisis, and its deleterious impact on the international economy in the post 2007 period, has revived discussion on regulation. And though capital flows have once again picked up momentum, even international financial institutions openly vouch for the need to address the problem of "too much of finance."[4]

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[3]Varoufakis(2011) gives a good description of this period.

[4] Given the importance of the monetary policy of the centre country in the propagation of global financial cycles, Rey argues that irrespective of whether a country is having a fixed or flexible exchange rate regime, independent monetary policy would be feasible only with controls on capital. Independent monetary policy and perfect capital mobility, she argues, is an irreconcilable duo (Rey, 2015).

At the Fed, Greenspan combined his bond purchases during the slowdown of the early 2000s, as did Bernanke in the course of the Great Contraction in 2007 and after, with a policy of maintaining low interest rates, both aimed at addressing the slowing rates of growth. These bond purchases from the time of Greenspan to that of Yellen have had a significant impact on capital flows to emerging markets, which in turn had an impact on exchange rates, due to the large interconnectedness of the international financial system. The steep decreases in central bank policy rates across US, the Euro Area as well as UK, in particular in 2001 and since 2008 are illustrated in Figure **2.1 .** While Volcker's objective was to target inflation in the eighties, in the period since post-2007 the central bankers across the world, by keeping interest rates close to zero, are trying to defeat deflation. But accommodative monetary policies have not yielded favourable results in the form of a significant growth revival.
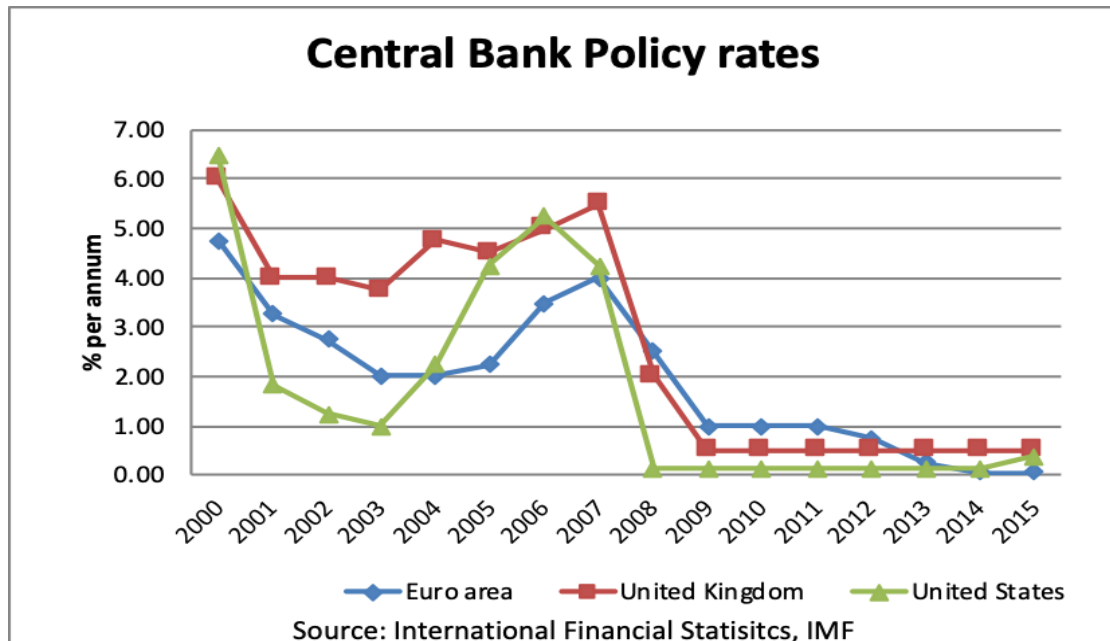
Figure 2.1:Central Bank Policy Rates

The period since 2000 was also witness to large increases in global imbalances. In their Bretton Woods II postulate on the international monetary system, Dooley and others provide the specific rationale discussed earlier for the mechanics of the system which facilitates the stability of the value of the dollar, despite the country's burgeoning deficits. It is important to recall that the period has been witness to large transfers of resources from the developing world, through the process of purchase of safe assets, like US treasuries, though of course this is not limited to the

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developing economies. By 2006, 65% of the total pool of world savings was being absorbed by United States, and contributing to the pool of savings were economies like China (12%), Japan (11%), Germany (8.8%) and Saudi Arabia (8.8%). The other leading savings absorbers were Spain (with a 7.4% share), UK (4.1%), Australia (3%) and France (2.8%). (Figure 2.2 & Figure 2.3). The financing of the balance of payments in the world economy was also underwritten by the accumulation of foreign exchange reserves by the emerging market economies. Contrary to the previous periods in history, the world was witness to current account deficits in the leading advanced economies being financed by current account or balance of payments surpluses in the developing/emerging economies under the Bretton Woods II regime
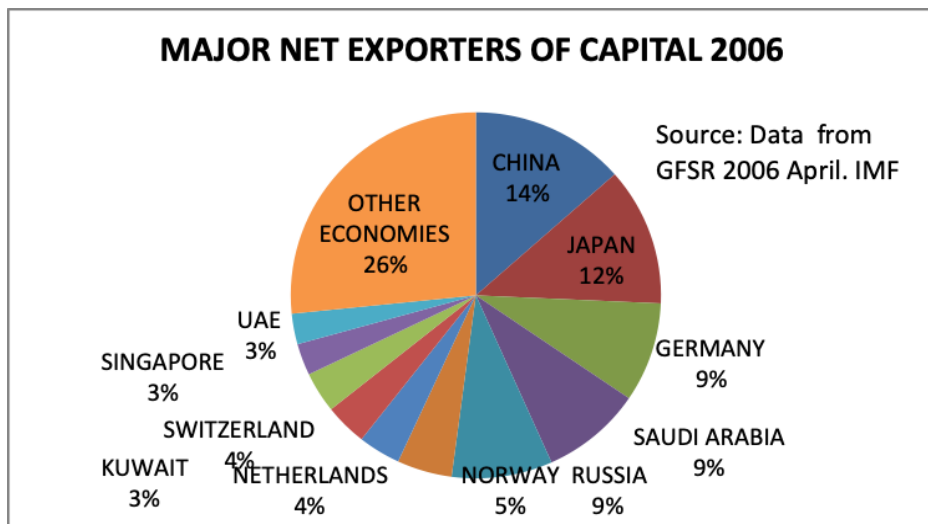
Figure 2.2: Major Net Exporters of Capital 2006
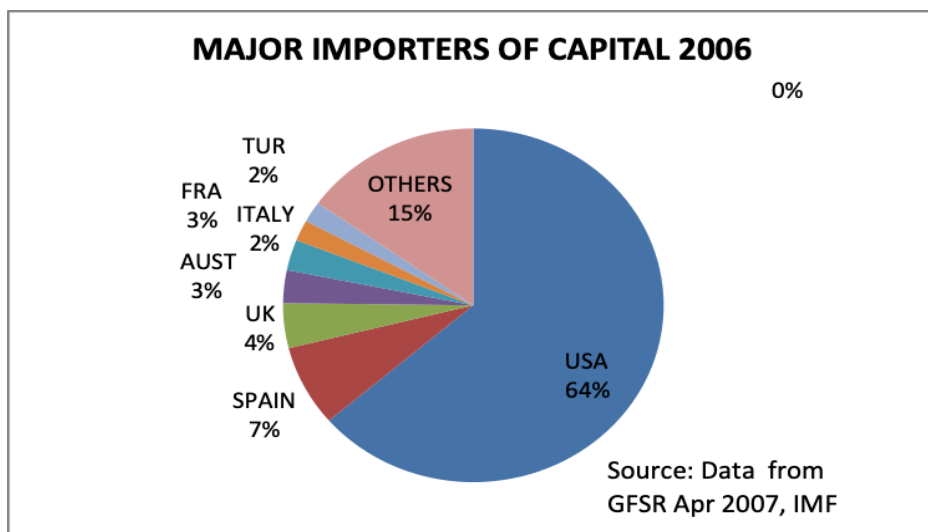
Figure 2.3: Major Importers of Capital 2006

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However, with the huge disruption in trade and increased volatility of oil prices in the global economy in the aftermath of the global financial crisis, it seems that the contribution of developing Asia and the oil exporters to the pool of savings shrank in the years till 2015. By 2014, the major net exporters of capital included Germany (18.9%), China (13.8%) and Saudi Arabia (7%) (Figure 2.4). In fact, the decline in oil prices had resulted in many Middle Eastern economies recording current account deficits in the post 2015 period, reducing their contribution to the pool of savings. Given the lower rates of growth in the USA and the process of deleveraging in the aftermath of the crisis, the capacity of the United States to sustain a credit financed consumption boom had also come under challenge. As a result, its draft on the total savings also fell, with its current account deficit declining from a historic high in 2006. In 2014, though the USA continued to be the leading absorber (36%) of savings from the world economy, there were others including the United Kingdom, Brazil, Turkey, Australia and Canada that were significant importers of capital (Figure 2.5). In fact, in the recent past, the advanced economies as a group have been able to generate a surplus, implying that   the economies in this group are able to finance the deficits generated by one or more of its members with the current account surpluses generated by the others. Noticeable also is the fact that other than Japan, Switzerland and Netherlands, Singapore was a contributor to the savings pool both in 2006 as well as in 2014.

The net import of capital by United States apart, there have been large positive net private capital inflows to the emerging markets and developing economies. Some of them like those in the east Asian region have been able to attract large amounts of net FDI.
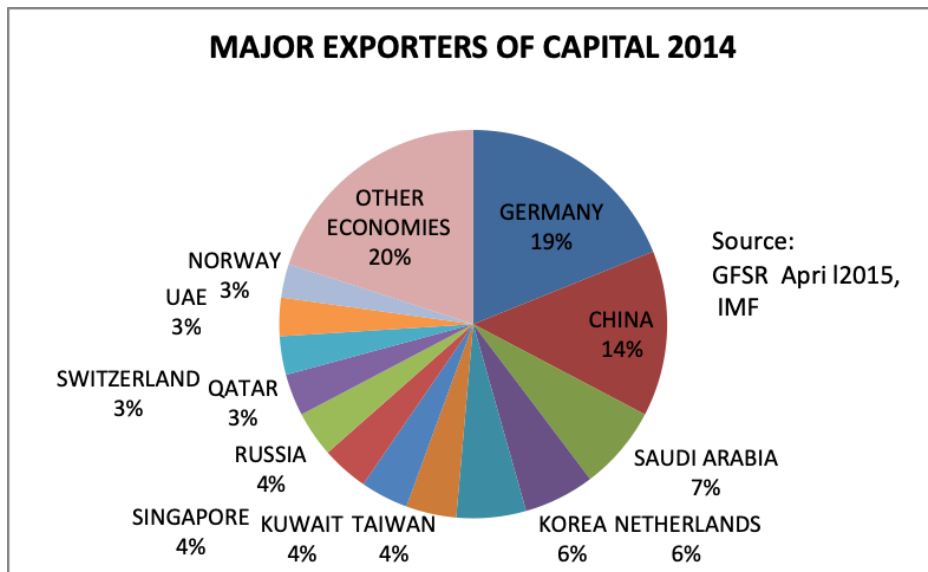
Figure 2.4: Major Exporters of Capital 2014
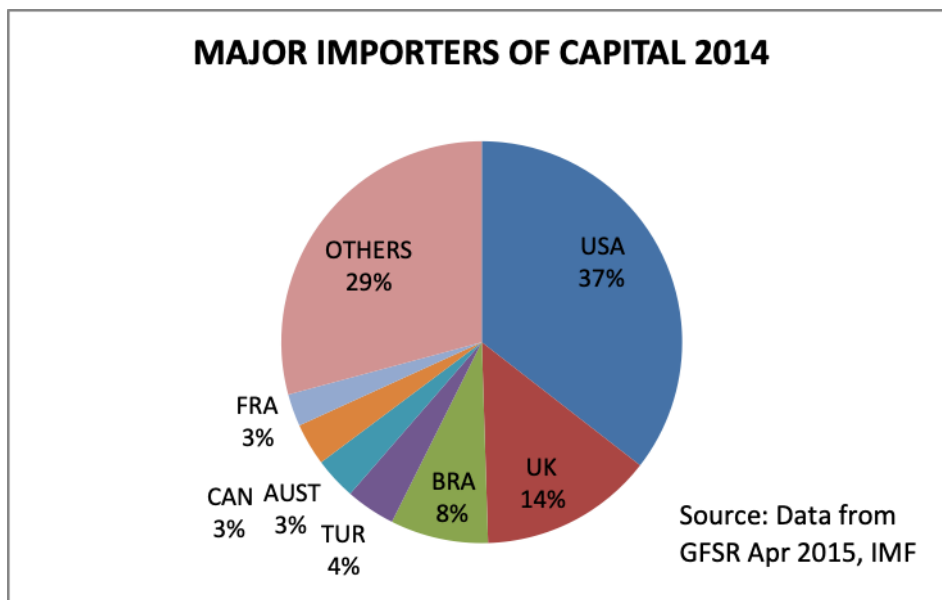
Figure 2.5: Major Importers of Capital 2014

Thus, whereas in the 1998 to 2007 period, we had American deficits being financed with the surpluses of the east Asian economies (in Figure 2.2, they are subsumed under Others) as well as the oil exporting economies, in 2010, and further into 2014, the surpluses of Germany and Japan had become important as sources to finance the deficits of United States. By 2014, the current account surplus of the EMDEs at $208.44 bn was lower than that of the ADV at $ 232.94 bn. Though, coupled with the net capital inflows, the EMDEs continue to accumulate US

Treasuries, as under Bretton Woods II, their current account surpluses at $ 145bn in 2014 is far lower than the $ 647.96 bn recorded in 2006, when the ADV country grouping had a deficit of $ 422.08 bn (Table 2.1).

Germany which has consolidated its economic position after the unification with east Germany recorded surpluses consistently over the years from 2006. In fact, whereas the euro area had a deficit in 2006, even when Germany had a surplus of $ 170.71 bn, by 2010 the euro area had a surplus of $ 36.59 bn, far lower though, when compared to the surplus of Germany of $ 192.25 bn implying that the rest of the euro area had a current account deficit. But, in 2014, we notice that the surplus in the euro area of $ 320.13bn is higher than the surplus generated by Germany of $ 282.88bn.

What needs to be underlined is that a part of this surplus resulted, not from the export success of these economies, but from the deflationary strategies some of them pursued when affected directly by the sovereign debt crisis and the financial crisis in general. The real exchange rate depreciation facilitated by the lower price levels in the advanced economies, policies based on labour market flexibility, as well as the reluctance to translate productivity improvements into higher wages in countries like Germany could have also played an important role in contributing to this surplus. Though far lower level than their surplus of $ 647.96 bn in 2006, EMDEs as a group continued to record a surplus of $145.46 bn. However, EMDEs outside of developing Asia had a deficit throughout. Even within EMDA, other than China and Malaysia, there are only a few countries which have had a consistent current account surplus (Table 2-1A).

In terms of ratios to their GDP, we find from Table 2-1B that the advanced economy grouping has found its current account balance move from -1.12% of GDP in 2006 to 0.495% in 2014. It should be noted that in 1997 too, it recorded a current account surplus to the tune of 0.3% of GDP. This implies that it is the unfavourable situation in the world economy in 2014, as compared with 1997, that has catapulted the advanced economies towards contributing to the savings pool. But remarkable is the transition of Germany from being a deficit country with a current account deficit of 0.50% (1997) to being a surplus country with surpluses amounting to 7.3% of GDP

in 2014, achieved largely through reductions in costs that rendered German goods and services competitive.[5] Meanwhile, there are signs that the developing periphery in Europe is being used as an export platform by the Germans and French, just as the US and Japan had utilized east Asia as a platform for export oriented production in the course of the eighties and nineties. It should be noted that while the advanced economies as a category have been able to generate surpluses of 0.23% of GDP during 2011-14, compared with a lower 0.16 per cent during 1993-97, the current account surpluses of the EMDEs have been on the decline (Table 2.2).

It needs to be noted that, while the current account surpluses of Germany have gone up from 5.68% of its GDP in 2006 to 7.30% in 2014, that of Japan has gone down from $ 174.5 bn (4% of its GDP) in 2006 to $ 24 bn (0.53% of its GDP) in 2014. But most importantly, the surpluses of China have been continuously contracting from $231 bn (8.43% of its GDP) to $219.7 bn (2.12% of its GDP). A part of the explanation for this change in China is its focus in the recent past on expanding its domestic market, as it reconciles itself to the fact that the growth based on exports facilitated by a competitive real exchange rate and its huge labour reserves, may have hit a ceiling. Hence, the reduction in the current account surplus was accompanied by an increase in investment and consumption. As per calculations based on the IFS Yearbook 2017, gross capital formation in China increased from 10505 bn Yuan (38.86% of GDP) in 2007 to 30,196 bn Yuan (43.3% of GDP) in 2015, and consumption expenditure increased from 9979 bn Yuan (36.72% of GDP) to 26,476 bn Yuan (38% of GDP) during the same period. Even when the government expenditure increased in the period from 3643 bn Yuan to 9457 bn Yuan, its share in the GDP remained at approximately 13 % of the GDP.[6]

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[5] We come to more on this in the chapter ahead which deals with the global liquidity and capital flows in the eurozone region.
    [6](IMF, 2018b)

Table 2-1: Current Account of countries

				Table 1A			
			Current Account of countries ($ bn)				
	1989	1992	1997	2001	2006	2010	2014
ADV	-63.42	-31.953	73.904	-210.828	-422.081	3.67	232.944
US	-99.485	-51.614	-140.72	-395.32	-806.726	-441.961	-389.525
JAP	63.142	112.394	95.154	86.186	174.536	220.986	24.404
GER	54.179	-25.287	-11.289	-7.085	170.717	192.253	282.884
OTH	-81.26	-67.446	130.759	105.391	39.392	32.392	315.181
EURO			56.94	-78.874	-24.648	36.598	320.129
EMDEs			-67.669	60.854	647.963	280.328	145.457
EMDA			12.151	40.699	272.629	233.467	208.444
CHINA			36.963	17.405	231.843	237.81	219.678
IND	-6.906	-3.526	-5.499	3.4	-9.565	-48.053	-26.72

				Table 1B			
			Current Account /GDP of countries (as % of own GDP)				
	1989	1992	1997	2001	2006	2010	2014
ADV	-0.392	-0.153	0.299	-0.804	-1.118	0.009	0.495
US	-1.758	-0.789	-1.635	-3.722	-5.822	-2.953	-2.245
JAP	2.092	2.917	2.2	2.071	4.006	4.019	0.531
GER	4.324	-1.188	-0.508	-0.363	5.681	5.616	7.301
EURO			0.818	-1.197	-0.22	0.289	2.384
EMDE			-0.991	0.892	4.866	1.239	0.474
EMDA			0.575	1.668	5.622	2.413	1.388
CHINA			3.843	1.302	8.425	3.96	2.106
IND	-2.301	-1.202	-1.299	0.688	-1.008	-2.813	-1.308

Table 2-2: Current accounts as % of respective GDPs

	Table 2-2: Current Accounts as % of respective GDPs								
	1989-97	1989-92	1993-97	1998-2007	1998-2001	2002-2007	2008-2014	2008-10	2011-14
ADV	-0.04	-0.30	0.16	-0.68	-0.48	-0.82	-0.09	-0.51	0.23
USA	-1.26	-0.96	-1.51	-4.35	-3.29	-5.06	-2.94	-3.44	-2.56
GER	-0.05	1.12	-0.99	2.05	-1.06	4.13	6.30	5.65	6.79
JAP	2.20	2.09	2.28	3.28	2.59	3.75	2.06	3.28	1.14
EMDE				1.95	0.24	3.09	1.40	1.99	0.95
EMDA				3.16	2.09	3.87	2.21	3.85	0.98
MENA	-1.54	-2.62	-0.67	7.76	3.98	10.28	8.71	6.87	10.10
Oil producers in MENA	-2.00	-6.03	0.42	11.12	5.16	15.09	14.33	11.07	16.77

The surpluses of the MENA region have shrunk over the years from a peak of $282.48 bn, to a deficit of -$111.69 bn. In other words, the excess of savings over investment it recorded for a long period of time has been reversed, resulting in a current account deficit in 2015 (Figure 2.6). In fact, Saudi Arabia and Qatar found the need to issue bonds in the international market to finance expenditures. The inextricable link between the current account of the MENA petroleum exporters and the level of oil prices is clear from Figure 1.6[8]. In fact, the oil price has displayed considerable volatility over this period. Having risen to a high of $110 per barrel in 2010 and 2011 from a very low level in earlier periods , it collapsed to touch $ 52 per barrel in 2016. As a result the current account of the MENA region had moved from $415 .7 bn in 2012 (when the international price of oil was $111.96 per barrel) to a deficit of $ 42 bn (2015) (with the price of oil collapsing to $52.39 per barrel).[9]

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[8] The data related to the price of Brent crude was extracted from the International Financial Statistics and the current account data is extracted from World Economic Outlook Database.
[9] Ever since there has been firming up of prices in the international economy.

Current Account Surpluses of Oil exporters in MENA and the Price of Oil
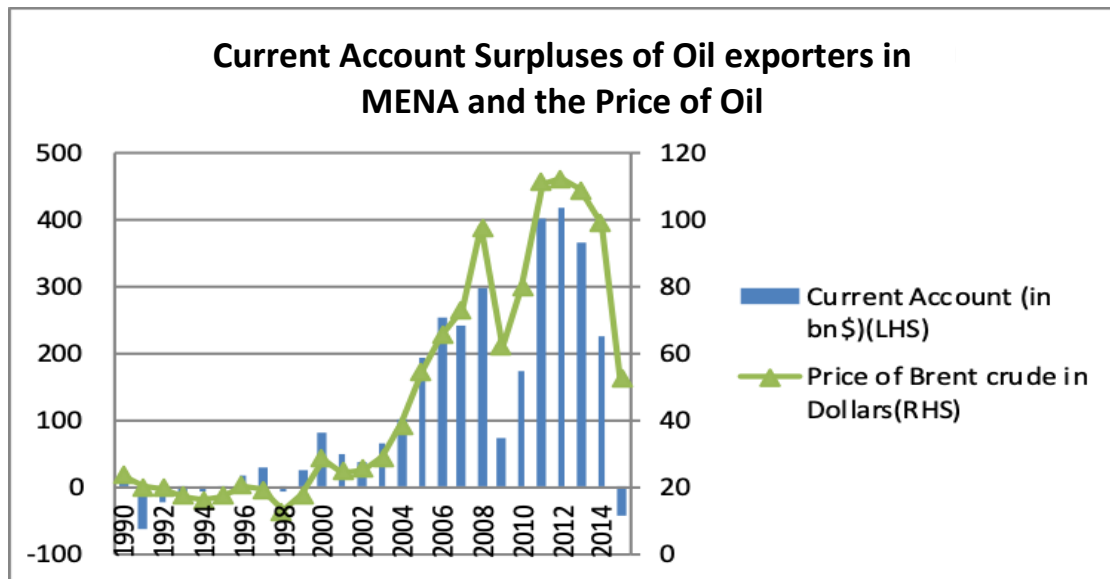
Source: BOPS(IMF) and WEO Database

Figure 2.6: Current Account Surpluses of oil exporters in MENA and price of oil.

Growth and the current account

The differential performance of the emerging market economies, both with respect to rates of growth as well as with respect to the current account is subjected to investigation in this section. The periodization adopted for the study is: 1989 to 1997, 1998 to 2007 and 2008 to 2015. The second period, i.e., the post 1997 phase, was witness to the emergence of large macroeconomic imbalances in the form of large current account surpluses and deficits in the world economy.

On the basis of the relationship between changes in rates of growth and in the current account, the study compartmentalizes the set of economies into four different clusters: (a) Those with rising rates of growth and improved current account; (b) those with falling rates of growth and improved current account (c) those with rising rates of growth and deteriorating current account; and (d) those with falling rates of growth and deteriorating current account. These cases are referred to as Positive Dynamic, Positive Static and Negative Dynamic and Negative Static respectively (Boratav, 2009)
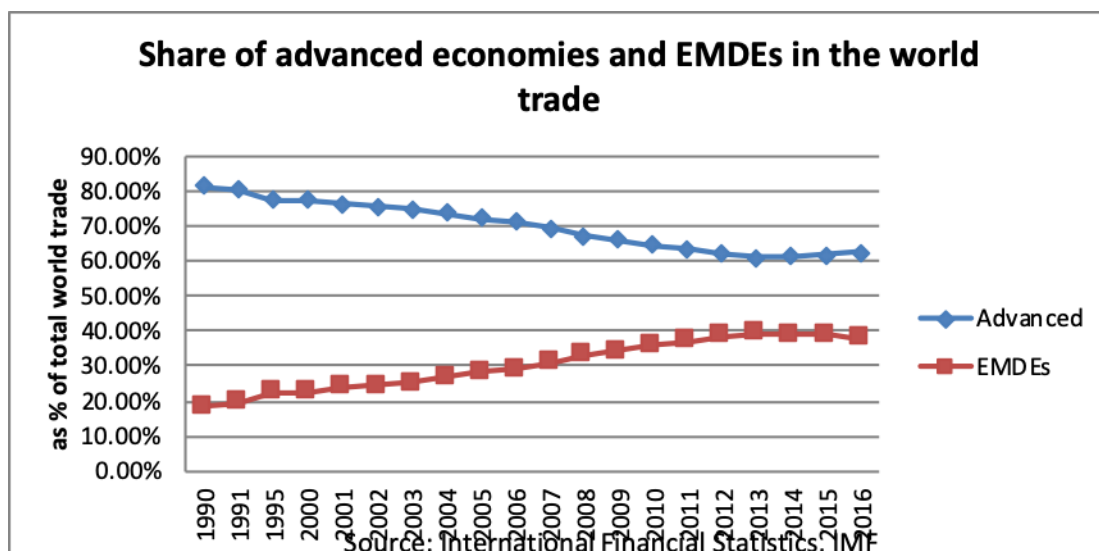
Figure 2.7: Share of advanced economies and EMDEs in world trade

Over these periods, the share of the emerging market and developing economies in world trade has been subject to large changes. The increasing disintegration of production and integration of nations through trade in the world economy made possible by more extensive global value chains, and a higher global value chain participation rate, has resulted in the share of the developing economies in world trade increasing. Whereas the share of the advanced economies in world trade (imports) has decreased from 81.35% in 1990 to 61.68% in 2015, that of the emerging market and developing economies has increased from 18.47% in 1990 to 38.78% in 2015 (Figure 2.7). In 2007, of the total imports valued at $16.35 trillion, $10.98 trillion was of the advanced economies and $5.4 trillion was of the EMDEs. The total imports of the world rose to $ 18.10 trillion in 2014, of which $ 11.32 trillion was of the advanced and $ 6.78 trillion was of the EMDEs. But after 2014, there occurred a significant decline in the total value of world exports, due in large part to the commodity price decline, to $ 15 trillion in 2016, though it had recovered to $19.36 trillion by 2018.[10]

Of the three periods which we look into (1989-1997, 1998- 2007 and 2008 to 2014), the first is characterized by a short term boom, followed by the Asian financial crisis in 1997. The second is characterized by a slowdown in the initial phase till 2002, followed by a period when there was a large increase in global liquidity and

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[10] All data from IMF Datawarehouse. This is specifically from World Regional Tables of BOPS Yearbook 2018

high rates of growth till the collapse of growth triggered by the global financial crisis. In the immediate aftermath of the global financial crisis, the world has been witness to low rates of growth in the backdrop of large scale deleveraging on the part of the corporates as well as the banks based in the United States and Europe in particular.[11] That apart, even while growth has not picked up momentum, there has been an increase in leveraged borrowing as per the Global Financial Stability Report.[12]

How has growth in the recent years (post GFC) fared in comparison with the 1989 to 1997 period and the 1998 to 2007 period?

During 1989 to 1997 and 1998 to 2007, the rate of growth of the world economy increased from 3.21% to 4.21%, but across these periods there was a near stagnation of the rate of growth of the advanced economies at 2.8% and 2.76% respectively. Much of the growth in this period seems to have come from the EMDEs, which had registered growth rate increases from 3.82% to 5.86%, and within them the growth of the group of economies classified under Emerging and Developing Asia has remained stable at a relatively high 7.69% (1989-1997) and 7.59% (1998-2007). But if we consider the smaller time period 2002 to 2007, the rates of growth registered by both the EMDE as well as EMDA groups of countries was 7.19% and 9.01%. All the groups were witness to reduction in growth during the downturn phase between 1998 and 2001, which was the period after the Asian financial crisis as well as the dotcom bust. Overall, during the 1998 to 2007 period there has been a remarkable increase in growth in the emerging market and developing economies compared to the 1989-97 period (Table 2-3).

Table 2-3: GDP Growth Rates during the two cycles and their sub-periods

	1989-1997	1989-92	1993-97	1998-2007	1998-2001	2002-2007	2008-14	2008-10	2011-14
World	3.21	3.04	3.34	4.21	3.37	4.77	3.25	2.79	3.59
Advanced	2.80	2.75	2.84	2.76	2.99	2.60	0.82	-0.06	1.48
EMDE	3.82	3.55	4.03	5.86	3.87	7.19	5.32	5.38	5.27
EMDA	7.69	6.81	8.39	7.59	5.46	9.01	7.54	8.12	7.10

Source: World Economic Outlook Database April 2017. International Monetary Fund

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[11] This, though, has reversed with corporate debt picking up in due course, as is revealed by various reports including (World Bank, 2017a)

[12] The Global Financial Stability Report 2018 draws attention to the fact that the global leveraged issuance market had touched a high of $788 bn, higher than the previous high of $ 762 bn in 2007. This is an indicator of increased risk taking. (IMF, 2018)

But a tendency for growth to slowdown from 4.21% (1998-2007) to 3.25% (2009-14) is visible. Particularly significant is the fact the rate of growth in the advanced economies has fallen to 0.82% after the crisis, from 2.76% in the previous period. Even when one avoids the period which was characterized by contraction of -0.06% (2008-10), we find that over 2011-14 also the rate of growth has been 1.48%. The rate of growth of the EMDEs too has slowed from 5.86% to 5.32% in 2008-14. In fact, growth in the period excluding the years 2008-10 of 5.27% (2011-14) is lower than during 2008-10 period for the EMDEs, as well as for the EMDA group. The rate of growth of Emerging and Developing Asia at 7.54% during 2008-14 is lower than the 9.01% registered in the years 2002-07, which were the years of the high tide of global liquidity.

Thus, the monetary policy push given by the developed economies did not hold them in good stead and the capital flows which have occurred to the developing world in search of yield did not have a significantly favourable effect on the latter either. The bouts of currency appreciation experienced by the developing countries associated with a barrage of capital inflows, coupled with the low rates of increase in the price level in the advanced economies, have set new barriers to the growth prospects of emerging economies. What does the data show at the level of the countries included in our study?

Different trajectories of growth of Emerging Market and Developing Economies(1989-97 to 1998-2007)

This section tries to understand the different trajectories of growth in EMDEs in the period 1989-2014. Included in this study are 18 emerging and developing economies: Argentina , Brazil, Colombia, Chile, Peru and Mexico from the Latin American region (Western Hemisphere), Indonesia, Korea, Malaysia, Philippines, Thailand, India, and China from Emerging and Developing Asia (EMDA) and Hungary, Romania, Poland, Turkey from Emerging Europe and Egypt from MENAP.

The period of study from 1989 to 2014 covers two long cycles and the period post 2008: 1989 to 1997, 1998 to 2007 and 2008-14 , with sub cycles: 1989 to 1992, 1993 to 1997, 1998-2001 and 2002-07, followed by the period 2008-14. The data in

Table 2-4 reveals that the average rates of growth of economies have been relatively higher in the sub-periods 1993-97 (5.43%) and 2002-07 (5.49%)

In both the long periods studied, i.e., 1989-97 and 1998-2007, the country that registered the highest rate of growth is China. After registering a rate of growth of 9.86% per annum in the first phase, it registered a rate of growth of 9.95% in the second phase. In the third phase, i.e., 2008-14, we find that China continues to register a high rate of growth of 8.79%, with only Korea being close at 8.06%. The performance of India through these phases has also been good, with growth rising from 5.40% in the first phase of 1989 to 1997 to 7.16% in the second phase. Even in the 2008-14 phase, though the rate of growth had decreased to 6.97%, given the unfavourable international economic environment, and given that the simple average for the countries in this phase was only 4.20%, this was not bad.

Table 2-4: Average Rate of Growth (% p.a.) (constant prices)

	Average Rate of Growth(% p.a) (constant prices)								
	1989-97	1989-92	1993-97	**1998-2007**	1998-2001	2002-07	**2008-14**	2008-10	2010-14
Argentina	3.93	3.11	4.58	2.78	-1.18	5.42	3.59	4.19	3.13
Brazil	2.18	-0.10	4.00	2.98	1.65	3.86	3.06	4.17	2.24
Chile	7.94	8.61	7.41	4.01	2.59	4.95	3.59	2.64	4.30
China	9.86	7.90	11.42	9.95	8.03	11.23	8.79	9.80	8.04
Colombia	4.00	3.61	4.31	3.10	0.24	5.01	4.15	3.06	4.97
Egypt	3.35	1.94	4.47	5.14	5.64	4.81	3.61	5.66	2.07
Hungary	-1.04	-4.43	1.68	3.74	3.88	3.64	0.09	-1.66	1.41
India	5.40	4.51	6.12	7.16	5.89	8.01	6.97	7.54	6.54
Indonesia	7.75	8.38	7.25	2.81	-0.93	5.31	5.90	6.17	5.70
Korea	8.34	7.83	4.82	4.97	3.34	3.07	8.06	4.91	3.19
Malaysia	9.20	9.13	9.25	4.28	1.99	5.80	4.62	3.62	5.37
Mexico	3.45	4.26	2.81	2.91	3.02	2.84	1.92	0.60	2.91
Peru	1.93	-4.21	6.85	4.13	1.10	6.15	5.61	6.21	5.16
Philippines	3.47	2.25	4.44	4.18	2.45	5.33	5.21	4.31	5.88
Poland	2.36	-2.08	5.92	4.21	3.74	4.51	3.06	3.42	2.79
Romania	-2.51	-8.28	2.10	4.07	0.64	6.36	1.25	0.20	2.05
Thailand	7.68	10.36	5.54	3.91	1.21	5.70	2.87	2.83	2.90
Turkey	4.53	4.10	4.86	4.16	0.20	6.79	3.29	1.66	4.50
Average of 18 countries	4.55	3.16	5.43	4.36	2.42	5.49	4.20	3.85	4.06
Average of 15 countries	5.53	4.78	5.88	4.43	2.35	5.62	4.75	4.49	4.46

Source: World Economic Outlook Database.(Author's calculations)

The average rates of growth of these 18 economies were lower at 3.16% and 2.42% during the sub- periods 1989-92 and 1998-2001, and relatively higher at 5.43% and 5.49% during the 1993-97 and 2002-07 periods respectively. (Table 4) Excluding Hungary, Poland and Romania, whose rates of growth were to begin with low in the early years, the 15 country average calculated for the sub periods stood at relatively higher levels of 4.78% (1989-92), 5.88% (1993-97), 2.35% (1998-2001) and 5.62% (2002-07).

In the sample of 18 countries over a period of 26 years (total 468 observations), China recorded a current account surplus for the maximum number of years, i.e., 23. Other than China, six of the countries, Egypt, Indonesia, Korea, Malaysia, Philippines and Thailand recorded a surplus in at least half of the years. Romania, Poland, Peru, India, Colombia and Turkey registered current account surpluses for five or less than five years. Of the total 468 data points in all, there were only 169 in which the countries had a current account surplus (Table 5). This is pertinent, because it indicates that a good portion of the accumulated foreign exchange reserves of the emerging market and developing economies is made out of the surpluses in the financial account rather than the current account.

Table 2-5: Number of years in 1989-2014 when economies had a current account surplus

Argentina	10
Brazil	7
Chile	7
China	23
Colombia	5
Egypt	13
Hungary	8
India	3
Indonesia	14
Korea	19
Malaysia	18
Mexico	0
Peru	4
Philippines	13
Poland	3
Romania	1
Thailand	14
Turkey	6

Source: World Economic Outlook Database. Apr 2017(tabulations are that of author's)

Whereas in the period 1989-97, the number of countries which registered a current account surplus on an average is only two (China and Egypt), the number shot up to nine in the 1998-2007 period (Table 2-5). The averages relative to GDP for some of the economies were very high: China at 4.07%, Thailand at 4.51% and Malaysia at 11.65%. In the wake of the global financial crisis, not only did the average of these countries move down from 0.08% during 1998-2007 to minus 0.80% in the 2008-14 period, those of China, Thailand and Malaysia also witnessed a decline to 3.72%, 2.17% and 9.35% respectively. In the period 2010-14, there has been a further decline in the average current account to -0.92% of GDP (Table 2-6).

Table 2-6 : Current account of EMDEs (as % of GDP)

Current Account (as % of GDP)									
	1989-97	1989-92	1993-97	1998-07	1998-2001	2002-07	2008-14	2008-10	2010-14
Argentina	-1.36	0.33	-2.72	1.02	-2.84	3.60	0.17	1.40	-0.74
Brazil	-0.94	0.16	-1.82	-1.28	-4.06	0.58	-2.88	-2.27	-3.33
Chile	-2.69	-1.54	-3.62	0.36	-1.84	1.82	-1.32	0.18	-2.44
China	1.80	1.49	2.06	4.07	2.00	5.45	3.72	5.99	2.01
Colombia	-1.47	1.47	-3.83	-1.26	-0.91	-1.50	-3.15	-2.55	-3.59
Egypt	1.35	1.72	1.06	0.80	-1.43	2.28	-1.82	-1.20	-2.29
Hungary	-3.40	0.31	-6.36	-7.34	-7.28	-7.37	0.16	-2.56	2.19
India	-1.38	-1.72	-1.10	-0.21	-0.45	-0.05	-2.86	-2.63	-3.04
Indonesia	-1.99	-2.10	-1.90	2.84	3.82	2.18	-0.88	0.85	-2.19
Korea	-0.55	-1.61	4.38	1.54	2.23	4.56	-1.14	2.67	3.56
Malaysia	-4.55	-3.11	-5.70	11.65	10.72	12.27	9.35	13.88	5.95
Mexico	-3.08	-3.70	-2.59	-1.81	-2.70	-1.22	-1.46	-1.11	-1.71
Peru	-5.60	-3.89	-6.97	-1.14	-3.56	0.48	-2.87	-2.41	-3.22
Philippines	-3.66	-3.08	-4.13	0.84	-1.59	2.47	3.14	2.90	3.32
Poland	-1.58	-0.83	-2.18	-4.44	-5.15	-3.97	-4.07	-5.42	-3.06
Romania	-3.88	-3.17	-4.46	-6.40	-4.13	-7.92	-4.71	-7.23	-2.81
Thailand	-5.89	-6.13	-5.70	4.51	8.49	1.86	2.17	3.53	1.15
Turkey	-0.54	-0.16	-0.84	-2.38	-0.36	-3.72	-6.03	-4.45	-7.22
Average of 18 countries	-2.19	-1.42	-2.58	0.08	-0.50	0.66	-0.80	-0.02	-0.97
Average of 15 countries	-2.04	-1.46	-2.23	1.30	0.50	2.07	-0.39	0.99	-0.92

Source: World Economic Outlook Database. Apr 2017(tabulations are that of author's)

Table 2-7 shows the relationship between rates of growth of economies and their current accounts. Countries having current account surpluses are seen to perform creditably. A country is said to have a current account surplus when it is absorbing far less than its output, i.e., the constituents in the form of consumption, investment, and government expenditure are together demanding less than the output produced. These economies are referred to as the current account surplus economies, which by virtue of spending less than what they produce have a current account surplus and are net lenders to the international economy. But it does not make much sense that economies which have per capita levels of consumption far lower than those in the advanced economies are serving as suppliers of savings to the international economy. Indeed, China and the set of economies with surpluses are lending to the world, whereas, those with deficits are borrowing from the world. A reasonable current account deficit towards supporting feasible investment would augur well for an economy. But it is also important to note here that, in the case of China, the large surplus on the current account was backed by higher investment ratios.

Table 2-7:Average rates of growth as against the current accounts of EMDEs

	rog	(CA/Y)	rog	(CA/Y)	rog	(CA/Y)
Countries	1989-97	1989-97	1998-2007	1998-2007	2008-14	2008-14
Argentina	3.93	-1.36	2.78	1.02	3.59	0.17
Brazil	2.18	-0.94	2.98	-1.28	3.06	-2.88
Chile	7.94	-2.69	4.01	0.36	3.59	-1.32
China	9.86	1.80	9.95	4.07	8.79	3.72
Colombia	4.00	-1.47	3.10	-1.26	4.15	-3.15
Egypt	3.35	1.35	5.14	0.80	3.61	-1.82
Hungary	-1.04	-3.40	3.74	-7.34	0.09	0.16
India	5.40	-1.38	7.16	-0.21	6.97	-2.86
Indonesia	7.75	-1.99	2.81	2.84	5.90	-0.88
Korea	8.34	-0.55	4.97	1.54	8.06	-1.14
Malaysia	9.20	-4.55	4.28	11.65	4.62	9.35
Mexico	3.45	-3.08	2.91	-1.81	1.92	-1.46
Peru	1.93	-5.60	4.13	-1.14	5.61	-2.87
Philippines	3.47	-3.66	4.18	0.84	5.21	3.14
Poland	2.36	-1.58	4.21	-4.44	3.06	-4.07
Romania	-2.51	-3.88	4.07	-6.40	1.25	-4.71
Thailand	7.68	-5.89	3.91	4.51	2.87	2.17
Turkey	4.53	-0.54	4.16	-2.38	3.29	-6.03
Average of the rog	4.55		4.36		4.20	
Average rog (of 15 countries)	5.53		4.43		4.75	

Source: World Economic Outlook Database. Apr 2017(tabulations are that of author's)

How do the emerging market economies in our sample perform? As suggested in the beginning, we categorise these economies into four types.[1]

Rates of growth and shifts in current account balances from 1989-97 to 1998-2007

In the first case, the average rates of growth rates of each economy in the 1989-97 and 1998-2007 periods are taken, and these values are normalized by subtracting from the values the average for the sample economies in the concerned time period and dividing the result by the standard deviation of the growth rates in our sample. All economies which witness an increase in their 'z' scores are ones registering high growth relative to the average, and the others are the ones with lower growth. After which we juxtapose them against what has happened to their current account, i.e., as to whether there has been an improvement or deterioration. The results are given in Table 2-8.

Table 2-8: Link between Current account and rate of growth: 1989-97 to 1997-2008

Between 1989-97 to 1997-2008	Very high or rising growth	Very low or decreasing growth
Improved current account	CHN IND PER PHI **Positive/Dynamic**	ARG COL MAL MEX CHL INDO KOR THAI **Positive/ stagnant**
Worsened current account	EGY POL HUN ROM **Negative/Dynamic**	BRA TUR **Negative /stagnant**

We find that the economies of China, India, Peru and Philippines are in the desirable situation of having an improvement in the current account, while at the same time recording an improvement in the rates of growth between the time periods of 1989-97 and 1998-2007. The only point to be noted here is that the rates of growth registered by Philippines or Peru are not very high. For Peru, it has increased from

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[1]Following the paper by Boratav, we classify economies growing at higher rates with improved current accounts as 'Positive Dynamic', those with improved rates of growth and worsened current accounts as 'Negative Dynamic', those with low rates of growth and improved current accounts as 'Positive Stagnant' and those with decreasing growth rates and worsened current accounts as 'Negative Stagnant' (Boratav, 2009).

1.93% to 4.13% and for Philippines from 3.47% to 4.18%, between these periods while their current accounts improved from -5.60% to -1.14% for Peru and -3.66% to 0.84% for Philippines (Table 2-8).

In the category of countries that saw improvement in their current accounts even while their rates of growth had been deteriorating are Argentina, Colombia, Malaysia, Mexico, Chile, Indonesia, Korea and Thailand. The presence of many east Asian economies are explained by the fact that the rates of growth registered by them in the first phase was higher, and the crisis which affected the Asian economies had a severe impact such that the rates of growth registered in the second half were lower. This is exactly the phase when they were squeezing out an export surplus, even when investment to GDP ratios were on the decline, implying that the surplus extracted comes in the context of a consumption squeeze.

In the third category, are those with worsening current account balances even when their rates of growth are on the rise. In this category are Egypt, Hungary, Poland and Romania. These are economies moving to higher growth with worsening current accounts (Negative/Dynamic). The implication of this outcome depends on whether a country is incurring a current account deficit on account of an investment upswing or because of increased consumption goods imports.

Turkey and Brazil show a deterioration in the current account simultaneously with deterioration in the level of incomes.

Growth rates and shifts in current account balances between 1998-2007 and 2008-14

What has happened to the rates of growth and the current accounts since the global financial crisis? It is a known fact that the rates of growth worldwide have declined and the current accounts have deteriorated, especially of the emerging market and developing economies.[2]

As far as rates of growth are concerned, all countries which have registered higher rates of growth in 2008-14 when compared with 1998 to 2007, or, have

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[2] Initially, the intention was to focus on 2010-14 instead of 2008-14,because of the financial crisis, but since there is not much difference to warrant the former choice, we stayed with 2008 to 2014.

recorded a rate of growth higher than 4.2%, which is the average for the 18 countries in our sample in the 2008-14 period are included in the rising growth category. This approach is to be seen in the context of the average rate of growth in the 2008-14 period being lower than the earlier phase. And economies which have registered deterioration in the current account of more than 1% point have been included in the worsening current account category for classification. Any classificatory scheme would have its own shortcomings.[3]

Between 1998-2007 and 2008-14, China and Philippines have moved to a better current account with higher rates of growth. Even as their growth rates stagnated, the current accounts of Chile, Hungary, Poland and Romania were witness to an improvement. Argentina, Brazil, Indonesia, India, Colombia, Korea, Peru and Malaysia experienced a reduction in growth but improvement in the current account. Turkey, Thailand, Egypt and Mexico experienced decreases in rates of growth and deterioration of their current accounts. (Table 2-9)

Table 2-9: Link between current account and rate of growth (1997-2007 & 2008-14)

Between 1997-2007 and 2008-14	Very high or rising growth*			Very low or decreasing growth		
Improved current Account*	CHN	PHI		CHL ROM	HUN	POL
	Positive/Dynamic			**Positive/stagnant**		
Worsened current Account	ARG COL PER	BRA IND MAL	INDO KOR	EGY TUR	MEX	THA
	Negative/Dynamic			**Negative /stagnant**		

*either more than 4.2% or improved high growth
**more than 1% decrease deterioration, otherwise improve

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[3]In this case, Malaysia's current account worsens from 11.65% to 9.35%, and given our criterion of more than 1%, it is included under the deteriorating current account category. Whereas, for economies with lower current account deficits to begin with, reduction in 1% might not be a bad indicator; for Malaysia, given its base it is not. We remain with the criterion, with the caveat that we can categorise Malaysia, under the Positive/Dynamic group as against the Negative/Dynamic group under which it is now placed.

Figure 2.8 provides the investment GDP ratios and savings GDP ratios of China, India, Hungary and Turkey as representative of the four cases.

I/GDP and S/GDP of China

Source: World Economic Outlook Database. IMF

I/GDP and S/GDP of India

Source: World Economic Outlook Database. IMF

I/GDP and S/GDP of Hungary

I/GDP and S/GDP of Turkey
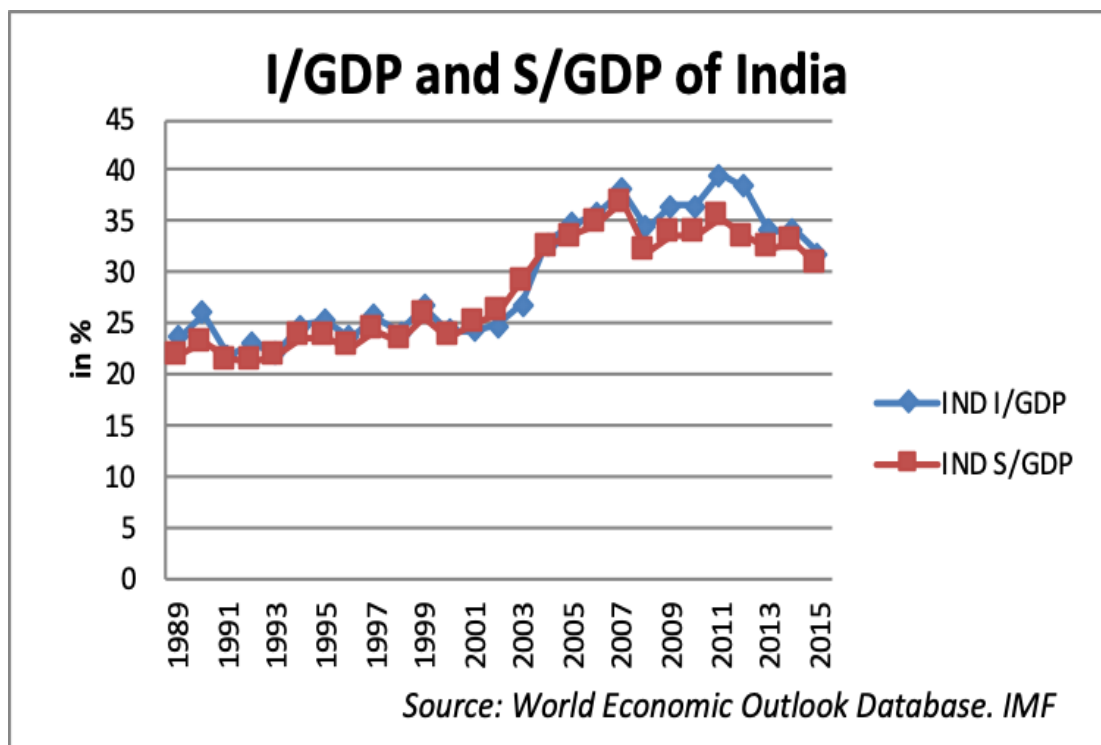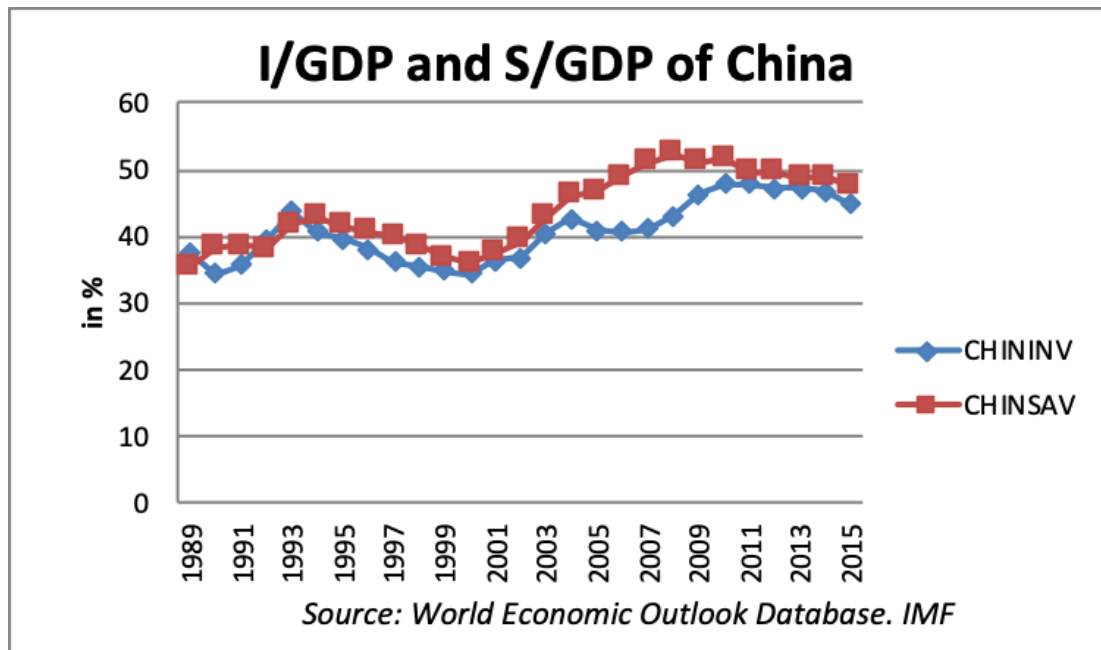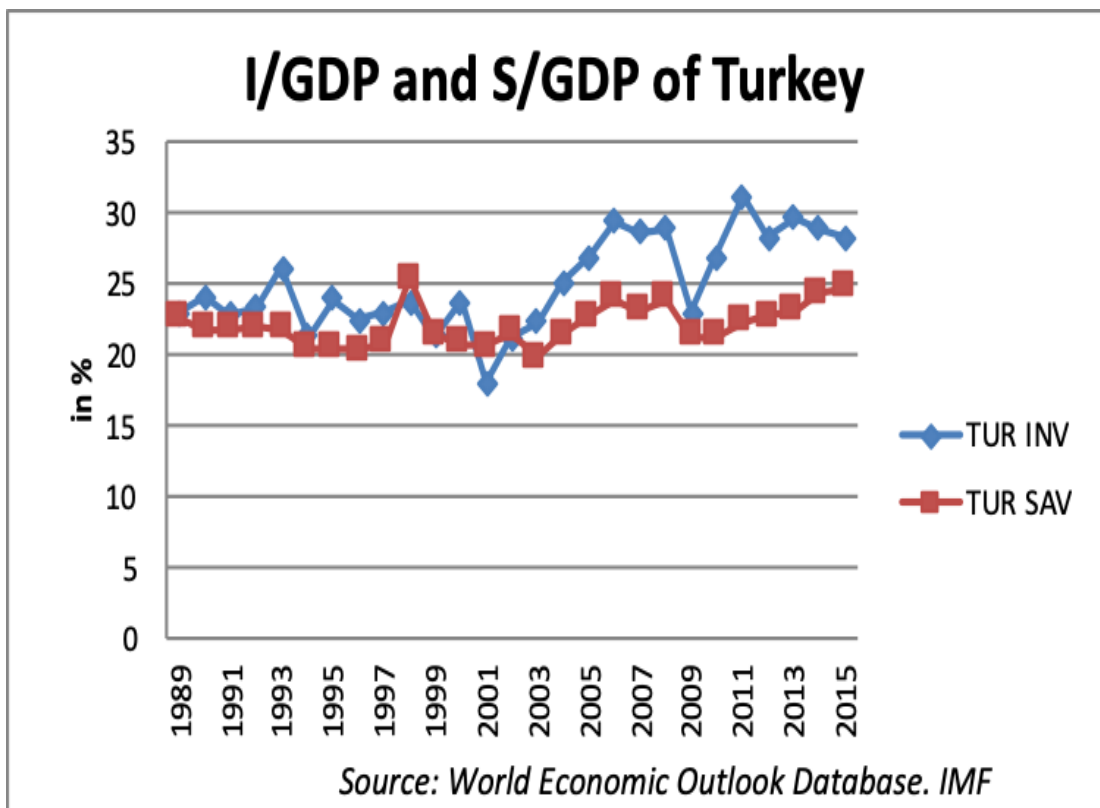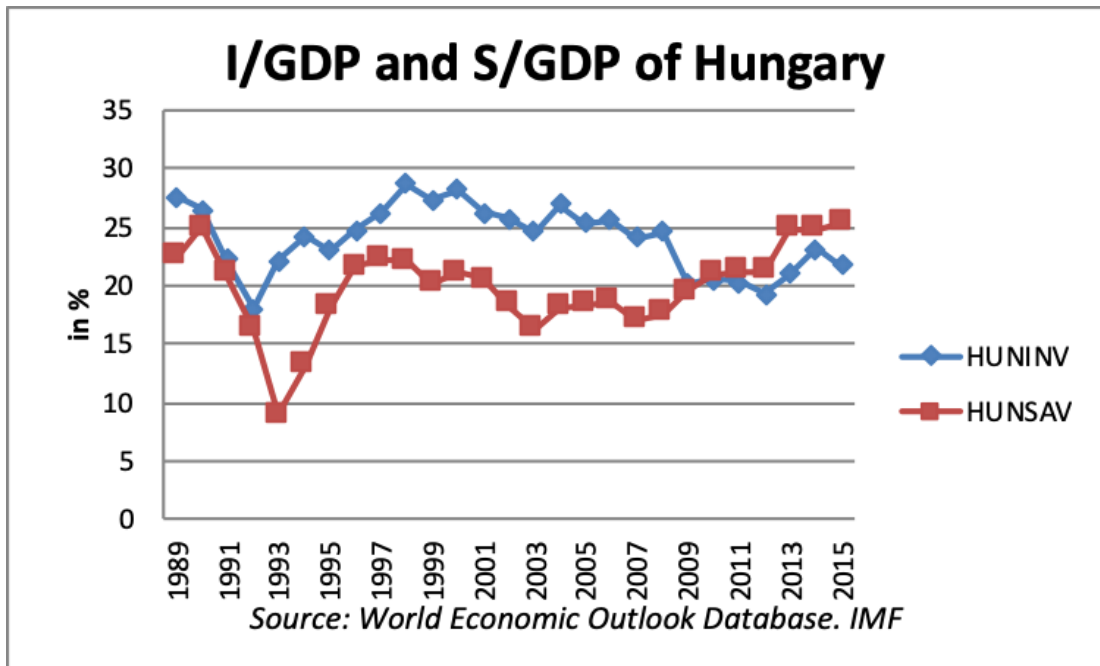
Figure 2.8: I/Y and S/Y of a set of EMDEs

Investment and savings ratios across countries

For any economy: Y=C+I+G+X-M

Y-C-G= I+X-M

(Y-C-T) +(T-G)=I+X-M

S+(T-G)=I+(X-M)

(S-I)+(T-G)+(M-X)=0

Our study intends to locate current account imbalances in the EMDEs in the larger context of global imbalances. When the absorption in an economy is higher than its output, as is true of the US, the country would record a current account deficit. And, if the absorption is lower than output, it would have a current account surplus like China. We cannot read causal linkages into this identity, though it is often argued that increases in government deficit spills over into the current account. A large investment boom, driven by technological innovations or a natural resource boom, could result in investment ratios being higher than the savings ratios. This, too, ceteris paribus,   could spillover in the form of a larger current account deficit. A current account deficit could be on account of increase in investment, or of consumption. Though both would have similar effects on the current account, the medium term impact of an increase in investment on growth would be different from the other case. When for economies like US, where its currency is an international reserve currency, the current account deficit would not matter much; it is not the same with other emerging and developing economies. This section tries to explore the links between I-S gaps and current account balances of the EMDEs.

It would be useful to extend our discussion of the investment and savings ratios of economies across the world. The data relating to the different country groupings as well as a set of developed economies is given in Table 2-10. The surpluses of the advanced economies group during the period under consideration have been more the result of a reduction in investment or capital formation. There has been a decline of investment opportunities in the advanced world. There have been different reports which speak of trillions of dollars in cash with the corporates in the US and UK and of their reluctance to undertake investment, despite the injection of

liquidity into the system through the purchase of bonds by the three big central banks in the world[4].

On the other hand, in the case of the EMDEs, there has been a large increase in investment ratios, from 29.5% (2009) to 32.59% (2014). So too is the case with EMDA nations, where the investment ratios have increased even more from 33.19% in 1997 to 37.32% in 2007 and further to 42.03% in 2014. However, the investment-savings gap has remained more or less the same as there has been a commensurate increase in the savings to GDP ratio as well.

The CIS region has also been witness to a reduction in investment ratios from 25.48% to 22.68%, because of the crash in the price of oil in the international market in the period till 2014. The decline in the price of crude during the 2010 to 2014 period had consequences for investment in the region due to the large changes in the valuation of oil based assets worldwide.

If developing Asia is aiming to raise levels of investment, ASEAN-5 economies are trying to catch up with their investment ratio recorded in 1997 of 34.5%. Between 2007 and 2014, the investment ratio in this group has risen from 26.27% to 28.41%, with a marginal increase in the savings ratio as well.

In Latin America, in the period from 1997 to 2007, the investment and savings ratios picked up simultaneously, with the investment ratio increasing from 19.78% to 22.12%, and the savings ratio from 16.63% to 22.12%, leading to a balance on the current account. Post 2007 till 2014, however, the continent has been witness to a decrease in the investment ratio of almost 1 percentage point and a decrease in the savings GDP ratio from 22.1% to 17.89%. This is a case where there has been an increase in the consumption to GDP ratio, with demand being met significantly with imports from abroad, which does not augur well for the region.

In the case of emerging Europe, there has been an increase in the I/Y ratio from 22.91% (1997) to 27.74% (2007), even as the savings to GDP ratio was stagnant at 19.76 and 19.94%. This meant that the gap was financed through capital inflows

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[4] The pile of corporate cash has grown in the aftermath of the recession. Despite increase in profit rates since the crash in 2009, corporates have been amassing cash at unprecedented levels- $2.8 trillion in Japan, $1.5 trillion in USA, and a trillion dollars in Europe. The value of cash held by British companies is larger than the value of plant and machinery. (Landau, 2013)

from abroad. But ever since the global financial crisis, partly because emerging Europe is yet to see capital flows like in the pre-2008 period, after the large squeeze in capital flows (in the immediate aftermath of the crisis), and partly because of the inability to attract capital flows, the investment ratio of the region has declined by 3 percentage points, whereas the savings to GDP has increased by 2 percentage points, effectively reducing its current account deficit.

Given the low price of oil in the international market in the period till 2014, it would be logical to expect the investment ratios in MENAP region to decrease. It has indeed decreased from 28.39% in 2007 to 26.77% in 2014. Along with the rising consumption to GDP ratios, due to the shift in the relative terms of trade against oil till 2014, the current account has worsened for the region. The steady decrease in the price of oil has also pushed important surplus economies of the past in the region like Saudi Arabia into a current account deficit in 2015.

Given the low level of aggregate demand, the advanced economies of US and Germany experienced a reduction in the level of investment, though in the case of Germany it was marginal. The current account surplus of Germany is also contingent on stagnant investment ratios. Between 1997 and 2014, there has been a I/GDP ratio decrease from 22.78% to 19.76%, whereas the savings ratio increased from 22.28% to 27%. This implies that a consumption squeeze explains Germany's current account position, giving credence to the argument that wages are not rising in tandem with productivity improvements.

It should be noted here that there are only a very few cases of a positive dynamic nature, where improvements in current account are occurring with increases in rates of growth. In our sample, China and Philippines are the only two economies which register in both periods of transition improved rates of growth and improved current accounts. In most of the cases, the improvement in the current account has been on account of an excess of savings over investment, reflecting deflation or a consumption squeeze. Also important to note is the transition made by economies like Hungary, Romania and Poland which moved from high rates of growth and worsened current accounts in the 1989 to 1997 period to low rates of growth and improved current accounts. This has also to do with the changing trends of financial flows to the region, which we deal with in detail in a later chapter.

Table 2-10: Investment and gross savings (as % of GDP)

INVESTMENT AND GROSS NATIONAL SAVINGS (as % of GDP)			
	1997	**2007**	**2014**
ADV(I/GDP)	23.836	23.44	21.156
ADV(S/GDP)	24.11	22.573	22.155
EMDE(I/GDP)	24.502	29.5	32.593
EMDE(S/GDP)	23.284	32.849	32.977
CIS(I/GDP)	20.401	25.48	22.683
CIS(S/GDP)	18.884	28.976	24.904
EMDA(I/GDP)	33.196	37.32	42.032
EMDA(S/GDP)	32.912	43.24	43.561
EMDEu(I/GDP)	22.907	27.739	24.919
EMDEu(S/GDP)	19.766	19.944	22.07
ASEAN-5(I/GDP)	34.506	26.273	28.414
ASEAN-5(S/GDP)	29.186	28.499	29.491
LATAM(I/GDP)	19.782	22.122	21.806
LATAM(S/GDP)	16.627	22.109	17.893
MENAP(I/GDP)	22.601	28.387	26.768
MENAP(S/GDP)	26.174	39.719	33.121
SSA(I/GDP)	18.297	20.656	21.346
SSA(S/GDP)	16.607	22.367	17.439
GER(I/Y)	22.783	20.75	19.761
GER(S/Y)	22.275	27.5	27.041
JAP(I/Y)	29.951	24.483	23.883
JAP(S/Y)	32.106	29.182	24.635
SNG(I/Y)	38.204	23.165	28.639
SNG(S/Y)	53.464	49.223	48.375
USA(I/Y)	22.364	22.351	20.014
USA(S/Y)	20.718	17.27	19.187

Source: World Economic Outlook Database

Foreign exchange reserves in EMDEs

The model proposed by Dooley and others considers the forex reserves as collateral of sorts provided by the emerging economies against the risky long term investments undertaken by the advanced economies. As we have seen, whereas the external balance sheet of the advanced economies like the United States have risky long term investments abroad as against the predominance of short term safe liabilities in the form of Treasury securities, the reverse holds true for the emerging economies. But the low rates of returns which accrue to the forex reserves, combined with the high propensity of the developing economies to accumulate reserves far more than is required to meet their short term external liabilities, is making the global economy even more fragile, by further compounding the problem of demand shortage.

The period, after the collapse of the Bretton Woods mechanism, in particular, the period after the mid-nineties, even when it was de *jure* characterised by capital openness and flexible exchange rates, has been witness to large scale intervention on the part of central banks to ensure reasonable exchange rates and financial stability particularly in the context of large gross capital inflows and outflows.[5] But increasingly, it is being argued that some restrictions on the capital flows would be a superior alternative to achieve this end.

As per the Triennial Survey conducted by the BIS, the daily foreign exchange turnover in global markets increased from $1.18 trillion (1995) to $5.06 trillion (2016). This steep increase has also to be seen in the context of growing demand for hedging against the risks emanating from the reversal of loose monetary policies by the advanced economy central banks.[6]

The inability of the Asian economies to mobilise liquidity from international financial institutions during the 1997 crisis, led to the practice of large scale accumulation of foreign exchange reserves, with a precautionary motive, by the

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[5] This tendency of forex accumulation with an intent of maintenance of financial stability, according to Aizenmann(2013), transforms the Mundellian trilemma into a quadrilemma.

[6] (BIS, 2016a) for further details

emerging market and developing economies. This accumulation of reserves was not always intentional, but was the result of the deflationary policies forced upon these countries in the wake of the deterioration of balance of payments conditions, resulting in investment falling short of savings. In fact, both in absolute terms as well as a percentage of their GDPs, there has been a huge increase in the volume of reserves. Figure 2.9 tracks the index capturing the change of foreign exchange reserves of emerging market economies. It can be seen that while China has been witness to an increase of its foreign exchange reserves by more than 25 times during the course of the fifteen years since 2000, taking the total to three trillion dollars, Brazil has witnessed an increase of ten times and India has witnessed an increase of seven times in its reserves since 2000 (Figure 2.9).
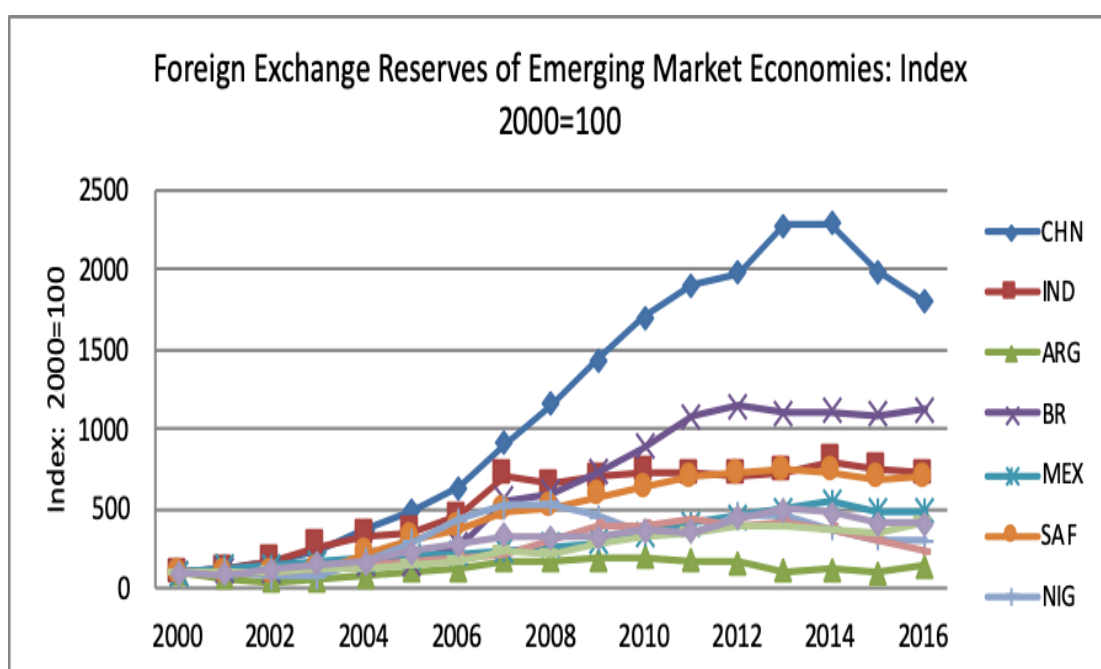
Source: IMF(2017)

Figure 2.9: Foreign Exchange Reserves of Emerging Market Economies: Index 2000=100

In this context, it is pertinent to note that while the foreign exchange reserves accumulated by China are due to current account surpluses, due to the very high rate of growth of exports, and the rising investment ratios which facilitated the same, those of most of the other emerging market economies have been on account of capital inflows. Of the total foreign exchange reserves held by all economies of $11.29 trillion in 2015, China with $3.35 trillion held 29.67%. Most importantly, a

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substantial share of the forex reserves of the EMDEs is on account of China. The data from IMF's International Financial Statistics reveal that the forex reserves of China have increased from $0.17 trillion (2000) to $3.35 trillion (2015) accounting for the lion's share of the forex reserves of the emerging and developing economies. In 2015, it accounted for 47.5% of the total forex reserves held by all EMDEs. The forex reserves of China as against the rest of the emerging and developing economies are tracked in Figure 2.10. It should be emphasised here that in contrast to the arguments of Dooley and others, the forex reserves of the EMDEs are not underwritten by their current account surpluses, but by net capital inflows, involving heavy fiscal costs for sterilization.

The reserves held by the emerging market and developing economies have also increased as a percentage of their national incomes. They increased from 7.87% of the EMDE GDP in 1995 to 22.32% in 2006. In 2014, it stood at 24.88% of the EMDE GDP. In fact, the forex reserves held by the EMDEs as percentage of the GDP of advanced economies has increased from 1.80% (1995) to 7.82% (2006) to further reach 16.23% (2014). As a proportion of the world GDP, the forex reserves amounted to around 9.82% (Figure 2.11).
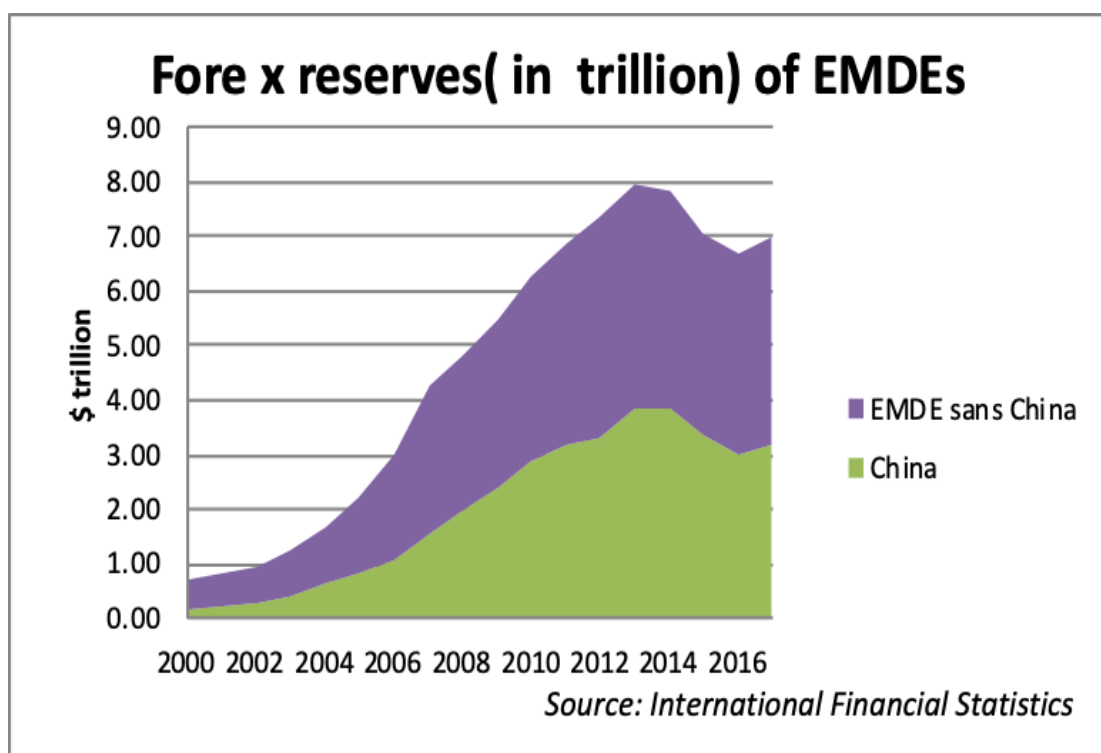
Figure 2.10: Forex reserves (in $ trillion) of EMDEs
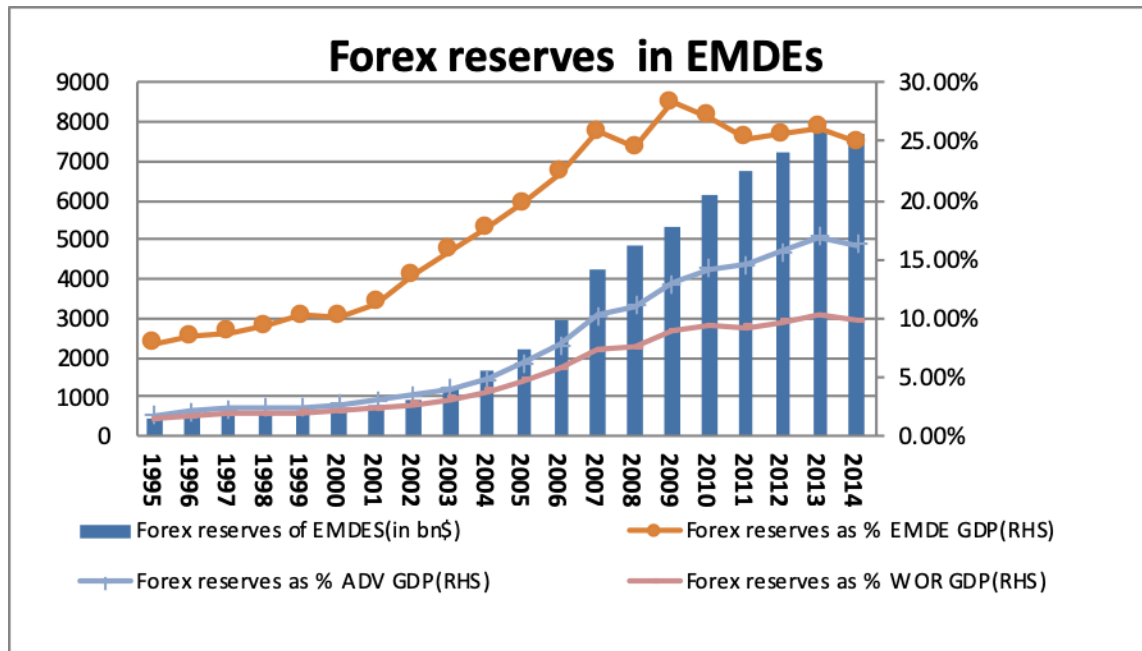
Source: IMF(2017)

Figure 2.11: Forex reserves in EMDEs.

An argument often made is that with prices of commodities increasing over time, what the accumulated forex reserves would command after a time period would be far lower than what they would have been able to command when first accumulated. This, per se, was a valid argument, when it was made, particularly so, when the price of oil was ruling high. But, in the changed context, in which general deflation has been haunting the world of commodities, as well as the fact that the rates of inflation in the advanced economies has been low since the global financial crisis, it seems that the reserves are far more valuable now than then. One would even say that Keynes' "wheat" rate of interest for the emerging market and developing economies is far higher now.[7]

The developing countries and emerging market economies have been forced to resort to this spree of forex accumulation, despite the costs involved. Even when the argument for restricting cross-border capital flows makes perfect sense, it is only in

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[7]The total return expected from the ownership of an asset over a period equal its yield(q) minus its carrying cost(c) plus its liquidity premium(l), i.e., q-c+l, this is the own rate of interest of any commodity. For further details, Chapter 17 of (Keynes,1936). This is return in terms of itself, i.e., say, wheat rate of return. Along with this, we ought to add the appreciation or depreciation of the asset concerned. As far as the forex reserves accumulated by economies are concerned, the overall return depends upon the change in the prices of the goods which they could command, which in a deflationary situation in the contemporary global economy turns out to be very high.

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the backdrop of the recent global financial crisis that there has been some amount of support for it in policy circles.[8] The ad hoc arrangements including the forex swap arrangement for a few economies with the Fed Reserve and other central banks, should be supplemented with a thorough reform of the international monetary system. The stability which is attributed by Dooley and others to the international monetary system based on Bretton Woods II heavily counts on readiness to acquire foreign exchange reserves, for the sake of self-insurance. Given the purely *ad hoc* nature of the international monetary system they can ill-afford not to do that. This accumulation of forex reserves as a collateral can be afforded only by that set of countries, which have surpluses on the current and/or financial account. It still leaves unaddressed the problems of financing growth in the low income countries.

IV

Bretton Woods II- Exorbitant Privilege of the Dollar and Net Resource Transfers to the US

The current account of a country being in deficit implies that resources are being transferred into the economy from the rest of the world, and, a current account surplus implies that resources are moving out of the economy. But a constituent in the calculation of the current account has exactly the opposite implication. When income balances are positive, undoubtedly the country gets a capacity to acquire resources, and if they are negative, the same goes out of the country.

$(X_g-M_g)+(X_s-M_s)+(I_c-I_d)=CAS$

Where X_g stands for Export of goods, M_g for Import of goods, X_s for Export of services, M_s for Import of services, I_c for Income credit, I_d for Income debit, CAS for Current account surplus), and CAD for Current Account Deficit.

The above also implies that
$(M_g-X_g)+(M_s-X_s)+(I_d-I_c)=CAD$
$[(M_g-X_g)+(M_s-X_s)]=CAD+(I_c-I_d)$

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[8] In this regard, see Epstein's cogently written argument favouring Capital Controls. (Epstein, 2017) As of late, there are arguments even from IMF in favour of some amount of capital controls.

NRT= CAD+(I_c-I_d)

Net Resource Transfers= Current Account Deficit + Balance on income account.

Inasmuch as the balance on income account is positive, the net resource transfers to the country is larger than the current account deficit.

So to gauge the extent of net resource transfers, it is important to look at current account deficits plus income balances. The United States has large current account deficits, but the net resource transfers (NRT) to US would be underestimated if we do not add the income balances of US to its current account. Indeed, it becomes larger. Even when the US has been living with large merchandise trade deficits, it has been enjoying a positive income balance by virtue of the payments received on account of royalties, dividends, investment incomes and so on. So too, the net resource transfers which occur from a country like China to the rest of the world is not just its current account surplus, since we have to make adjustments for the income balance to get the exact assessment of the net resource transfers it makes to the world economy.

At $223.93 bn, the income balance account of the United States comes to around 1.38% of the US GDP in 2012, the year in which the balance on current account was $ -440.42bn, or approximately -2.71% of its GDP. In other words, the surplus on the income account proves to be important for the current account of the United States (Figure 2.12). As can be seen the income balance has been positive all through. Even for other advanced economies like Germany and Japan, which record a current account surplus, the balance on income account helps to consolidate their external account. In 2010, at $666.82 bn, the balance on income account amounts to around 2.02% of the GDP, when the current account comes to approximately 6% of the German GDP (Figure 2.13).

Figure 2.14 gives a comparative chart of balance on primary income (in $ bn) of US, Germany and Japan. Included in these charts are also the data of China and Korea for comparison. This captures for us the payment made by the multinational corporations operating from their shores, as well the interest payment on account of debt.

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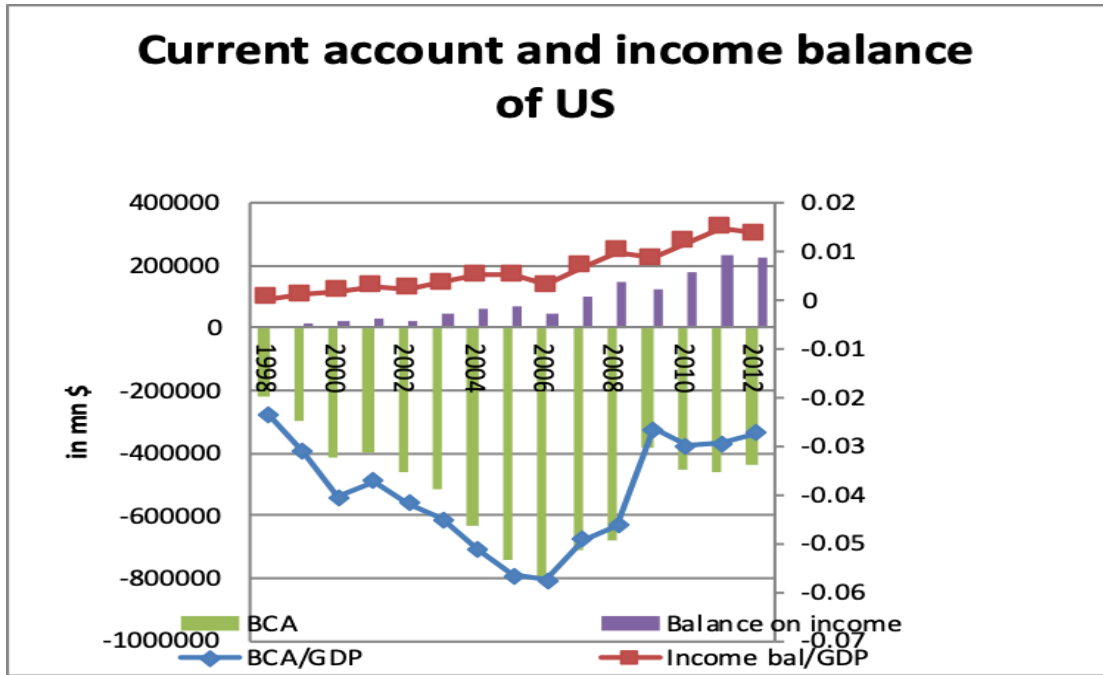
Figure 2.12: Current account and income balance of US. (Source: IMF BOPS)
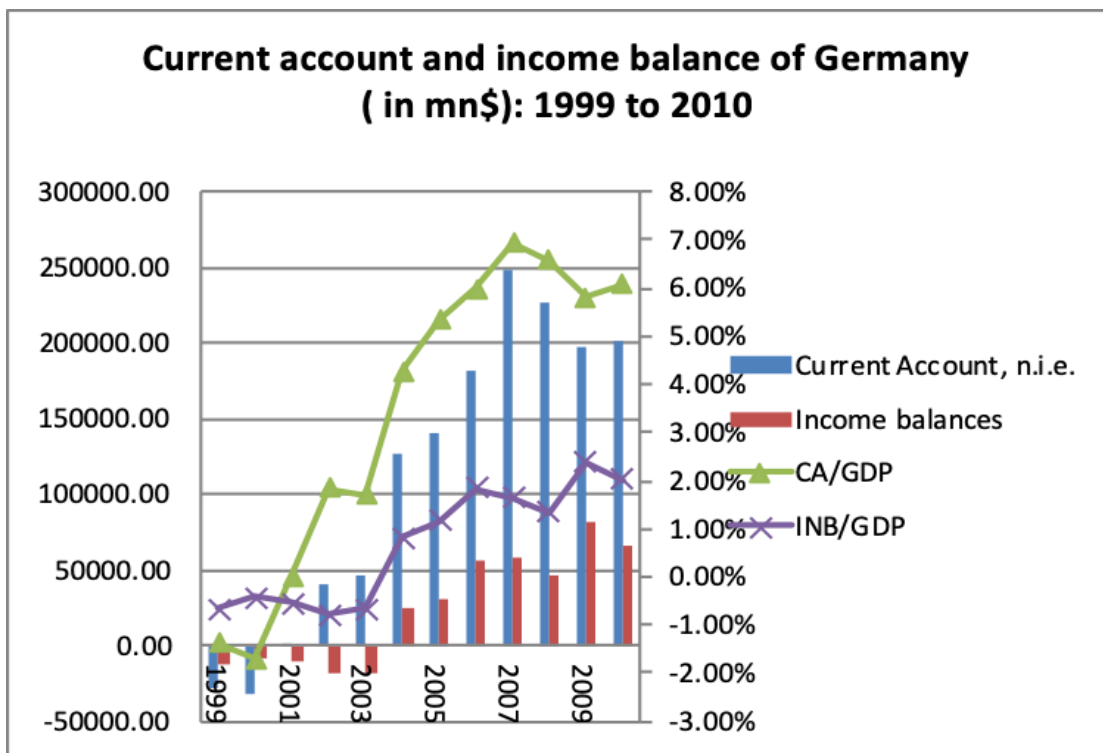
Figure 2.13: Current account and income balance of Germany (in $ mn) (Source IMF,2017 BOPS)

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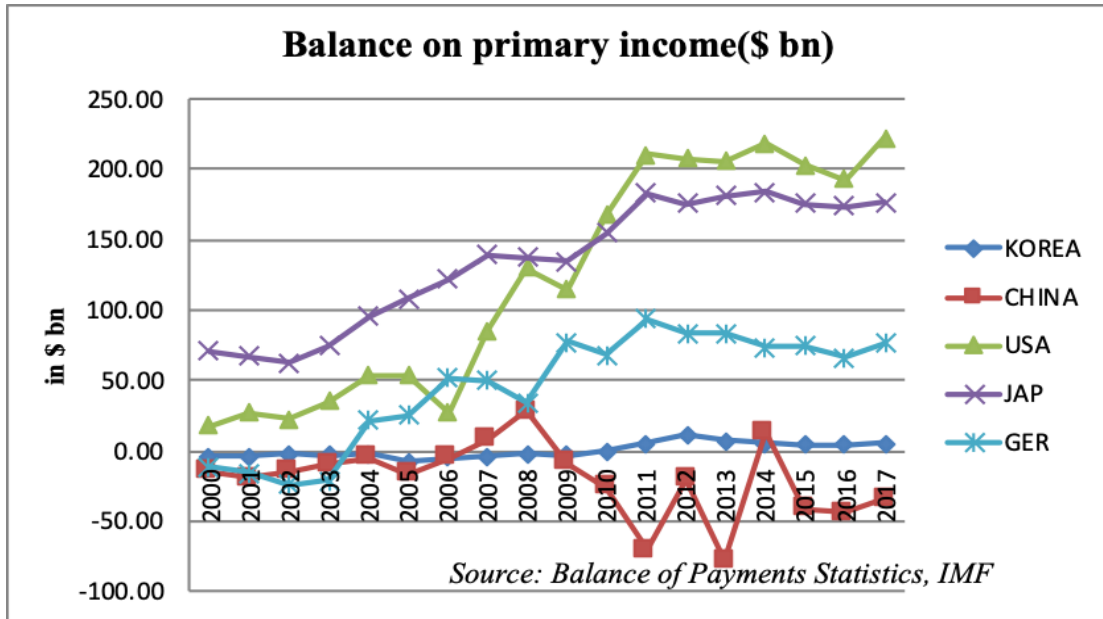
Figure 2.14: Balance on primary income ($ bn)

Even when most of the emerging market economies like Brazil, India, Hungary and Malaysia are in the negative on the balance of income account, and therefore, contribute net resource transfers to the rest of the world that are far more than the current account surplus which they record, we find that Korea from 2007 had a positive income balance throughout. And most importantly, China has been witnessing a surplus in this account in a few years. Possibly, this is an indication of the changing composition of its external assets (Figure 2.15).

Source: IMF(2017)BOPS
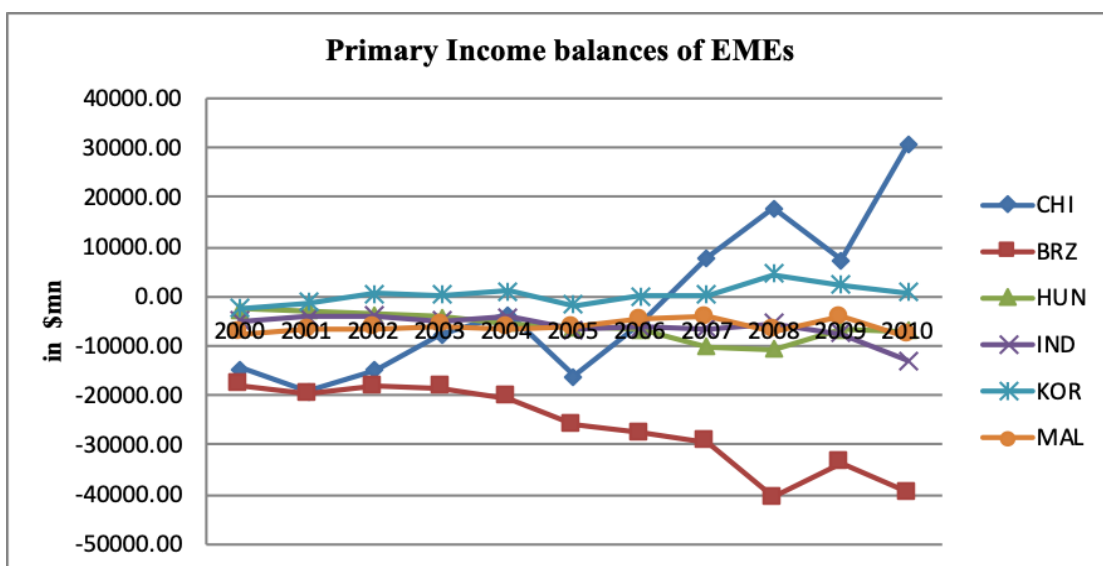
Figure 2.15: Primary income balances of EMDEs.

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It would be of interest to assess whether the United States earns higher returns on its external assets in comparison to its external liabilities .Though the dollar centric nature of the system seems to be unchallenged, does it continue to facilitate net resource transfers to the United States? To what extent, does it continue to facilitate the provision of markets for the emerging economies? For an exploration of this issue, we look at the rate of return of United States on its external assets abroad and contrast it with the return which it has to make to the rest of the world on its external liabilities. While the stock of external assets has increased from $2.7 trillion to $ 27.80 trillion, during 1991 to 2017, its stock of external liabilities grew at an even faster pace from $ 2.85 trillion to $ 35.52 trillion. Though the stock of external liabilities has been far higher than the assets, the investment income inflows in 2017, at $ 921 bn, has been far higher than the investment income outflow at $ 686 bn.

We take the data of the external assets and liabilities of the United States from the data relating to the International Investment Position collated by the IMF, and we take the investment income inflows and outflows from the Balance of Payments of the United States. We calculate the return on assets as a ratio of investment income inflows to the external assets, and the return on liabilities as a ratio of investment income outflows as a share of external liabilities. Figure 2.16 shows that wedge between the return on assets and return on liabilities has been on the increase. The difference between the return on external assets as against the payment on external liabilities has increased from 0.87% (2006) to 1.51% (2016). Given the very low rate of interest which accrues to the external liabilities of US (which includes safe treasury securities), particularly after the global financial crisis, this implies that the exorbitant privilege of the dollar continues to hold in the current dispensation. It is able to borrow even cheaper and earn a higher return.

Difference in the return on US external assets as against external liabilities
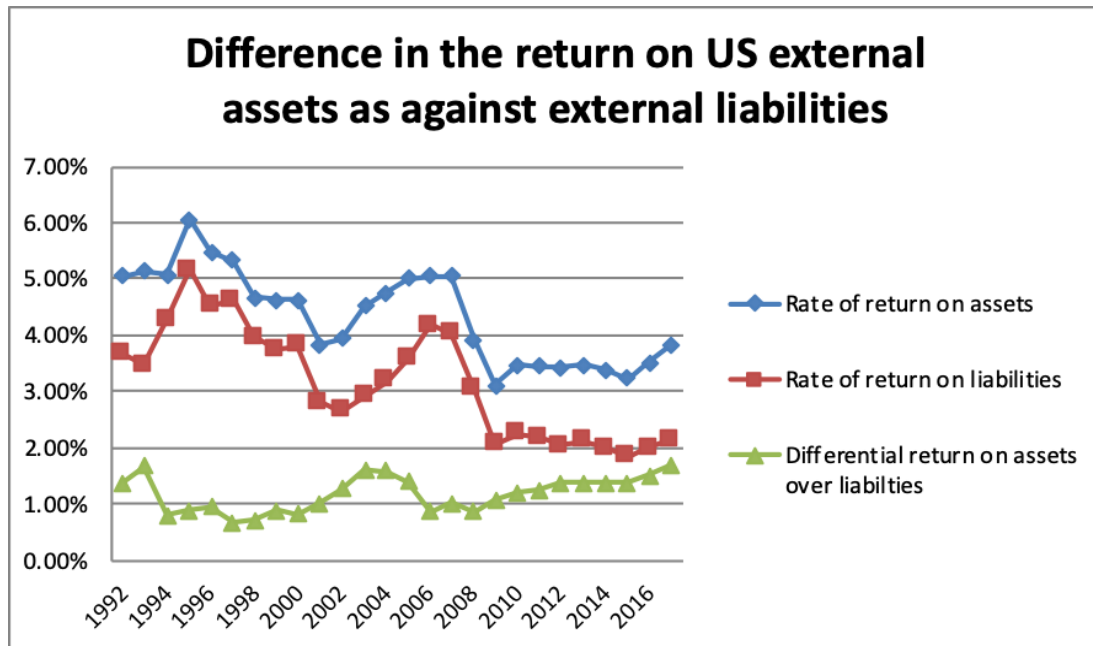
Source: IMF(2017)BOPS

**Figure 2.16: Difference in the return on US external assets
as against external liabilities**

Some Concluding Observations

This chapter drew attention to the process of growth in the emerging market and developing economies during the period 1989 to 2014, with a focus on the "Bretton Woods II" period. In the first section, the links between the rates of growth of economies and their current account performance during the transition from 1989-97 to 1998 -2007 was compared. Given that Hungary, Poland and Romania have shifted from being a set of economies characterized by high rates of growth and worsening current account (1989-97 to 1998-2007) to ones with lower rates of growth and improvement in the current account (1998-2007 to 2008-14), the fourth chapter would explore in depth the pattern of growth in these economies during this period. The chapter also explored the process of reserve accumulation by the emerging market economies, as well as the pattern of net resource transfers to United States.

The accumulation of foreign exchange reserves has been the fulcrum around which the idea of Bretton Woods II has been structured. The foreign exchange reserve accumulation has been projected by Dooley and others as a policy pursued with explicit mercantilist intent. Needless to say, reserve accumulation has been resorted to by EMDES as a strategy of self-insurance, in a world characterised by

untrammelled mobility of capital.   Even as the BW II regime has had a deflationary influence on the world economy, it has been successful in assuring the stability of the dollar for a long period. Most importantly, the BW II dispensation has also been able to assure and consolidate the continual net resource transfer from the rest of the world to United States. Even as the "assured" markets for EMDEs have got reduced, reflected by their dwindling current account surpluses, the growing difference between the rates of return on the external assets as against liabilities of United States only reinforces the exorbitant privilege enjoyed by dollar in the global economy. It is indeed paradoxical that even as the Bretton Woods II mechanism has been able to assure reasonable stability to the dollar despite the macroeconomic troubles that confronted United States, it has pushed emerging market economies and their currencies to a high level of volatility and uncertainty.

Chapter 3

Global Liquidity and Emerging Market Economies:
Exploring Vulnerabilites

Introduction

This chapter traces the vulnerabilities which the emerging market economies have been afflicted with, even when it is claimed by the proponents of Bretton Woods II that they have been making the best use of the opportunities offered by the accommodative monetary policies of the advanced country central banks. The build-up of vulnerabilities in the emerging economies in tandem with the surge in global liquidity prior to the global financial crisis, is compared with developments since the crisis.

After the setback to cross-border capital flows in the immediate aftermath of the global financial crisis, and the deleveraging which followed the global financial crisis and the European sovereign debt crisis, there has been an increase in the volume and a shift in the direction of cross-border flows to the emerging market economies, in particular to Developing Asia and the Pacific as well as Latin America and the Caribbean. Besides an increase in the international banking liabilities of the economies in these regions, some financial and non-financial corporations have successfully mobilized funds from the international market through the issue of international debt securities, including in their own currencies. Does this indicate that the developing countries have greater room for manoeuvre in the international financial system which allows them access to finance, including debt denominated in their own currency? Has the "*original sin*" hypothesis been challenged, such that economies in the developing world can borrow internationally in their own currencies without being subject to the asymmetries of the past? In this chapter we examine these issues relating to the external financial vulnerabilities of the emerging market economies largely relying on the BIS database.

Of the five sections in the chapter, the first deals with banking flows through the Locational and Consolidated Banking Statistics[1]. The second section is on dollar credit to non-banks outside United States. While the third section engages with the

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[1] The data relating to the same is from (Bank for International Settlements, 2017 & 2018)

boom in the international debt securities market, the last one looks at miscellaneous data from BIS on vulnerabilities of EMDEs.

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I

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Locational Banking Statistics, Cross border flows and credit to GDP ratios

As per the Locational Banking Statistics[2] of the BIS , the outstanding cross border claims of all reporting banks had increased from $ 6.18 trillion (26.3% of WGDP) in 1990 to $10.55 trillion (31.2% of WGDP) in 2000. Thereafter it rose further to $ 32.91 trillion (56.6% of WGDP) in 2007. (Figure 3.1) Widely characterized as a period of a high tide in liquidity, the credit to GDP ratios of the economies increased during this phase, and the ease of access to financing also led to large increases in the prices of assets. Retail and other deposits in the banking system rose rapidly and by a large margin, given the excess liquidity in the system. Banks in turn found it easier to lend. This was also the period which was witness to large increases both in financial market indices as well as residential property prices. The favourable domestic credit conditions coupled with the high leverage ratios made possible by rising property prices, led to larger absorption of goods and services in the US, taking the current account deficit of the United States to its highest level in 2006.
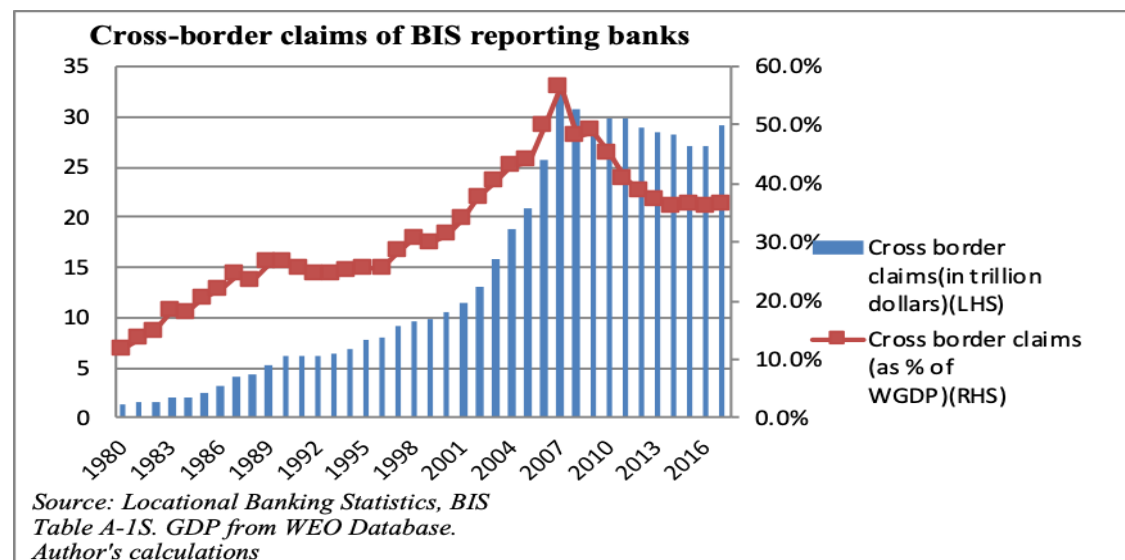
Figure 3.1: Cross-border claims of BIS Reporting banks

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[2] This is extracted from Table A-1 S , which gives the summary of locational banking statistics by currency, instrument and residence of counterparty. While Locational Banking Statistics provide details relating to claims and liabilities on the basis of location, the Consolidated Banking Statistics provides it on the basis of nationality.

US deficits were financed with large inflows into dollar-denominated assets. The investments consisted of both investment in 'safe' Treasury securities as well as in derivative products of various kinds, manufactured as part of the financial innovation aimed at spreading risk to facilitate the credit boom. Prime among these were the mortgage-backed securities and derivatives derived from them.

But, in the aftermath of the global financial crisis, there has been a steady decline of cross-border claims, both in absolute terms and as a ratio of the world GDP. Following the collapse of residential prices in the US and the consequent unravelling of the mortgage backed securities market, the cross-border investments in these kinds of assets fell, contributing to a liquidity squeeze. Private liquidity which was abundantly available disappeared. Matters came to such a head that central banks had to resort to co-operation with swap lines to meet the shortage of dollar funding. Even after ten years of the crisis, the pre-crisis levels of private claims had not been restored. This is despite the efforts of the US Federal Reserve and European Central Bank to revive markets by resorting to the purchase of securities on a large scale. By 2016, the global total had fallen to $ 27.08 trillion (36% of WGDP) (Figure 3.1).

That said, it must be mentioned here that in terms of the global liquidity indicator, international credit (which includes apart from bank credit, international debt securities), BIS data reveals that the figure had increased from 33% (2015 Q1) of global GDP to 38% (2018Q1).[3]

The excessive and unsustainable levels of leverage of the banks, which had resorted to borrowing in the market for wholesale liabilities, took a toll on the finances of the sovereign governments. In fact, the increasing reliance of banks on non-core sources of liabilities in the form of wholesale deposits ultimately proved to be risky.[4] The banks, in particular, European ones, badly affected by the decline in the value of the asset backed securities held by them, were keen on reducing exposures in

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[3]With the increasing mobilization of resources through international debt securities by banks and non-financial corporations, the BIS data on international credit adds up cross-border bank credit with funds mobilized through international debt securities. In fact according to the September 2018 issue of BIS Quarterly, international credit (bank loans as well as international bonds) had increased from 33% (Q3 2015) to 38% (Q3 2018) of the global GDP (Aldasoro& Ehlers, 2018).

[4] This practice in global banking is characterised by Landau as the double-decker model of banking, wherein regional banks borrow from global banks, which in turn borrow from international financial centres. (Landau, 2013). For an overview of the challenges posed by cross-border flows through banks in the international economy see Committee on International Economic Policy and Reform (2012).

other economies. This resulted in the reduction of cross-border claims. Most of the decline in the cross-border claims on developed economies has been due to the drastic fall in the cross-border claims on Europe. Figure 3.2 shows the striking association between movements in the cross-border claims of developed countries and the euro area.
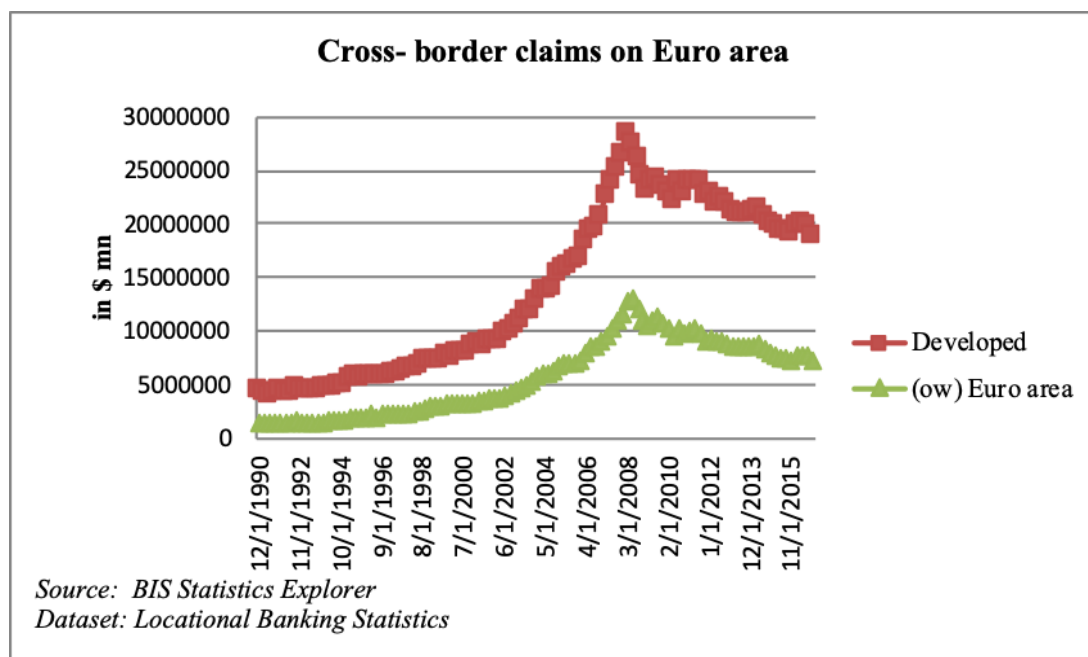
Figure 3.2: Cross-border claims ($ mn) on developed countries(of which euro area)

In fact, credit in the system has failed to pick up in the advanced economies even after various rounds of quantitative easing. Patnaik argues that the absence of credit buoyancy despite the substantial injection of liquidity into the system is because banks themselves were becoming wary of the consequences of lending, and holding on to liquidity, which he refers to as excessive liquidity preference.[5] If these economies had to get themselves out of this trap, what was needed was enhanced public spending, which alone would be able to make up for the squeeze in expenditure due to reduction of household consumption as well as investment.

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[5] In this article, Patnaik distinguishes the genre of liquidity preference, which is the tendency amidst the public for the preference for liquidity to the specific tendency among banks during such recessionary situations to have excessive preference for liquidity, that is not to give out credit. (Patnaik, 2009b)

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Cross-border claims on emerging market economies

As compared to this trend in the developed economies, cross border claims on many of the developing regions like Developing Asia, Latin America and the Caribbean and the Middle East and Developing Africa have risen to levels above their pre-global financial crisis highs. A set of these emerging economies has been witness to a huge surge in liquidity, both through these cross-border flows banking flows as well as through the issuance of international debt securities (to which we come later). Should this be seen as per the precepts of neoclassical financial theory as discovery of "appropriate" prices of assets, or as making a fetish of liquidity as Keynes and others viewed it? In the backdrop of the efforts which were initiated to rein in banks in the post-crisis era, lobbyists using neoclassical financial theories were arguing that such regulatory measures would affect the process of market making and there would be dearth of liquidity. Neoclassical financial theories see a direct link between liquidity and efficiency of capital allocation. Contrary to this is the post-Keynesian perspective, which argues for a more non-linear relationship between liquidity and efficiency of markets. In fact, the case of excess liquidity is viewed a fetish of sorts which could promote decision making of a short-term nature, and tend to be highly speculative, coming often at the cost of the long term capital development of the economy.[6] Concerns about this huge surge of liquidity to different emerging market economies, particularly towards Asia and the Pacific, have to be seen in this context. These regions were possibly facing a *liquidity dilemma* of kind to which Keynes drew attention long back.[7]

In the aftermath of the Asian financial crisis in 1997, east Asia was witness to capital outflows, and there was a reduction in the outstanding claims on banks based in Developing Asia between 1997 and 2000. From $282.97 bn (Dec 2000), cross border claims increased to $935.88 bn (March 2008), only to decline till March 2009. Thereafter, claims witnessed a steady increase to reach $2.05 trillion in June 2014, far higher than their pre-global financial crisis peak in March 2008. This implied that the amount outstanding had increased by almost three times in the course of five years.

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[6] In Keynes' own words: "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of an economy becomes a by-product of the activities of a casino, the job is likely to be ill-done." p.159 (Keynes, 1936)

[7] Liquidity dilemma refers to the problem which Keynes associated with market liquidity. While market liquidity could make investors willing to invest in long term capital, that is supportive of employment and productivity growth, it could also lead to excessive speculation, instability and stagnation.

In Latin America, during the period from 1998 to 2005, there was a decrease in cross-border claims from $ 304.03 bn in Dec 1997 to $ 259.41 bn in 2005, after which they rose to a peak of $ 435.3 bn in March 2008. After a dip following the global financial crisis, cross- border claims on Latin America increased to $ 648.68 bn in March 2014 before registering a small decline thereafter. The Middle East and Developing Africa region has also been witness to an increase in cross-border claims. Starting from a previous peak of $ 469.79 bn (1997), they registered a marginal decline, but thereafter the figure rose and stood at $624.2 bn in June 2016 (Figure 3.3).
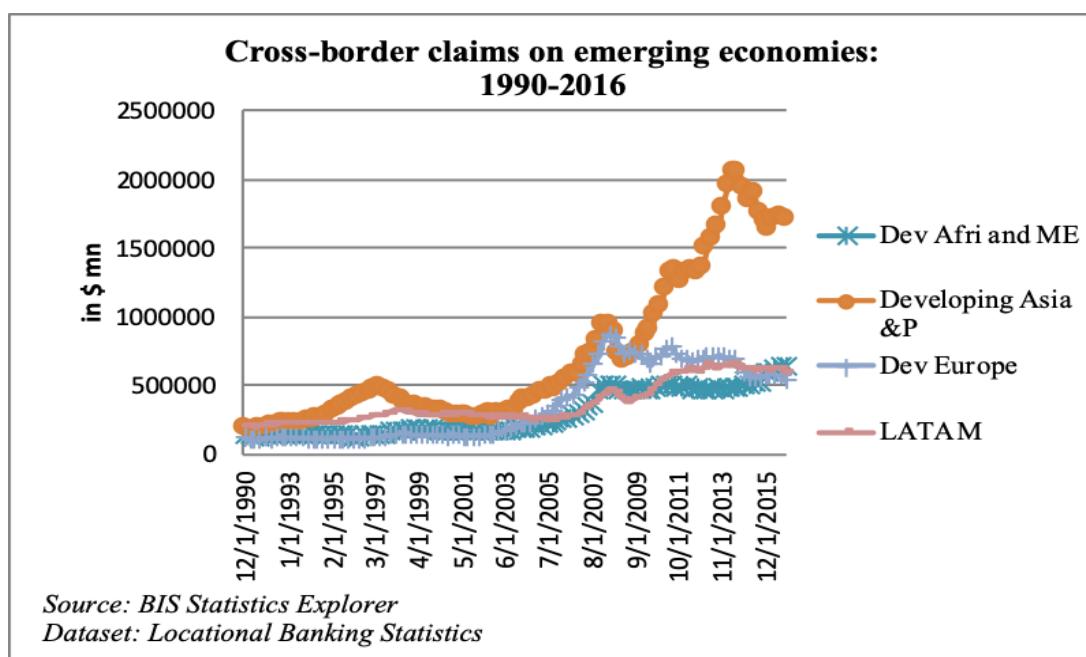
Figure 3.3: Cross-border claims on emerging economies: 1990-2016

Cross border claims on developing Europe rose to a peak of $ 866.61 bn in June 2008 from $149.94 bn in December 2002, or increased 5.77 times. Subsequently, the figure has been on the decline reaching a low of $ 540.23 bn in Dec 2016. Banking flows have been on a retreat from emerging Europe, which has the disadvantage of being near the countries which suffered from the banking and sovereign debt crisis and the prolonged recession that followed (Figure 3.3). While in the recent period bank claims have risen across regions, in the case of emerging Europe, even after many years, the figure has not risen to its old levels. It should be noted that the overall decline in cross border claims comes as a result of the decline with respect to United States as well as Europe.

Change in cross border-credit to GDP ratios

As against the Euro region, which registered a decrease of cross-border credit to GDP ratios from 27.3% (2009) to 20.5% of GDP (2017), and United States which too saw a decline from 16.8% (2007) to 14.8% (2017), the developing economies, other than CEE, have witnessed an increase. As per the Global Liquidity Indicators Database of BIS, the cross-border credit to GDP ratio increased from 3.9% (2008) to 5.7% of GDP in 2017 for Developing Asia. It rose from 6.2% to 6.8% of GDP for Latin America in the same period. But for Central and Eastern Europe, which had a high cross-border credit ratio of 18% in 2009, it fell to 8.7% in 2017 (Figure 3.4).
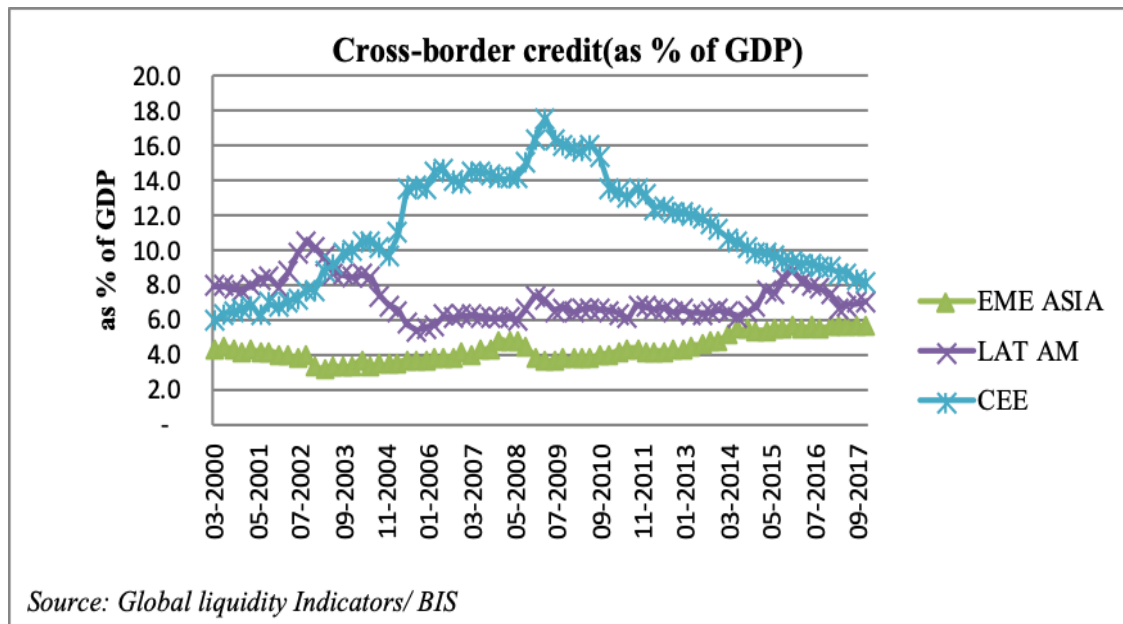
Figure 3.4: Cross-border credit (as% of GDP)

While the share of the cross border claims on banks as counterparty decreased from 76.6% (1990) to 52.7% (2017), those of the non-banks have increased. But within the non-banks, there are non-bank financial institutions, for which the data is provided only from 2013, when it constituted just 17% of total non-bank sector, but it accounts for 38 to 42% of the total non-bank sector in the period 2015 to 2017. The increasing share of the non-bank sector has to be seen in the larger context of rise of "shadow banking" in emerging markets (Figure 3.5).
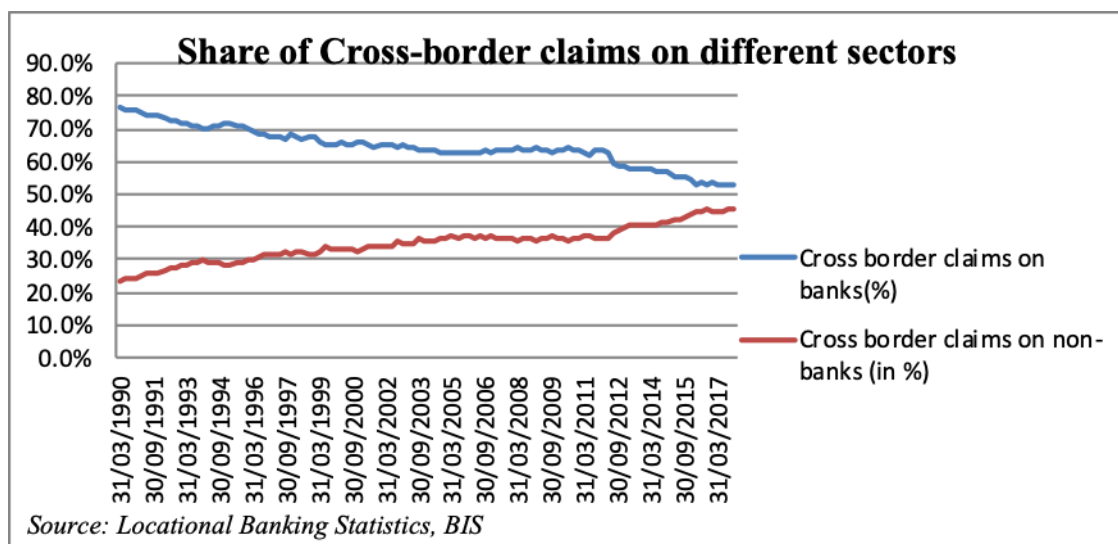
Figure 3.5: Share of cross-border claims on different sectors

But the detailed disaggregated figures reveal a lot about the changing contours of the global banking system. In the case of banks based in Germany, France, Netherlands, Belgium, Switzerland and Austria, there has been a steady decline in their cross-border claims (Figure 3.6). The same is true also with respect to the UK and United States. Over 2008-2015, the cross border claims outstanding of Austrian banks have declined by 60% from $ 414 bn (2008) to $167.3 bn (2015), that of Germany by 54% (from $5.9 to $2.7 trillion) and France by 33% (from 4.2 to 2.8 trillion). That of Switzerland too declined in this period, from $ 3.7 to 1.8 trillion, i.e., almost by 50%.

Japan, as we know, has been in a deflationary trap since the collapse of the property price bubble in the late eighties. The expansionary monetary policies pursued in Japan ever since have resulted in the assets in the balance sheet of Bank of Japan increasing from 94.1 trillion Yen (2000) to 476.4 trillion Yen (2008). In terms of Japan's GDP, the assets of the Bank of Japan has increased from 23.5% (2008) to 86.7% (2016).[8] The low interest rate environment prevalent in Japan for a long period has encouraged the practice of borrowing cheap in the yen market and investing elsewhere, which is referred to as the yen carry trade.   The figure shows that even as the cross-border claims of different European and US banks have

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[8] As per the 2018 data of BoJ, the assets of the Bank of Japan stood at 552 trillion yen, i.e., as high as 100% of Japan's GDP. The data related to the same provided by Bank of Japan has been accessed from https://fred.stlouisfed.org/series/JPNASSETS

registered a decline, that of Japanese banks have increased by three times from $ 1.5 trillion (2002) to $ 4.5 trillion (2015), whereas the cross border claims of Chinese banks stood at $ 1.45 trillion (2015)[9] (Figure 3.7).
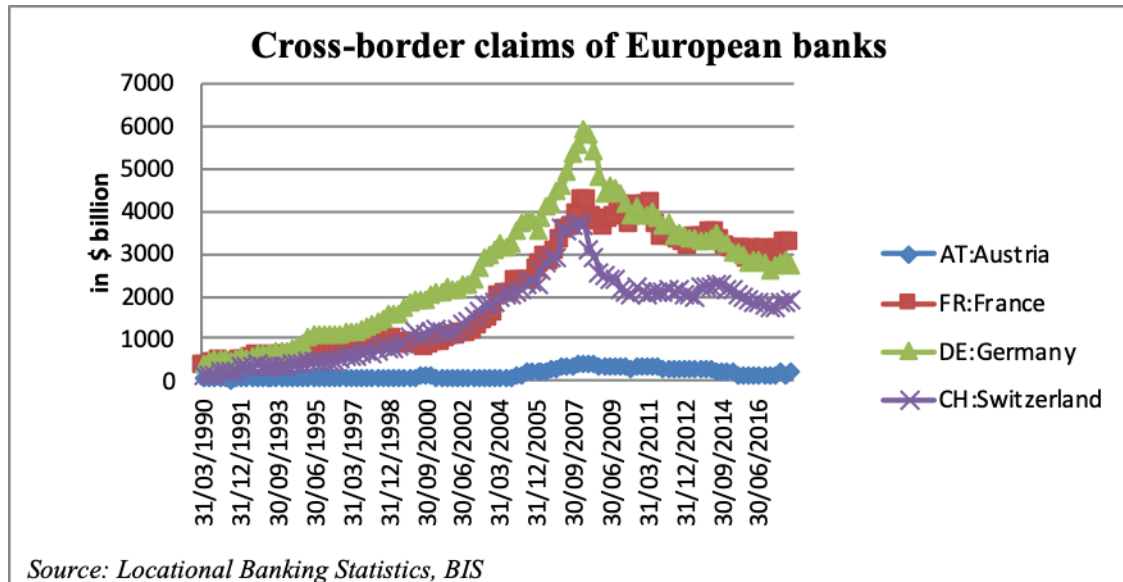
Figure 3.6: Cross-border claims ($ bn) of European banks

The continuous rise in the current account surpluses recorded by Japan and China have transformed them into creditor countries, for whom the share in cross border claims is very high.[10] A study on the five large commercial banks of China (Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, Bank of China and Bank of Communications), which account for most of China's international banking presence, reveals that between 2005 and 2015, they have established 153 branches and subsidiaries overseas, of which 35 were in 19 developing economies.[11] Eichengreen, Walsh and Weir (2014) draw attention to the role played by internationalisation of Chinese banks in facilitating the use of yuan as an international currency.

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[9] The data reported by BIS for China starts only from 2015. It increases to $1.99 trillion in 2017 as shown in Figure 3.7.

[10] Among other economies which were witness to large increases in cross-border claims between 2001 and 2015, are Singapore (from $8.77bn to $209 bn) , Australia (from $72 bn to $554 bn) and Canada ($ 257 bn to $979 bn) .

[11] For further details, see the section on The Global Expansion of Chinese banks in (World Bank, 2018)
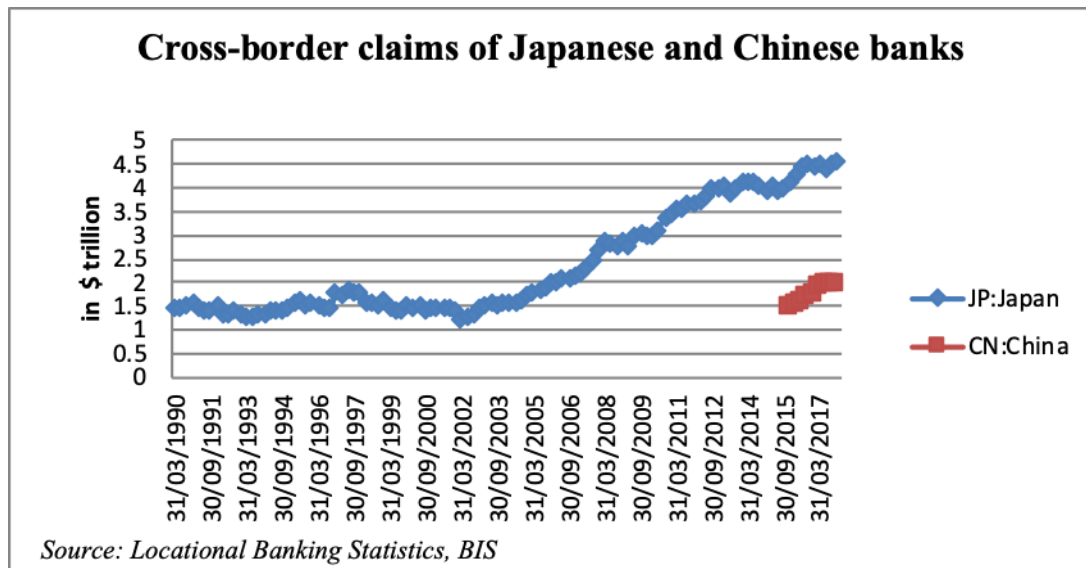
Figure 3.7: Cross-border claims of Japanese and Chinese banks

Are these signs of banking flows at least marginally moving to EMEs with Asia as an important destination? Given the nature of the deleveraging of European banks, one cannot avoid speculating on these lines. Studies have drawn attention to the increasing regionalisation of banking in the Asia-Pacific region in the aftermath of the crisis (Remolona & Shim, 2015). The cross-border activity in the region was driven till 2007 by the dollar credit intermediated through European banks. With the increasing sales of European banking assets in the region, banks from the region, particularly from Singapore and Hong Kong, have stepped in to perform this task. This has further received an impetus due to ASEAN initiatives in this regard.

Empirical studies note that though cross border lending has fallen sharply since the crisis, the share of foreign claims of the advanced country banks has decreased only marginally (Claessens & Horen, 2014). They continue to command 89% of total foreign assets, whereas the developing economies have doubled their presence to 8% in the post GFC period till 2013. There is anecdotal evidence of the increasing momentum in favour of regional EME banking systems. Chile's Corpbanca bought the Colombian operations of Santander. HSBC sold its operations in Costa Rica, El Salvador and Honduras to Banco Davivienda of Colombia. Sberbank of Russia bought the eastern European subsidiaries of Austria's Volksbank.[12] There have also been instances of takeover of the banking activities of

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[12] All of this information from (Claessens & van Horen ,2014)

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European banks in Asia. In 2013, Sumitomo Mitsui Banking Corporation bought out Societe Generale's Japanese private banking arm. In 2016, OCBC Bank acquired the investment business of Barclays in Singapore and Hong Kong (Menon, 2017). We refer to the growing evidence of such tendencies in the different economies of eastern Europe in a later chapter.

A report of BIS also draws attention to the fact that a substantial share of the increase in cross border claims on emerging market economies, which has occurred in the post GFC period, has been through loans from China, Russia and Brazil. It further draws attention to the growing role of dollar intermediation done by Hong Kong and Singapore.[13] There has been a distinct increase in the activities of banks headquartered in China, Singapore and Hong Kong, particularly after global financial crisis. As per BIS data, between 2008 and 2014, the share of international claims on Asia from the European banks halved to just 15%, whereas the share of Asian banks has increased to 60%. One of the explanations offered for the regionalization of finance, and the emergence of EME banking systems has been the large flows of investment, with its origins in developing economies. While the South-South FDI in the world's total FDI increased from 8% in 2001 to 12 % in 2012, the share of South-South portfolio investment increased from 1% in 2001 to 3% in 2014. In absolute terms, South-South portfolio investment increased from $93 bn to $ 1063 bn and FDI from $ 518 bn to $ 2845 bn between those dates (World Bank, 2018).

With 6500 Chinese enterprises having established offices in Singapore, in order to cater to the south-eastern Asian region, the banks headquartered in Singapore have been playing an important role in providing banking services to them. In fact, in the internationalization of the renminbi, the banks based in the international financial centres of Hong Kong and Singapore have played a pivotal role. The approach of the ASEAN to adopt a regional banking integration framework is likely to further increase the Asian share in the region. Prior to the crisis, banks headquartered in Hong Kong and Singapore used to take dollar loans in wholesale markets to lend to other regions and countries. Ever since, they have been lending largely in the Asian region, while reducing net lending outside the region.

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[13] See (BIS, 2014). Also of interest is the Global Financial Development Report 2017/18 (World Bank, 2018)
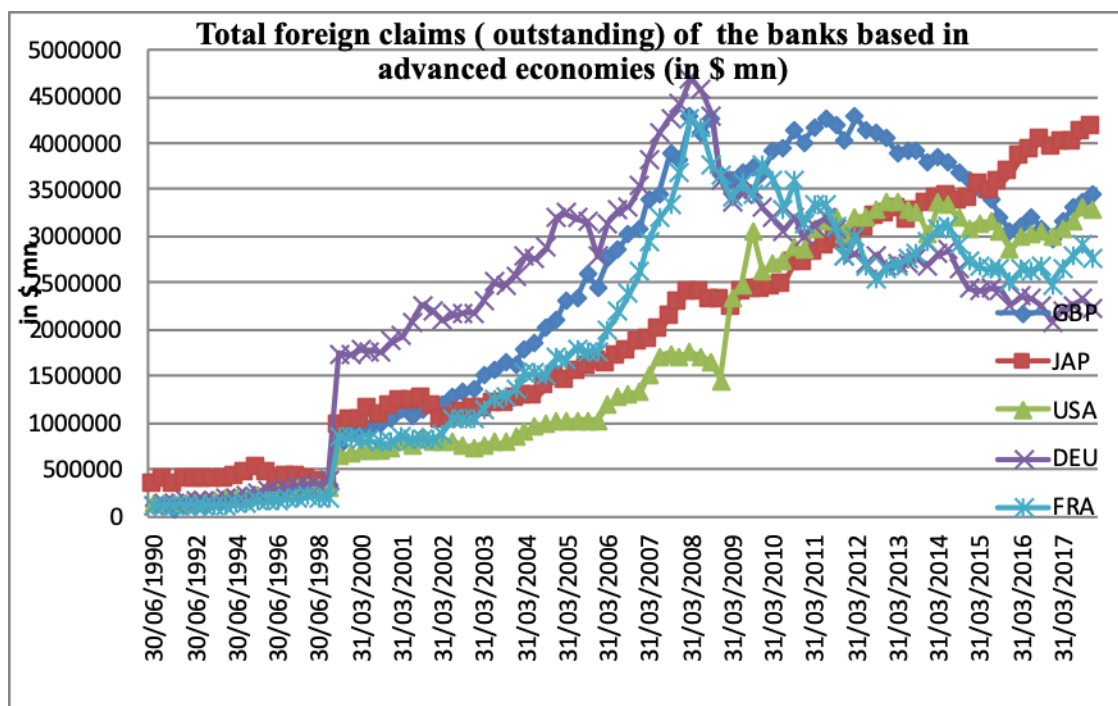
Source: Consolidated Banking Statistics, BIS

Figure 3.8: Total foreign claims(outstanding) of the banks based in advanced economies (in $ mn)

We now turn to the total claims outstanding of banks of different *nationalities* (as opposed to locations) and how they have changed since the nineties, on the basis of the Consolidated Banking Statistics. This will also help us figure out the changing shares of the different banking systems in the total claims, and how they have changed with different crises in the global economy. To begin with we need to note that the major surplus countries in the world economy which have major stakes in the global banking system are Germany and Japan.[14] The other major players include United States, and international financial centres like UK and Switzerland. Most importantly there are new entrants, who have increased their share in the total foreign claims outstanding of banks like Canada, Australia and Singapore.

Figure 3.8 gives us a glimpse of the nature of reduction of total foreign claims of German and French banks and the rise in the foreign claims of Japan. In fact, during the period from 1999 to 2017, in the total foreign claims outstanding of all banks, the share of the Japanese banks has increased from 11.6% to 15%, since the lack of growth within Japan has forced them to lend abroad.

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[14] For China is not a CBS reporting country, we have to limit our analysis relating to China to that based on the cross-border movements we have already identified using LBS data.

Currency of denomination

The dollar continues to be the most important currency of denomination of cross border claims. Though the share of claims denominated in dollars had declined since the eighties, there is a reversal of that trend since the GFC. While 77.6% of the total cross border claims was denominated in dollars in 1983, its share has since come down, and in 2008, 40% each of the total cross-border clams was denominated in dollars and euros. In 2015, the share of the cross border claims denominated in dollars is 49%, as against 29% which is denominated in euros. While 19% of the cross border claims were denominated in Japanese yen in 1995, its share has come down to 5% by 2015. The share of pound denominated cross border claims has remained at around 5% since 2000. But, it is pertinent to note that the share of the cross border claims denominated in currencies other than all of the above as well as swiss francs has increased from 4.3% (1999) to approximately 10% in 2015 (Figure 3.9). There has been some diversification of in denomination of claims in currencies other than the dollar.
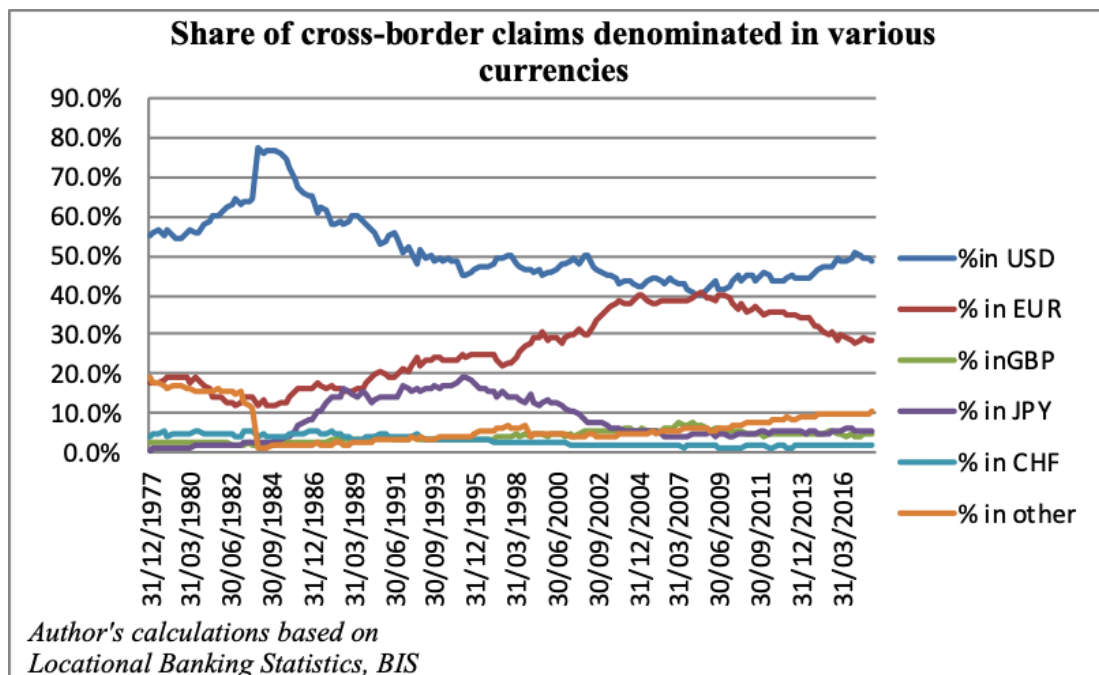
Figure 3.9: Share of cross-border claims denominated in various currencies

The huge increase in the absolute value of cross-border claims on the emerging market regions of Developing Asia, Latin America and Developing Africa and Middle East has to be seen in the context of the low rates of interest prevalent in the advanced economies. Table 3-1 provides deposit rates and lending rates for a

select few emerging economies and advanced economies. This differential in the deposit rates and lending rates is also an important reason why transactions similar to the "yen carry trade" of the eighties were occurring in the emerging market economies, i.e., of borrowing in the currencies of the advanced economies to lend in the domestic currencies of the emerging markets. But, it is also true that some developing country firms have been able to directly tap the international markets and benefit from the low rates of interest prevalent there.

Table 3-1: Deposit and Lending Rates across Economies (2004-14)

	DEPOSIT RATES (avg percentage per annum)					LENDING RATES(avg percentage per annum)				
	2004	2006	2008	2010	2014	2004	2006	2008	2010	2014
USA	1.56	5.15	2.97	0.31	.28 (2012)	4.34	7.96	5.09	3.25	3.25
Germany	1.93	2.61	4.13	1.1	0.37	5.12	5.4	5.97	3.87	4.95
Japan	0.08	0.68	0.59	0.5	0.42	1.77	1.66	1.91	1.6	1.22
China Mainland	2.25	2.52	2.25	2.75	2.75	5.58	6.12	5.31	5.81	5.6
Indonesia	6.44	11.41	8.49	7.02	3	14.12	15.98	13.6	13.25	12.61
Hungary	9.09	7.45	9.92	4.92	1.42	12.82	8.08	10.18	7.59	4.45
Brazil	15.42	13.93	11.66	8.87	10.02	54.93	50.81	47.25	39.99	32.01
Source: IMF(2016) International Financial Statistics Yearbook										

Contrary to the viewpoint of the proponents of Bretton Woods II that current account surplus economies were providing a fillip to the demand for dollar assets, and keeping its value stable, is the findings of a study by the US Federal Reserve. More than anything, it was the crises in various emerging economies that provided a huge surge in demand for dollar as a currency held abroad.(Judson, 2017) The lack of trust in the local currency led to a process of dollarization in the 1990s, with strong demand for the dollar, particularly from erstwhile Soviet Union and Argentina, with a rise in the share of dollar notes held outside United States. Thereafter, this share fell in early 2000s. Ever since the collapse of the Lehmann Brothers and the associated uncertainty, there has been an unprecedented surge in the demand for the US currency outside the United States. The study by Judson (2017) estimates that 60% of stock of US dollars, and 75% of all $ 100 notes issued by the Fed Reserve are held outside United States in 2016, amounting to a value of $ 900 bn. (p.11).

II

US dollar credit to the non-bank sector outside United States.

As per the recent figures, dollar credit outstanding to non-banks outside the United States stood at $11.34 trillion (Dec 2017), having registered an annual rate of growth of 7.4% on a y-o-y basis. At this level, the dollar credit to the non-financial sector outside the US comes to almost 60% of the US GDP, and 18% of the non-US GDP of the world. Compared to $5.53 trillion in Dec 2007, the dollar credit to non-banks outside United States has almost doubled to reach 2017 levels. Even when a part of the dollar credit in the rest of the world is issued by different non-US banks, US money markets continue to be the important centre from which the foreign banks offices in United States mobilise the much needed dollar liquidity, and send to their headquarters (Bertaut and Pounder,2009). Though under the Bretton Woods II framework, United States is a net borrower from the rest of the world, and the rest of the world subscribes to its Treasuries, in the case of of the banking flows, there are net outflows from US to the rest of the world.

The credit outstanding to EMEs during the same period increased by almost two and a half times from $ 1.46 trillion to $ 3.59 trillion (i.e., from 8.8% to 11.29% of EMDE GDP). Much of the increase in the growth of credit to the EMEs in the post 2007 period has occurred when there has been a large increase in FDI abroad by those economies. Studies reveal that the international debt securities mobilised by India abroad has gone into the financing of its acquisitions abroad (Gruić & Wooldridge, 2014). In fact, during the period of massive net capital inflows into India, the central bank had encouraged foreign investment abroad by the Indian corporations. The differential in interest rates in the developing economies from that prevalent in the advanced economies had also resulted in credit flows purely on a carry trade basis. The risks associated with this phenomenon would only be known once the reversal of the quantitative easing policies gathers momentum.

Though the unconventional monetary policies of the Federal Reserve were expected to increase the dollar credit off-take of the non-bank sector within United States, dollar credit flow to non-financial borrowers outside the United States has grown at a much faster rate. This should be seen in the context of the faster

transmission of the US monetary policy to the rest of the world. While there were limits to growth in domestic credit, it was only appropriate for bankers to explore the lucrative avenues of carry trade opportunities available elsewhere, given the difference in interest rates with the rest of the world. Other than in June 2009, US dollar credit outside the United States has registered a positive y-o-y rate of growth (Figure 3.10).
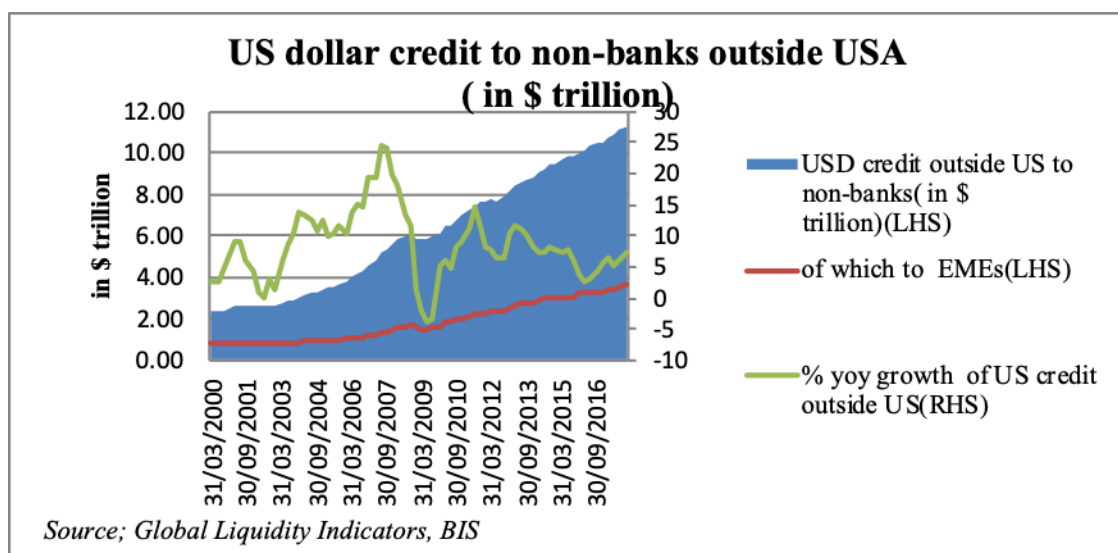
Figure 3.10: US dollar credit to non-banks outside USA ($ trillion)

It should be noted that of the total dollar credit extended to the non-financial sector outside United States in the post-2000 period, at least 46 to 52% has been through the issue of international debt securities. In 2017 Q4, of the total outstanding, $ 5.9 trillion is on account of international debt securities and $5.5 trillion on account of bank loans (Figure 3.11).

While the dollar credit within United States to the non-financial sector increased from $ 32.7 trillion in December 2007 to $ 43.52 trillion in December 2015, and further to $48.4 trillion in December 2017, the dollar credit extended outside the United States literally doubled, albeit from a lower base. It should be noted that the rate of growth of dollar credit within United States was far lower then the rate of growth of dollar credit outside United States. The dollar credit within the USA to the non-bank sector, which registered y-o-y rates of growth of as high as 12.71% in December 2004, has been, on an average far lower, in the period after 2007. It is important to note that in the period from 2003 to 2008, dollar credit extended to the

non-financial sector in the US increased from $ 21 trillion to $32 trillion. This is the period which Bernanke refers to as the one which saw large amounts of mal-investment in the USA, due to the mispricing of risk. He attributes the same to the large capital flows from Asia. But, it should be noted that more than the net capital inflows into treasury securities, it was the capital inflows from the euro area, which went to the market for asset backed securities, the financing of which was through the wholesale dollar funding in the US market, which culminated in the crisis.[15]
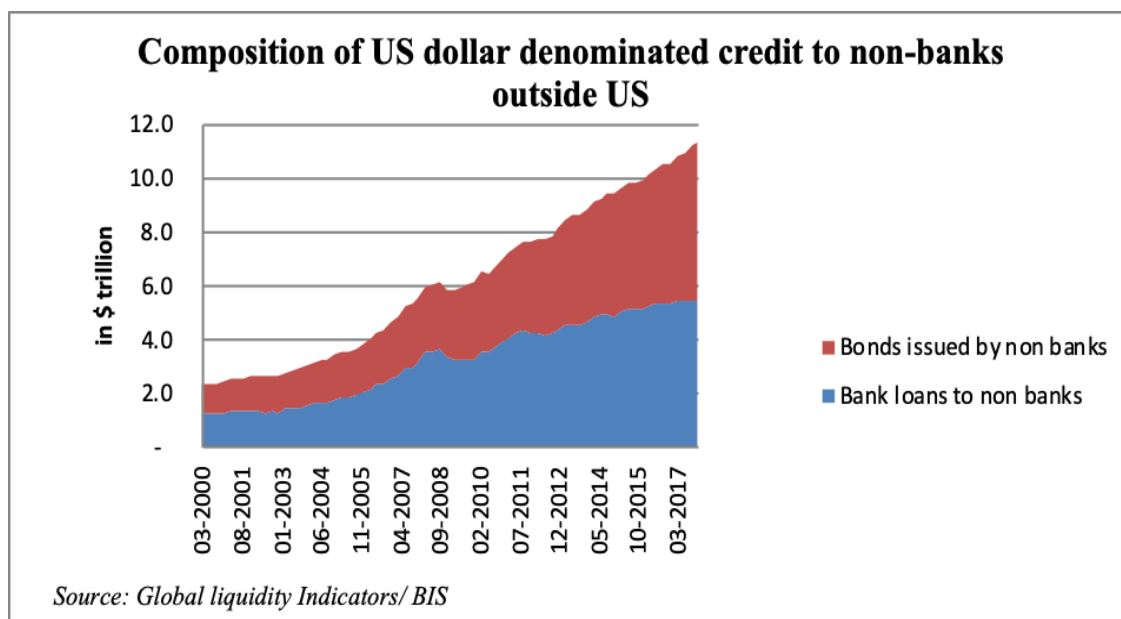
Figure 3.11: Composition of dollar denominated credit to non-banks outside US

A part of the dollar loans of the banks outside United States are financed through their own deposits. For financing the rest, they rely on various sorts of funding including wholesale funding as well as short term foreign currency options. The data from BIS reveals that the cross-border claims denominated in dollars of banking groups of Japan, France and Canada have been witness to a faster pace of growth compared to their liabilities in the form of dollar deposits. In the event of the reversal of the loose monetary policies of United States, there could be risk regarding the rollover of the wholesale dollar liabilities.

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[15]In fact Hyun Song Shin refers to the phenomenon not as a savings glut but as a banking glut. For a comparison by contrast of the transatlantic (banking glut) as against the transpacific ("savings glut") origins of the global financial crisis, (McCauley, 2018)
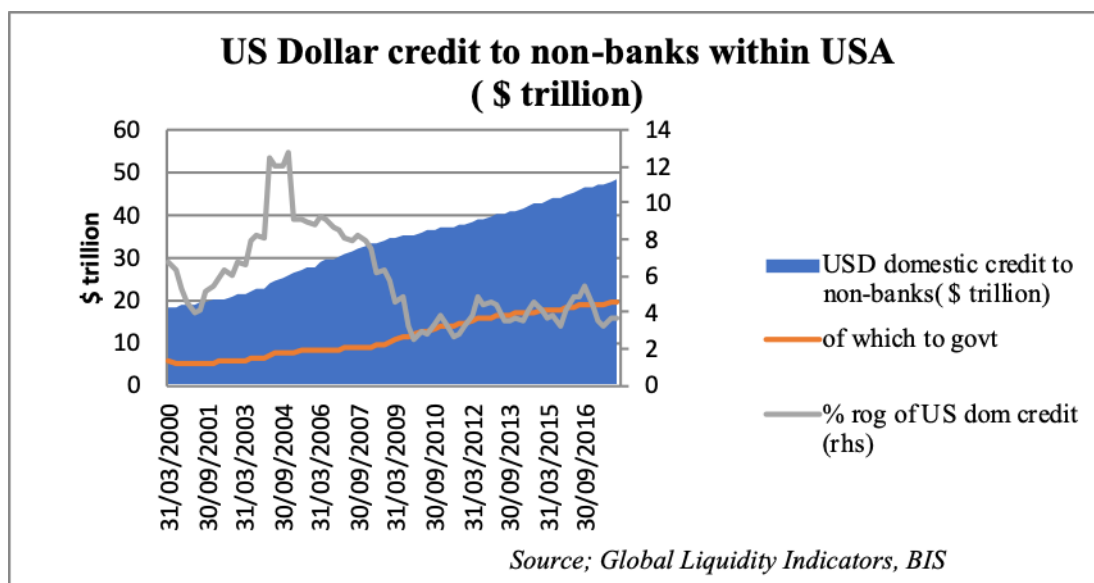
Figure 3.12:US dollar credit to non-banks within USA ($ trillion)

As providers of dollar credit, even as both banks based in US as well as other advanced economies play an important role, the emerging market economies have been witness to a faster rate of growth of dollar borrowings. A number of studies have drawn attention to the loans being directed to non-tradable sectors in the emerging economies. An empirical study based on credit to firms provided by firms in Mexico tries to bring out the fast pace of transmission of monetary policies, and quantitative easing policies pursued by United States, euro area and the UK through their impact on credit availability, routed through the foreign banks based there. It also draws attention to the risks associated with the "search for yield" measures pursued by the foreign banks. (Morais, J.L., Roldan, & Ruiz, 2018)

One should not underestimate the risks in the dollar credit market outside United States in the eventuality of domestic credit growth within United States picking up momentum, and, with the possible depreciation of the EME currencies in the eventuality of the capital outflows from EMEs in another round of monetary tightening. Different reports have already drawn attention to the increase in the credit default swap rates on developing country dollar securities, in the backdrop of the depreciation of the currencies of the emerging markets.[16] All of this reveals to us the fickle nature of finance under Bretton Woods II. The barrage of capital inflows occurring to the EMDEs, only to benefit from yield differentials, would vanish, with

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[16] See (IMF, 2018) for instance and the various issues of BIS Quarterly in this regard.

reversal of policies in advanced economies, pushing the exchange rates and asset prices of EMDEs into disarray. The danger associated with the sort of rationalisation of such capital flows through the BW II logic of Dooley and others is that we fail to even appreciate the virtues associated with capital controls.

A relative comparison of the credit extended to the non-financial sector outside their own region in dollars, euros and yen would be in order. In the period from 2007 to 2017, while dollar credit to non-financial sector outside US doubled to $11.34 trillion in 2017, euro credit outside the euro area increased at a marginal pace from 18.21 trillion to 27.7 trillion euros. During the same period the yen credit outside Japan registered a steep decline from 70 trillion yen to 44 trillion yen. For comparison, we convert the yen and euro at 112.95 Yen/ $ and 0.89 euros/ $.[17] As per this conversion, of the total credit offered in these currencies, dollar accounted for 11.34 trillion (76.6%), euro for $3.33 trillion (22.1%) and yen for 0.39 trillion (2.5%). (Calculations by the author using BIS Global Liquidity Indicators Database)

In fact, dollar has supremacy of sorts as the currency of denomination of loans to the non-financial sector. As against the other currencies, a short term depreciation of the dollar, i.e., the *de facto* reserve currency, is followed by an appreciation in due course, stabilizing its value, as against the other currencies. Not only does the short term depreciation of the dollar improve matters on the trade account front, but given that most of its liabilities are denominated in dollars and assets in other currencies, the depreciation also enables the improvement of the net international investment position of the US.

On the contrary, the currencies of emerging market economies go through a process of destabilising speculation. In fact, the leader country can afford to go ahead with expansionary policies without the supremacy of its currency in the international financial markets being contested. But this is not the case with the other set of economies which nurture reserve currency ambitions. In case, hypothetically, any of them would like their currency to acquire a reserve currency status, they would have to pursue deflationary strategies.[18] In fact, the shortage of safe assets in the world economy too comes in the context of the reluctance of countries to hold assets denominated in currencies, other than dollar, euro and yen.

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[17] These are the period average exchange rate figures of December 2017 provided in International Financial Statistics

[18] For the elaboration of this specific argument, see the chapter on international monetary system in (Patnaik & Patnaik, 2016)

III

International debt securities, EMEs and the original sin hypothesis

There has been a steep rise in the mobilization of resources through the issue of international debt securities in the aftermath of the global financial crisis. The ability of the global banks, in particular banks from Europe, to provide intermediation services to the non-financial corporations, through the mobilization of wholesale liabilities, has suffered a severe setback. Several studies by BIS and reports relating to cross-border banking flows provide evidence in this regard (CIEPR, 2012). Even as the external liabilities mobilised by both banks and non-financial corporations through loans have been witness to a steady decline in the aftermath of the crisis, there has been an increase in the share of the liabilities mobilised through international debt securities. It received attention with a number of non-financial corporations from emerging market economies being able to tap long term resources at lower rates of interest. In certain instances, the rates of interest were comparable to those of their counterparts in the advanced economies. But, all of this has been in the backdrop of the low interest rates prevalent in the international economy. Mobilizing funds through this route, some of the leading corporations in the emerging economies have been able to sidestep the domestic monetary policy regime, whereas the others had to go in for loans under the high interest rate regime back home.

The total amount outstanding under international debt securities (residence of issuer) has increased from $5.44 trillion (2000) to $23.93 trillion (2017), with the developing economies also registering an increase in the outstanding on this account from $515.18 bn to $2.39 trillion during the same period. Though in absolute terms, the amount mobilised by the emerging economies through issuance of international debt securities has definitely increased, their relative share in the global aggregate in the post-2010 period of 5 to 10%, is far lower than 13% of the total mobilised in 1997-98 (Figure 3.13). The stock of international debt securities outstanding of the EMDEs in terms of GDP decreased from 7.2% (2000) to 4.5% (2010). But since 2010, it has increased to 7.5% of the EMDE GDP in 2017.
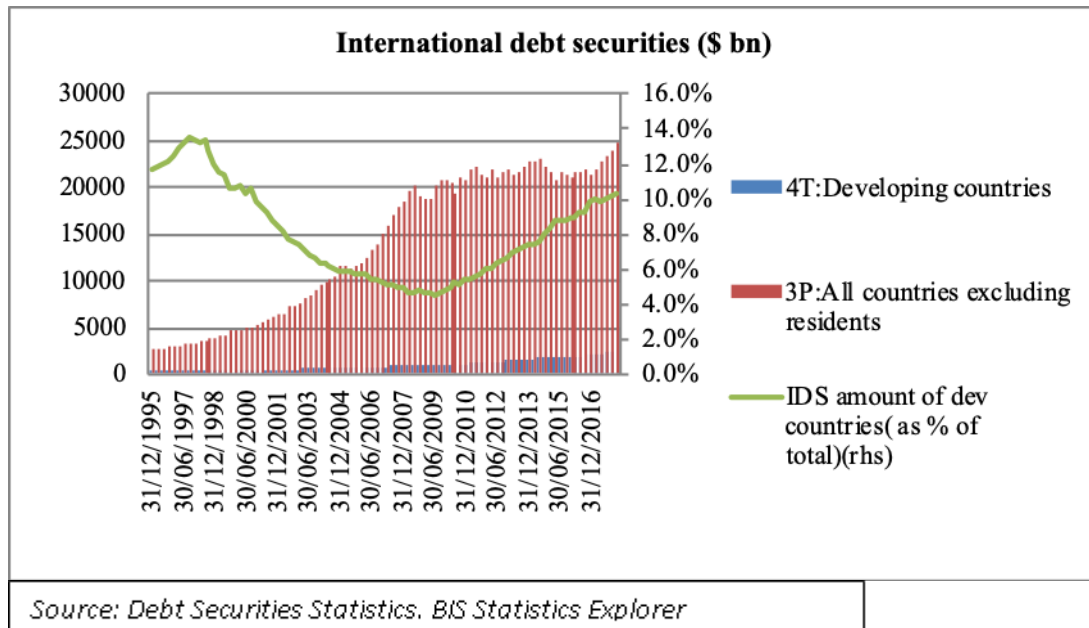
Figure 3.13: International debt securities ($ bn):

Initially, the outstanding value of debt securities issued by developing country agents increased from $98.4 bn in 1991 to $512.2bn in 2000 (or five-fold in the course of ten years). It further increased to $ 941.5 bn by June 2008, almost doubling in the course of these nine years. After a small dip in the following two quarters, to $886.6bn in December 2008, the mobilization of funds through issue of international debt securities by the developing economies recorded a sharp upswing, with the amount outstanding reaching $2.53 trillion in December 2017. Even after this unprecedented mobilisation of funds by the developing economies in the post-global financial crisis period, the amount outstanding against them as a group amounts to approximately one-tenth of the total international debt securities outstanding of $24.27 trillion. Of the amount outstanding, as per the BIS data of December 2015, the single largest proportion of 39.5% is due from the government, 29% from non-financial corporations and the rest from various financial institutions. But since 1990, the share of the government in the total outstanding has been on the decline and that of the non-financial corporations has been on the increase (Figure3.14). The largest addition since March 2009 to the amount outstanding through the issue of debt securities, was on account of non-financial corporations. They had mobilised an additional $367.82 bn, while the government had mobilised $318 bn during this period. So, the increase in borrowing from the international debt securities market by

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the non-financial sector (as well as financial sector), was far more than that of the government, in the post-2009 period.
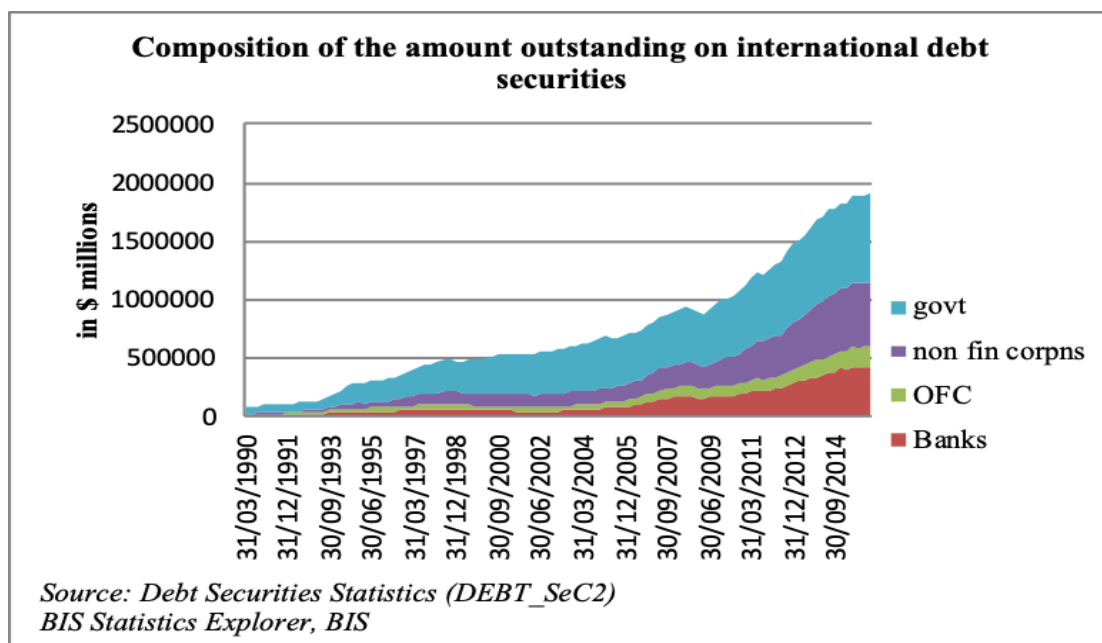
Figure3.14: Composition of the amount outstanding on international debt securities

In fact, India too has mobilized funds through issue of international debt securities over these years. A good proportion was mobilised by non-financial corporations and banking institutions. However, as compared with the other developing countries, the share of the international debt securities mobilised by the government has been far lower (Figure 3.15).
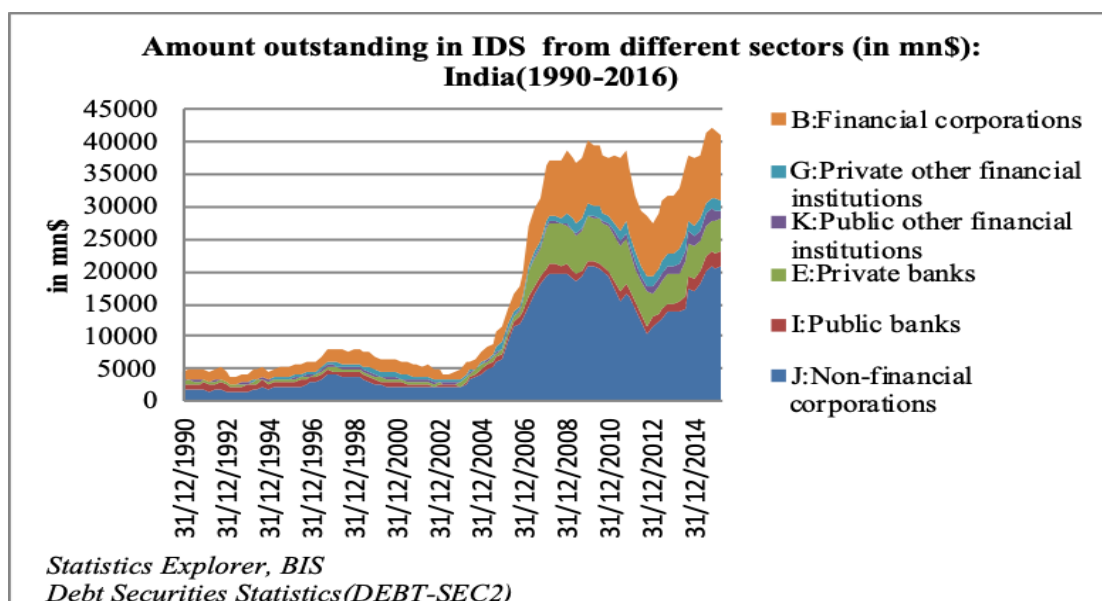
Figure 3.15: Amount outstanding in IDS from different sectors ($ mn): India (1990-2016)

Contrary to what is being argued and heard in public, the extent to which the emerging market economies have been able to mobilise funds through international debt securities in local currencies has been small. The 'original sin hypothesis' has barely been challenged. This is illustrated in Table 3-2, which disaggregates the amount outstanding in domestic currency international debt securities.

Table 3-2: Amount outstanding in international debt securities in domestic currency

AMOUNT OUTSTANDING IN INTERNATIONAL DEBT SECURITIES IN DOMESTIC CURRENCY							
	30/06/2008	30/06/2009	30/06/2010	30/06/2011	30/06/2012	30/06/2013	30/06/2014	30/06/2015
Foreign	28503	27595	30008	26397	20856	21778	25376	30678
Domestic	140	126	132	178	142	135	134	124
All currencies	28363	27469	29877	26218	20714	21644	25242	30554
Source: BIS Statistics Explorer (DEBT_SEC2), Updated 27/05/2016 16:25								

Table 3.2 provides data related to a group of emerging market economies, extracted for one of the quarters of 2016 , from the BIS Statistics Bulletin of July 2017 for

illustration. The mobilization done in the international debt securities market through the issue of local currency instruments is provided in parentheses. Their share is negligible when compared with funds mobilized through instruments denominated in dollars, euros, yen, Swiss francs and so on. Among the emerging market economies, for which BIS provides detailed data, Brazil, China, India, Singapore, South Africa, Thailand and Turkey have been able to mobilise relatively small amounts in their local currencies. But, this cannot in anyway be seen as an invalidation of the "original sin hypothesis", which had flagged the inability of the developing economies to borrow in their domestic currency as being primarily responsible for the crises in the developing world, such as the East Asian crisis or the Mexican crisis.

Table 3-3: Amount outstanding in International Debt Securities (in $ bn): Emerging market economies

	ARG	BRA	CHN	IND	INDO	KOR	MAL	MEX	POL	RUS	SARAB	SNG	ZAF	THA	TUR
Resident															
Total debt securities	185		9398.8				331.5			399.2		338.7		321.6	269.9
Dom debt securities	116.8	1996.4	9181.9	753.8	167.2	1580	296.1	485.2	289.6	221.5	62.7	78.4	195.6	309.7	170.4
Intl debt securities	79	132	124.9	34	88.2	172.3	44.8	235.4	64.9	103.9	9.1	122.1	29.2	10.8	117.9
Banks	1.3	30.8(0.8)	52.3 (8.8)	8.2	1.6	93.3	13.8	11.3	1.7	32.6	1.4(1.3)	66.8(2.9)	2.7(0.3)	1.3(0.1)	45(0.6)
OFC	1.3	14.2	37	4.1(0.9)	18.1	19.6	23.2	14.7	2.1	5.6	1 (1)	29.6(2.3)	4.1(0.9)	1.8(1.8)	1.3
Non fin corpns	12.1	35.9 (0.8)	22.4	21.7(0.5)	13.2	53	2.8	142.1	0.9	33.1	6.7(0.3)	25.7(8.8)	9.8(1.9)	7.4(0.3)	8(0.1)
Gen Govt	64.5	51.1(3.4)	13.3	nil	55.3	6.6	5	67.4	60.2	32.5			12.5	0.3	63.6
	Note: local currency denomination is shown within parantheses							Source: Tables C3 of various economies. Statistics Bulletin July 2017, BIS							

Though countries across developing economy groups have, since 2008, mobilised resources through the issue of international debt securities, the reliance on this route has been greater in Latin America and the Caribbean and Developing Asia and Pacific. The amount outstanding as on December 2017 for these regions was $863 bn and $761 bn respectively (Figure 3.16). It should be noted that in the case of Developing Africa and the Middle East, the outstanding figure which began with a very low base value in 2007, recorded a four-fold increase to $400 billion in the course of ten years, approaching the total outstanding figure of Emerging Europe. Saudi Arabia, United Arab Emirates and South Africa account for a substantial share of the total debt securities outstanding of Developing Africa and Middle East. Contrary to the tenets of the B W II postulate which presumes that the surpluses of the export success economies are driving up the dollar by financing dollar deficits, now the surpluses are recycled with some of the banks of China emerging among the top in the world. It is the borrowings undertaken by many of these EMDEs, which of course are also facilitated by the monetary policies of the advanced economies that are now getting invested in safe US Treasuries. Needless to say, all of this has increased the vulnerabilities of the EMDEs.
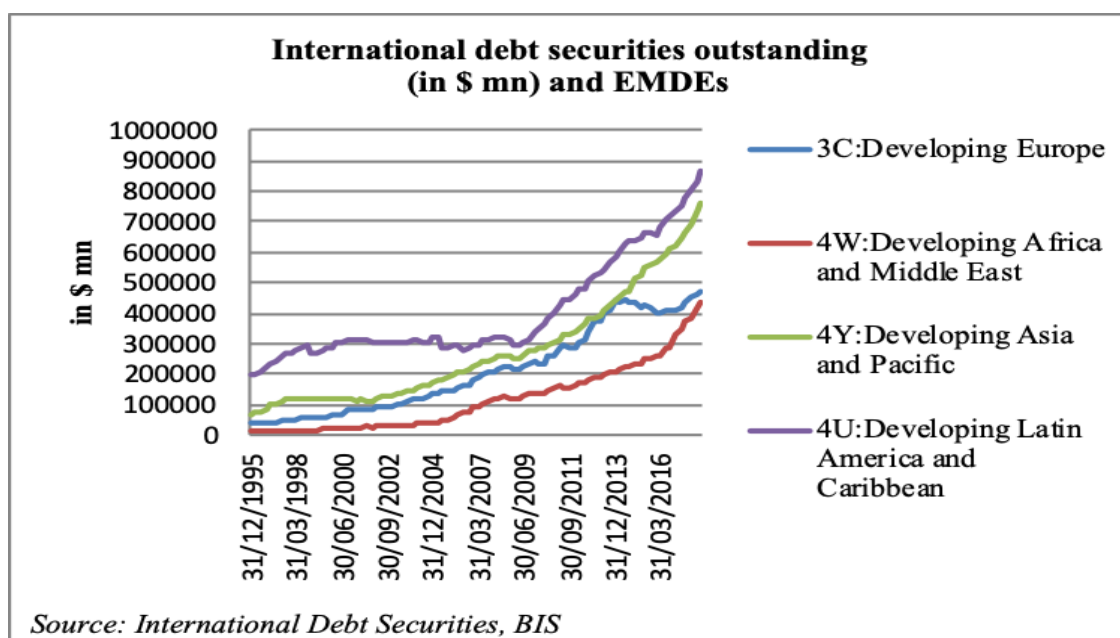
Figure 3.16: International debt securities outstanding ($ mn) and EMDEs

In what follows we examine the benefits and vulnerabilities associated with reliance on international debt securities based on the experience of three emerging market economies: India Brazil and China.

INDIA :

In 2017 Q1, the total debt securities outstanding in the case of India included $ 861 bn worth of domestic debt securities and $ 42 billion worth of international debt securities. Of the international debt securities, $0.5 bn, $6.8 bn, $ 7.2 bn and $ 27.2 bn are the sums outstanding from the government, banks, other financial corporations and non-financial corporations. Other than $1.9 bn of debt securities issued by the non-financial corporations, the rest is denominated in foreign currencies. Of the total international debt securities outstanding on nationality basis of $100 bn, other than $10 bn mobilized in other currencies, which could include Indian rupee, the rest has been issued either in dollars or euros. It should also be noted that there is a growing wedge between the outstanding on international debt securities on nationality basis and residence basis in the case of India. Though the funds being mobilised appear in the consolidated balance sheets of the corporations concerned, it does not make an appearance in the balance of payment sheet of the country (Figure 3.17).

Source: International Debt Securities Database, BIS
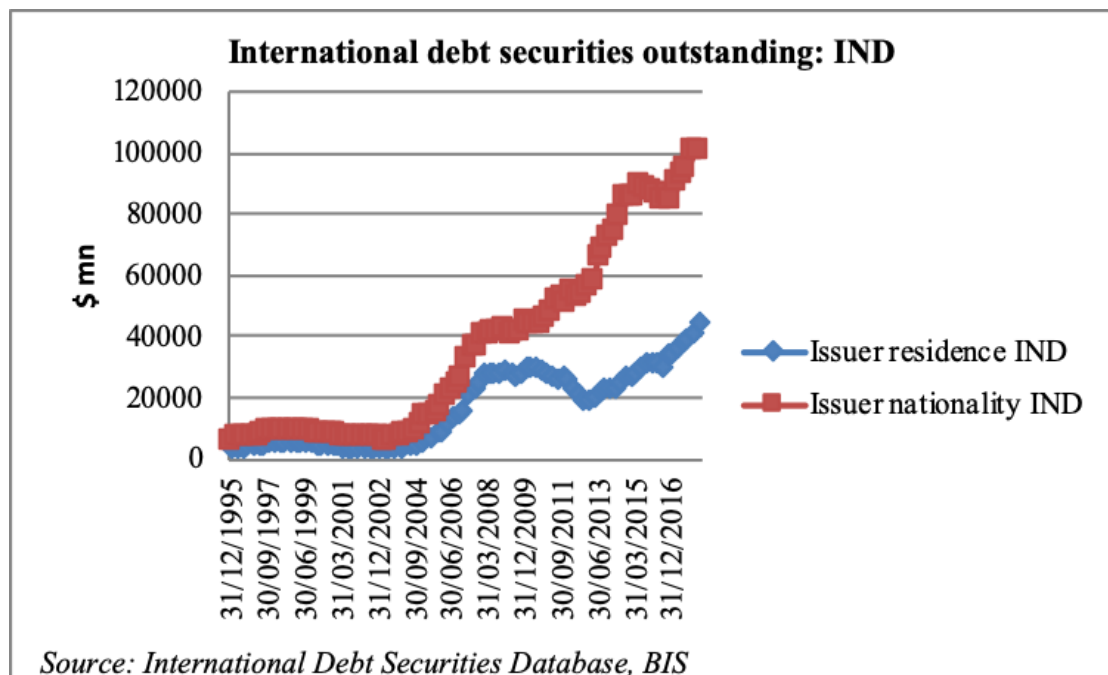
Figure 3.17: International debt securities outstanding($ mn): India

This is on account of the funds being mobilised by corporations in other international financial centres, towards undertaking investment in third economies. In case, the investment undertaken goes awry, it would affect the balance sheet of the corporations. The ability of the corporations in the country to mobilise resources through the issuance of international debt securities, was in the initial stages viewed with a sense of optimism. Concomitant with the increase in international debt securities mobilised on a nationality basis, there has been an increase on account of inter-company borrowings as well as equity liabilities in the balance of payments accounts of Brazil and China, but this is not the case with India, implying that the increasing borrowings undertaken by the corporations of India is not reflected in the balance of payments sheet of the country (Gruić & Wooldridge, 2014).

Given that resources were mobilised at competitive rates of interest, and , in certain cases, far lower than the domestic rates, this was an opportunity for at least a group of Indian corporations to sidestep the tighter monetary policies pursued within the country. Following the decision of the Federal Reserve relating to the tapering of bond purchases in 2013, the exchange rates of currencies of different emerging economies including Indian rupee depreciated vis-à-vis the dollar. Those corporations which have not hedged against this possibility found their balance sheets being affected. In fact, the decision to encourage Indian corporations to invest overseas came in the backdrop of the appreciation of the Indian rupee in the 2003-05 period, and, some had not hedged against the exchange rate risks, counting on the Indian rupee to be stable .

BRAZIL:

In the case of Brazil, the amount outstanding under domestic debt securities is $ 2183.7 bn, and international debt securities issued by residents is $ 127.5 bn in 2017. Contrary to the other countries, almost 40% of the amount outstanding is due from the government. Other than $ 3.9 bn,   the rest of the amount outstanding has been mobilized in   dollars or euros. Under the issue by nationality head, $ 299.7 bn worth of international debt securities is outstanding as of 2017 Q4. Of the same, $ 163.6 bn (i.e, 1.8%) has been mobilised by nonfinancial corporations. Just $5.5 bn of the total international debt securities mobilized has been denominated in other currencies, which could include the Brazilian real. The large wedge between the

amount outstanding on residence and nationality basis holds true for Brazil as well (Figure 3.18). Most importantly, due to the reversal of expansionary monetary policies pursued by the United States, there has been a decline in the amount outstanding on account of international debt securities from 2014. The benefit of the low interest rate accruing to the nonfinancial corporations in the developing economies is set to come down. Given that the debt securities mobilised have been long term in nature and have been largely taken at fixed rates of interest, Brazil is free of both of these risks. However, given the steady depreciation of the real in the course of the last few years, in case borrowers, especially the government have not hedged against forex risk, they are likely to be adversely hit.
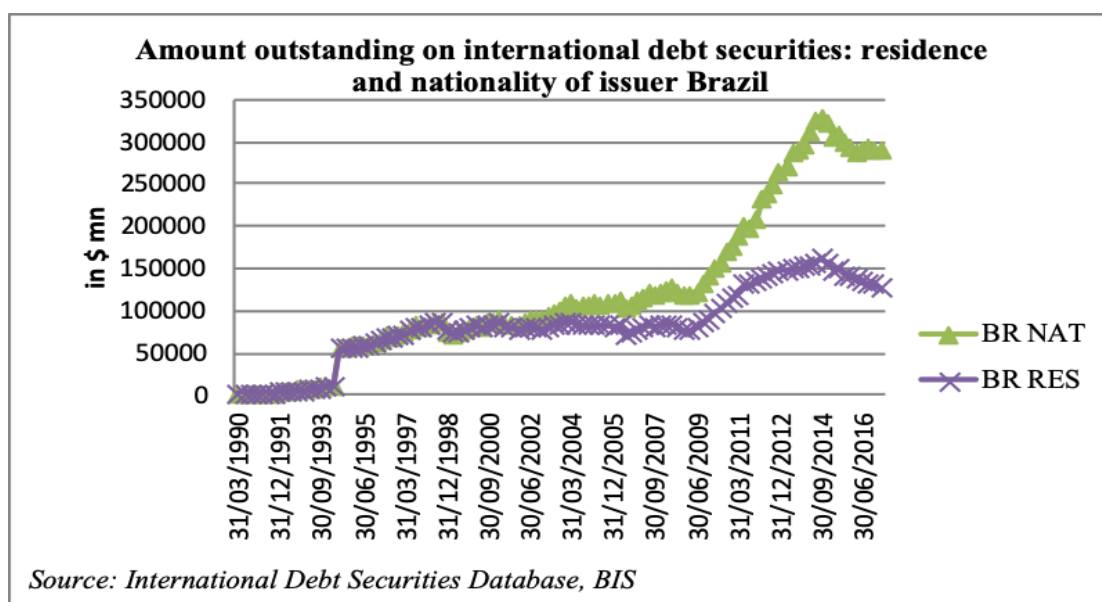
Figure 3.18: International debt securities outstanding($mn): Brazil

CHINA

Of all the emerging economies, the share of international debt securities mobilised in local currency is highest for China. Even in the case of China, the local currency denomination of international debt securities is less than 10% of the total outstanding. This is despite the efforts undertaken by the People's Bank of China to promote the internationalization of the renminbi through the provision of incentives for the offshore renminbi market in Hong Kong. The first offshore renminbi bond was launched by the China Development Bank in 2007, with a coupon rate of 3% and face value of 5 billion renminbi. The Ministry of Finance of the Government of China had

issued Treasury securities worth 6 bn renminbi in October 2009, which helped in setting a benchmark yield rate.

The boost to the offshore renminbi market came in January 2011, following the decision of the People's Bank of China to permit mainland companies to undertake outward investment through the issue of renminbi bonds. This was due to the strategy pursued by the government of promoting outward foreign investment, without incurring exchange rate risks. The offshore corporate dim sum bond market in Hong Kong has grown nine fold between 2011 and 2015 , reaching a size of 580 bn renminbi.

In October 2011, further the Ministry of Finance in China permitted foreign investors to use offshore renminbi bonds to finance foreign direct investment Different multinational firms like Caterpillar, McDonald's and Unilever have mobilized resources through the offshore renminbi bond market in Hong Kong for undertaking foreign direct investment in China. But, empirical studies have revealed that net issuance of offshore renminbi bonds are related more to the overseas foreign investment undertaken by mainland firms based in China, with the role of foreign direct investment being insignificant (Chow and Law,2019).[1] As we would see in the coming section, this has definitely increased external debt of a private non-guaranteed nature, and exposed the economy to a large level of volatility.

Is this process of mobilisation of resources through the issuance of international debt securities sustainable? With the interest rates firming up in the international economy, the price for these bonds would fall, increasing the cost of fresh mobilization of debt securities though this route. In fact, the net issuance of international debt securities from the emerging market economies in the period since 2013 shows a fluctuating trend, reflective of the Fed policies of tapering of bond purchases(Figure 3.19).

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[1] See also (DING, D., HUANG, Y., & Yue, Z,2019)
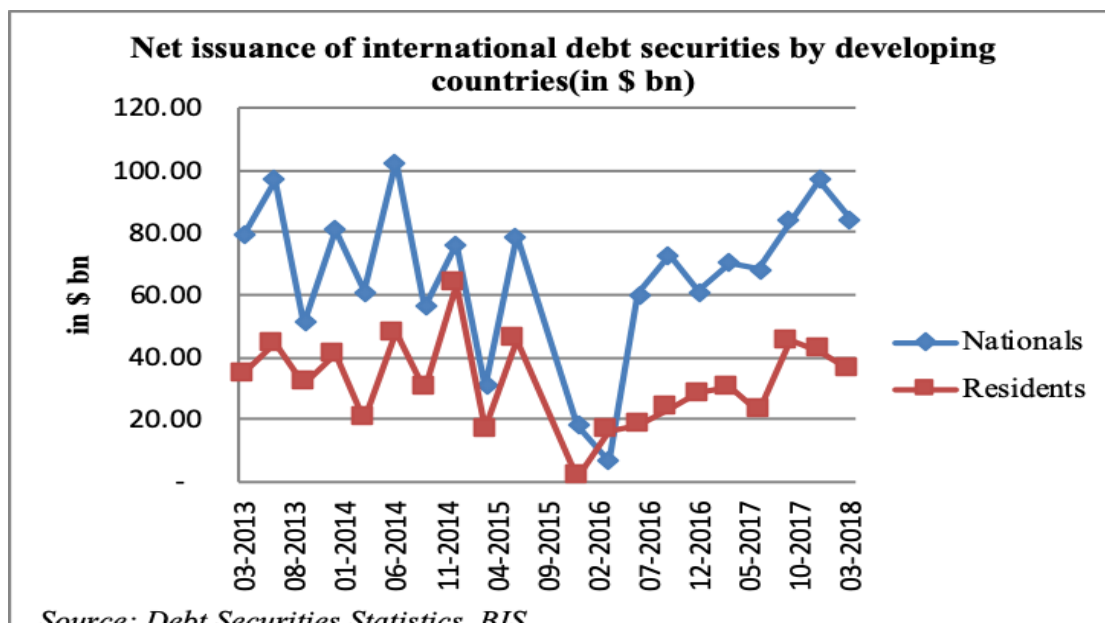
Figure 3.19: Net issuance of international debt securities by developing countries($ bn)

A perusal of the exchange rate data provided by BIS with Base = 100 (1995) of the currencies of these countries would be useful. Note that, as per this index, an increase in the value implies an appreciation of the currency concerned against the dollar (Figure 3.20). During the period from June 2008 to March 2018, the dollar exchange index has moved from 104.3 to 66.3 in the case of the Indian Rupee, 99.9 to 47.2 for the Brazilian real, 88.3 to 49.1 for the Mexican Peso and 120.2 to 131.6 for the Chinese Yuan. This implies that other than the Chinese Yuan, all other currencies were experiencing large depreciations, with the Brazilian real depreciating in this period by more than 50%. It is pertinent to note that with the quantitative easing policies, the exchange rates of most of these currencies have appreciated in the period from 2008 to 2012, before their fall. In fact, the steep appreciation of the Brazilian real resulted in the Finance Minister arguing that the policy of quantitative easing was a currency war of sorts, which was hurting the competitiveness of the developing countries. The benefits of low interest rate on the bonds mobilised during the post 2008 period would have been wiped out by the steep depreciation of these currencies. By virtue of the appreciation of its currency, Chinese corporations could have benefited from the issue of international debt securities.
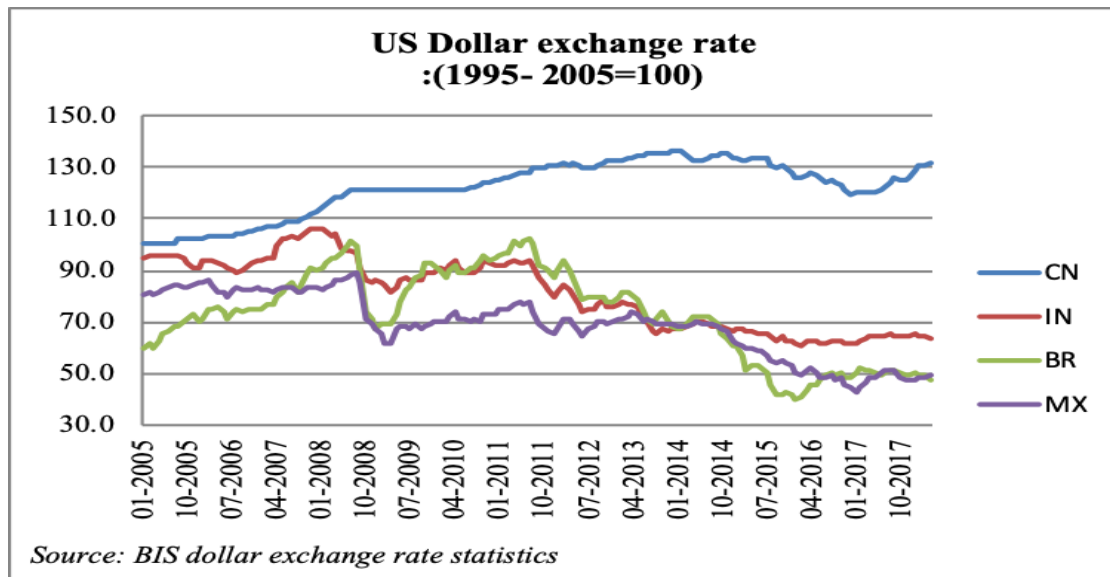
Figure 3.20: US Dollar exchange rate(1995=100)

A proper overview of the international corporate loans mobilised as well as the precautionary steps taken towards hedging against exchange risk would be in order. In fact, the use to which resources thus mobilised are put is also of importance and ought to be regulated. In an empirical investigation done in 47 countries outside United States, it is found that the funds mobilised by the EME corporations were displaying a dollar carry trade pattern, with the funds mobilized being invested in high yielding deposits within the emerging economies, or in shadow banking products and commercial paper (Bruno & Shin, 2015).

Also, is there much to celebrate about the foreign participation in local bond markets, and the mobilization of bonds in the international markets in EME currencies like rupee and yuan (i.e., through masala bonds and dim sum bonds)? To begin with, this only reveals to us the desperation to which international capital has been pushed to in their "search for yield". Even as the associated appreciation of the local currency would add to the return accruing to the foreign investor, in the event of foreign capital exiting the country due to any reversal in the policies in the major advanced economies, it would simultaneously result in a process of depreciation of the currency, coupled with a decrease in the price of the bonds that increases yields. The Annual Report 2018 of the BIS too draws attention to this. (BIS, 2018)

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External debt stocks: public and private

   The growing level of external debt stock of emerging market economies has been another matter of concern. This assumes importance due to the growing share of the private non-guaranteed debt mobilised in international markets during the Bretton Woods II period. What does the data with respect to the external debt reveal?

Table 3-4: External Debt Stocks Public And Publicly Guaranteed ($ millions)

	1995	2000	(% of GDP)	2005	2010	2015	(% of GDP)	2015/2000
ARG	55221	90358	29%	59419	69183	72246	11%	1.22
BRA	98763	96622	15%	94354	97486	172274	10%	1.83
CHN	94674	94489	8%	84212	94003	158402	1%	1.88
IDN	65299	70025	39%	77705	103387	160037	19%	2.06
IND	79726	81196	17%	54726	100563	175717	8%	3.21
MYS	16023	19125	19%	34387	61858	66385	22%	1.93
MEX	95257	82767	12%	115549	145925	259274	22%	2.24
RUS	102077	90270	32%	76005	165621	194155	14%	2.55
THA	16881	29462	23%	12602	15929	22419	6%	1.78
TUR	50317	55736	20%	64482	93009	102027	12%	1.58
ZAF	9837	9088	7%	20743	36274	57598	18%	2.78
Source: International Debt Statistics . World Bank Updated as on 6/1/2017								
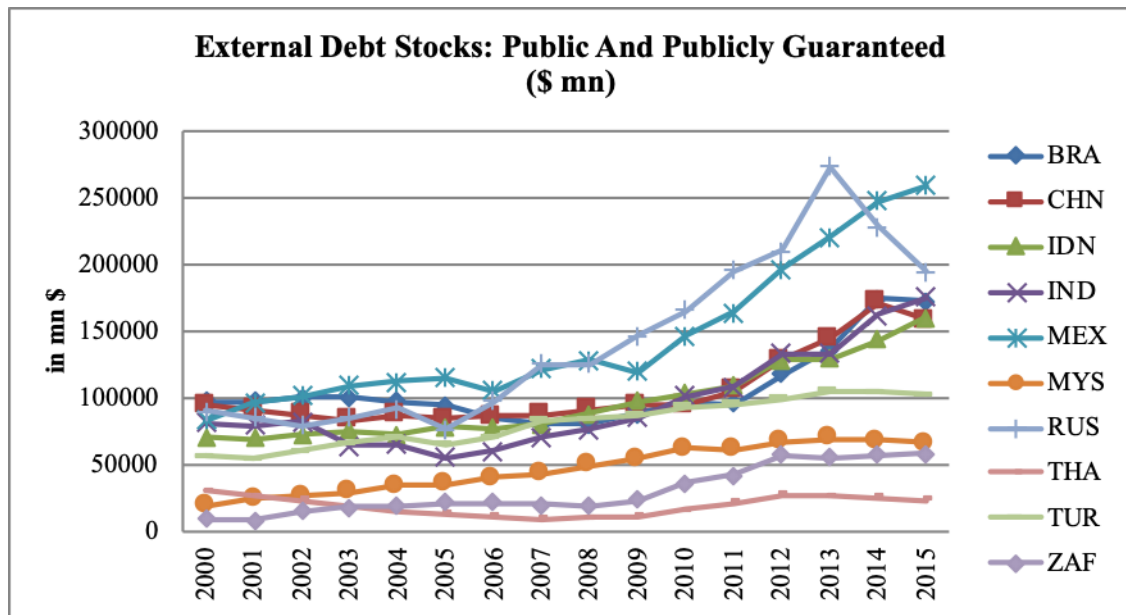
Figure 3.21: External Debt Stocks($mn):Public and Publicly guaranteed.

Figure 3.21 makes clear that publicly guaranteed external debt has increased across economies. Relative to 2005, the external debt (publicly guaranteed) had by 2015 increased by more than three times in Malaysia and Mexico. As a share of GDP, while it barely changed (remained around 23%) for Malaysia , it increased from 13% (2005) to 23% (2015) for Mexico. Though the publicly guaranteed external debt has increased by more than two times in the case of India, Indonesia and Russia, in terms of GDP, for all of these economies, there has been a distinct decrease between 2000 and 2015: Russia from 32 to 14%, India from 17% to 8% and Indonesia from 39% to 19% (Table 3-4). But, South Africa saw its publicly guaranteed external debt increasing from 7% to 18% of the GDP, and in absolute terms by more than six times in the same period (Figure 3.21).

Table 3-5: External Debt Stocks: Private Non-Guaranteed(PNG) ($ mn)

EXTERNAL DEBT STOCKS PRIVATE NON GUARANTED (PNG) IN $ MILLION								
	1995	1997	2000	2005	2010	2015	2015/2005	2015/2000
Argentina	16066.43	23410.63	25909.35	26360.82	37934.28	40867.02	1.55	1.58
Brazil	30830.19	75833.03	112681.70	69504.73	184940.32	314782.79	4.53	2.79
China	1089.86	2411.59	37789.00	50492.00	117375.37	329581.15	6.53	8.72
Indonesia	33123.19	44468.77	41169.28	45243.99	58783.49	106865.56	2.36	2.60
India	6618.20	9208.04	15586.00	56679.77	127289.64	216765.09	3.82	13.91
Mexico	18348.40	27455.87	50480.74	32658.32	52529.38	93349.21	2.86	1.85
Malaysia	11045.88	15481.75	18066.78	17149.53	18592.75	46233.73	2.70	2.56
Russian Federation	0.00	1905.00	21762.09	138589.02	183272.99	223554.53	1.61	10.27
Thailand	39117.18	47142.15	32315.56	29729.75	38277.70	54634.78	1.84	1.69
Turkey	7078.57	18683.45	27828.33	55443.21	123079.89	192195.97	3.47	6.91
South Africa	4935.00	2413.00	6507.36	9402.95	47638.00	48740.41	5.18	7.49
Source : International Debt Statistics, World Bank(updated as on 6/6/2017)								
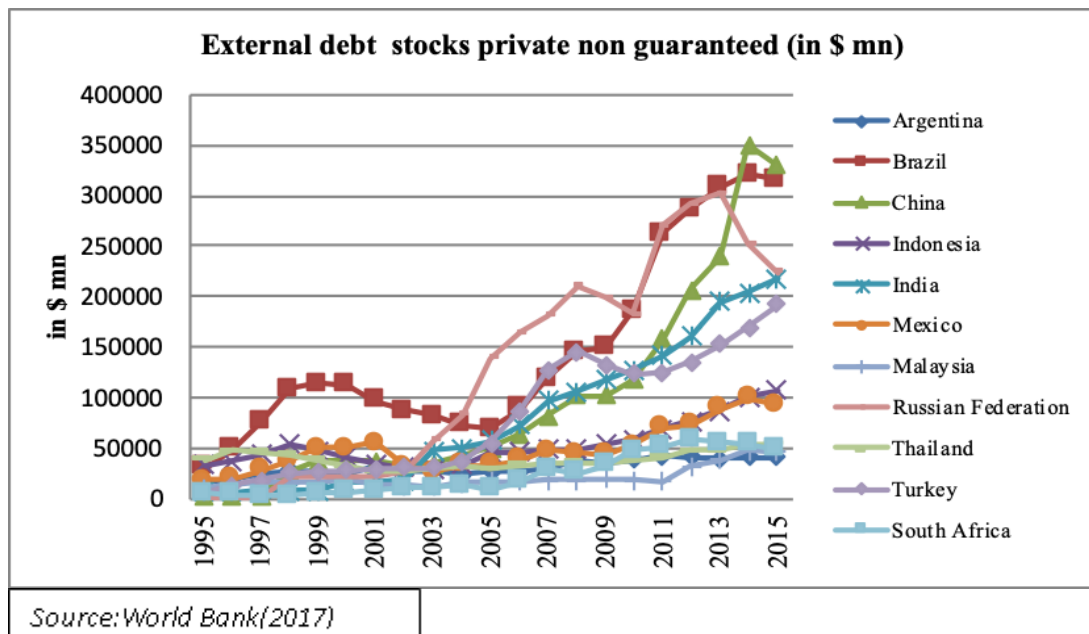
Figure 3.22: External debt stocks private non-guaranteed ($ mn)

As can be seen from Table 3-5, the stocks of private non-guaranteed external debt of the emerging economies in our sample have invariably increased by more than the external public debt. In the case of India, it has increased in the period 2005 to 2015 by 13.91 times. The increase in the case of other economies like the Russian Federation, South Africa, China and Turkey has been by 10.27, 7.49, 8.72 and 6.91 times respectively. Between 2005 and 2015, the external debt stock of private non-guaranteed nature has increased from $ 69 bn to $ 314 bn in Brazil, $ 50.5 bn to $ 329.5 bn in China and $ 56.68 bn to $ 216.7 bn in India (Figure 3.22). The mobilisation of funds under this category seems to have been least affected by the global crisis, implying that there has been a steady upswing with respect to carry trades to exploit interest rate differentials. It should be noted that during the post 2009 period, some of these economies have experienced an investment slowdown too. In fact, the mobilization from different sources of funds from abroad is all set to generate new vulnerabilities that the policymakers of the emerging markets would have to face.

VI

Credit GDP gaps and debt servicing ratio gaps

Certain indicators which have been developed by the BIS towards assessing the state of risk and vulnerability to financial stability are based on the difference from the mean of the concerned variable in the past years. The credit-GDP gap and the debt service ratio gap are examples of this. Consider first, the credit GDP gap, implying the difference between the prevailing credit to GDP ratio and the long-term credit to GDP ratio.

The understanding implicit in the approach is that the credit GDP ratio for a country should be around the average at which it stood in the last few periods. A large variance from that is not desirable. By that benchmark, the reduction in credit GDP of some the euro-peripheral economies would not be considered desirable. In fact, the high average credit GDP ratio which those countries had, in the past, to begin with, was undesirable. Now that it is declining, one cannot consider that to be undesirable. And, if with growth prospects and higher investment to GDP in an economy, there is large increase in credit to GDP for an economy, while this could technically give cause for caution, it should be borne in mind, that unless the credit is diverted to unproductive/non- tradable sectors, the trend may not be adverse. Unless we examine the disaggregated figures, it would not be appropriate to arrive at a judgement. Therefore, this approach is heavily static, in the sense that it relies heavily on the credit to GDP ratios of the past as the benchmark for judgement. However, some use of this tool, to the extent that it could help predict the time of transition of an economy from a hedge to speculative to Ponzi situation, in the Minskyian sense, is plausible.[1]

Large increases in credit to GDP ratios are also reinforced by huge increases in cross border flows of capital, under a financial system which is less regulated, like happened in Eastern Europe and the European periphery in the run up to the crisis. Table 3-6 provides the credit-GDP gap ratios of a set of emerging economies. Certain economies like China have been witness to unusual increases in credit to GDP ratios. In fact, the credit GDP gap in China has moved up from 6.3 and 13.3 in 2011 and

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[1](Minsky, 1992) for the financial instability hypothesis.

2012 to 27.5 in 2015. This is also reflective of the large inflows into China during that period. Notable again among these economies is Hungary, for which the credit-GDP gap has been going down from -8.2 in 2012 to - 27.2 in 2015. It is self-evident from the table that the credit-GDP gap is positive for most of the economies of Latin America and East Asia, which have recorded large increases in cross-border claims, whereas, other countries are notable for negative numbers. Given the fragile nature of finance, shouldn't these high positive numbers be seen as early warning signals of a bubble in the making?

Table 3-6: Credit GDP gaps of selected EMEs

Credit GDP gaps of selected EMEs					
Country	2011	2012	2013	2014	2015
Argentina	-3.9	-1.3	0.7	-0.7	2.3
Brazil	6.1	6.6	7.8	4.5	3
Chile	-1.8	3.5	7.9	14.4	19.1
China	6.3	13.3	19	21.6	27.2
Colombia	7.7	6.9	8.8	12	13.3
Czech Republic	15.1	13.2	13.6	11.6	3.1
Hungary	6.3	-8.1	-17.8	-21	-27.2
India	2.6	1.6	0	-3	-3.5
Indonesia	6.4	10.4	13.2	12.3	11.4
Korea	3.5	3.2	1.4	2.2	1.7
Malaysia	-4	-0.4	5.8	7.7	11.6
Mexico	4.8	4.5	6.5	6.7	8
Poland	5.5	1.7	0.5	0.3	-1.3
Russia	-3.1	-3.5	0.8	7.5	4.8
S Arabia	-9.2	-8.8	-3.3	0.3	11.5
Singapore	5.1	15.1	22.1	24.5	22.5
South Africa	-4.8	-2.9	-3.3	-3.9	-0.5
Thailand	6	9	15.4	16.3	15.6
Turkey	12.9	9.7	13.2	10.7	9.8
Source: Statistics Bulletin July 2017. BIS					
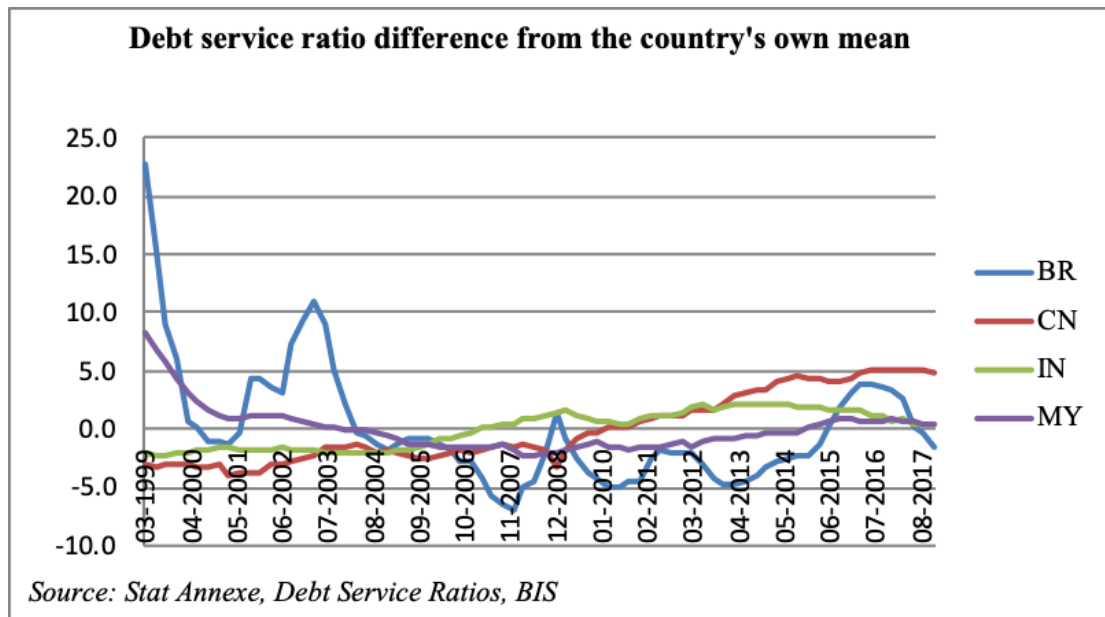
Figure 3.23: Debt service ratio difference from the country's own mean

The large capital flows occurring to the Asia and Pacific is in all likelihood going to prove costly. The debt service ratio of China in 2017 (Figure 3.23) has increased by 4 percentage points from its historic mean. Any decline in the rate of growth of income would further complicate matters. That of Malaysia and China also shows increases. Though the data relating to Brazil show declines, it is not clear whether the figures have been adjusted for large exchange rate fluctuations which could possibly pose risks to the Brazilian corporations.

VII

Some Concluding Observations

The initiatives on the part of the central banks in advanced economies to go for an unprecedented purchase of assets , in the aftermath of the global financial crisis, has resulted in an increase in liquidity in the world system. This has been accompanied by sharp reductions in the   interest rates to very low, near zero or negative levels.

Indeed, for a good period, the world has been witness to the flow of capital towards the emerging market economies, in search of yield, resulting in the

appreciation of their currencies, and enhancing the leverage of firms and individuals. The reversal of this rising credit-GDP ratio in some of these emerging market economies has already exposed the system to risks and vulnerabilities, which would unravel in the course of any monetary policy reversal by the Federal Reserve.

On the other hand, in the case of many of the advanced economies, notwithstanding the low interest rates, the credit offtake from the system has not been forthcoming. This comes in the backdrop of the unfavourable expectations which continue to prevail in the economy. The reluctance of governments worldwide to go ahead with expansionary fiscal efforts keeps alive the signs of deflation. Despite the very low long term interest rate in the world economy, this gives rise to the risk of an increasing real interest rate, and also an increase in the real value of debt per se, as well as the real value of debt service. This would further add to the woes of the existent borrowers, who would also be confronted with the prices of their goods declining. Forced to sell off their assets, this could result in further decline in the prices of assets, pushing the banks to another round of crisis. In the name of there being an overhang of debt, governments are even reluctant to go ahead with increased expenditure arguing that this would result in further addition to the stock of debt. Given the strict preference for public debt over private debt as securities during times of downturn, the low rates of interest prevalent, and the fact that the economy is operating far below full employment, the governments should spend, so that the problem of "excessive liquidity preference" in the banking system, a la Patnaik, would get resolved. It makes no sense to clubbing public debt with private debt.[2]

As part of the search for yield, we have seen unprecedented mobilization of funds from the international markets, which have made their way into high interest bearing deposits in the emerging market economies. In fact, the credit GDP gaps of certain economies have reached unsustainable levels. In case, governments still stick with fiscal austerity, and count on a bubble-led revival of growth, possibly, with another round of the tightening of monetary policies, with flight of funds back to the advanced economies, we would be again witness to volatility in global liquidity. It is yet to be seen whether there would be a collective endeavour in the global economy

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[2]See (Patnaik,2009a) for a elaboration of this theme along with a critical appraisal of the ideas of Keynes and Fisher in the background of economic crisis.

towards raising a battery of capital controls coupled with fiscal expansion, which alone would be able to deliver us out of the crisis.

What, in fact, are the changing trends of global liquidity to which the international economy is witness to in the period after the global financial crisis? Firstly, there has been a large shift in the share of resources mobilised by non-financial corporations, also in emerging economies, through the issue of international debt securities as against bank borrowings. Second, there has been an unprecedented increase in international credit, in the direction of the emerging economies of East Asia and the Pacific as well as Latin America. The search for yield has reached such a state of desperation that international capital has been ready to invest even in local bond markets. And, most importantly, growing uncertainties in economies have been forcing many of them towards dollarization, resulting in the dollar notes held abroad as a share of the total stock of dollar notes reaching values as high as 65%. In sum, contrary to what has been propagated by the proponents of the BW II postulate, the dollar garners its strength , to an extent, far more than from the trade surpluses of economies that were subscribing to Treasury securities, from the air of uncertainty which prevails over many emerging economies, and, now, even erstwhile advanced economies.

The spurt in global liquidity serves as an incentive for risk taking, and, therefore for facilitating growth , as per the neoclassical paradigm in finance. But hasn't this abundant liquidity been responsible for the boom-bust cycles in economies? Shouldn't the regimes receiving such capital flows be wary of its consequences, and, resort to some regulation?[3] Contrary to the period prior to 2007, when the nodes from which banking flows used to emanate were largely confined to advanced economies, we find that some of these economies in East Asia have not only emerged as nodes of lending, but economies like China have banks which are amidst the top twenty in terms of assets in the international arena. The period post-GFC is witness to the structural shift in the asset portfolio of China in favour of risky investments.

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[3] For a critical overview of the neoclassical paradigm in defence of liquidity and their argument resuscitating the perspective of Keynes relating to the socialization of investment see (Crotty & Epstein, 2014)

The recycling of surpluses, when it is happening through lending done to different economies, is further resulting in the accumulation of safe Treasuries by the recipient economies, through which the Bretton Woods II regime continues to receive sustenance. Though the trade surpluses of Japan continue to be invested in US Treasuries in a big way, the pace at which external liabilities have picked up in the emerging economies due to the accommodative monetary policies of the advanced countries, would be witness to more economies with surplus inflows in the capital account, rather than the trade account, subscribing to the US Treasuries.

Chapter 4

From Financialisation Induced Growth To Deleveraging Induced Squeeze: Emerging Europe

Introduction

An examination of the trajectory of growth of eastern European economies reveals that they were subject to major changes over the last three decades. The economies of eastern Europe, made their transition from full-fledged state-controlled regimes to free market economies in the course of the nineties. This transition was in keeping with the tenets of the Washington Consensus. With liberalization of capital flows and freedom to enter afforded to foreign financial firms, the share of foreign banks in the total assets of the banking system was continually on the rise. Though not part of the euro-area, as part of the European Union, these economies have also benefited from grants and transfers from EU. As a result, these economies were witness to large scale cross-border flows, particularly from banks headquartered in Europe, during the years characterized by a surge in global liquidity. This trend received a further fillip during the years when the central banks of advanced economies adopted quantitative easing policies, which increased access to low cost credit in foreign currencies, till the eruption of the European Sovereign Debt Crisis.

The high rates of growth registered by these economies in the period prior to the global financial crisis were linked to the increase in capital inflows. Given the process of deleveraging resorted to after the crisis by banks in western Europe, Emerging Europe found its accumulation of large foreign capital stocks a problem because of capital outflows, and was forced to adopt a series of steps to restrain foreign capital. Caught in the midst of the three important events of macroeconomic significance: the Global Financial Crisis, the European Sovereign Debt Crisis and the Swiss Franc appreciation of 2015[1], these economies have been forced to revisit the

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[1]The growing demand for the Swiss francs as a safe haven and its negative impact on its exports forced the Swiss National Bank(SNB) to peg the exchange rate at 1.2 Swiss Franc per euro in 2011. By 2014, this had resulted in the SNB accumulating about $ 450 bn worth of foreign currency, amounting to 70% of the Swiss GDP. The sustainability and feasibility of this situation, particularly in the background of projected increases in bond purchases by the ECB forced the SNB to move out of the peg resulting in the Swiss franc's appreciation in 2015 by 25 to 30%. This had immediate consequences on the balance sheets of the Swiss banks which had a large share of their assets

principles on the basis of which their financial system was restructured during the transition. It appears that the east Europeans are making Keynes' advice, "Let finance be national", their motto. This chapter explores the volatility that characterized growth in the emerging Europe region during the Bretton Woods II period. It also explores the evidence relating to deleveraging and the conversion of foreign currency loans into domestic currency debt.

After an overview of emerging Europe in the first section, the next three sections deal specifically with the economies of Hungary, Romania and Poland. We end with some concluding observations, with some speculation on whether, after the current impasse, emerging Europe could become a dynamic periphery in the near future. That is, if Bretton Woods II continues to be a working arrangement, is it possible that these "floaters" of the last decade could transform themselves into "current account economies", and take on the role of accumulators of reserves? The chapter explores the prospects for such a shift.

I

Capital Flows and Emerging Europe-An Overview

To start with, let us consider how the IFI ratios of the economies in emerging Europe compare with those in emerging Asia during the period from 1994 to 2014, by taking five of the years in the period. In Table 4-1 are included the aggregate data for all economies classified under Emerging Asia(EMA) and Emerging Europe(EME) by the IMF.

As can be seen from Table 4-1, the extent of international financial integration was far higher in Emerging Europe in the period prior to the crisis. The IFI ratios for emerging Europe were both high and volatile. On the contrary, historically, the Asian region has been characterized by far lower IFI ratios. In 1994, the IFI ratio of Emerging Asia was at 66.5 far lower than that of Emerging Europe at196.0. In 2000, the IFI ratio of the two regions had converged in part to 89.2 (EME) and

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denominated in foreign currencies. This also adversely affected the balance sheets of households and firms of eastern Europe and Baltics, which have denominated their loans in terms of Swiss franc, by virtue of the low interest rates.(SNB,2016)

EMA(76.6).It should be noted that the IFI ratio of EMA rose despite the south east Asian crisis. In 2014, six years after the global financial crisis, the IFI ratios of EMA had risen to 106.8, whereas, it had fallen to 113.7 in EME. Of the three economies of Emerging Europe under study in this chapter, Hungary is far more financialised than the other two. Romania was witness to a faster pace of financialisation as compared to Poland, given that the initial level of its IFI ratio in 1990 was far lower. (Figure 4.1)

Table 4-1: IFI Ratios of Emerging Europe and Emerging Asia

IFI RATIOS OF EMERGING EUROPE & EMERGING ASIA ($ mn)								
	Assets	Liabilities	GDP	IFI (EME)	Assets	Liabilities	GDP	IFI (EMA)
1994	70597.2	183402.1	129564.6	196.0	287895.4	697669.4	1481494.4	66.5
2000	149085.1	364702.9	576198.3	89.2	700876.1	1045875.4	2279452.2	76.6
2004	299580.1	728409.0	432698.8	237.6	1396698.7	1512478.8	3496139.8	83.2
2008	809627.4	1662264.9	1852081.5	133.5	3880320.8	2935541.2	7297651.6	93.4
2014	926335.0	2082616.9	2646850.7	113.7	8040650.6	7834718.2	14859492.7	106.8
Source: EWN Database by Lane and Milessi Ferretti(2015) *Author's calculations*								
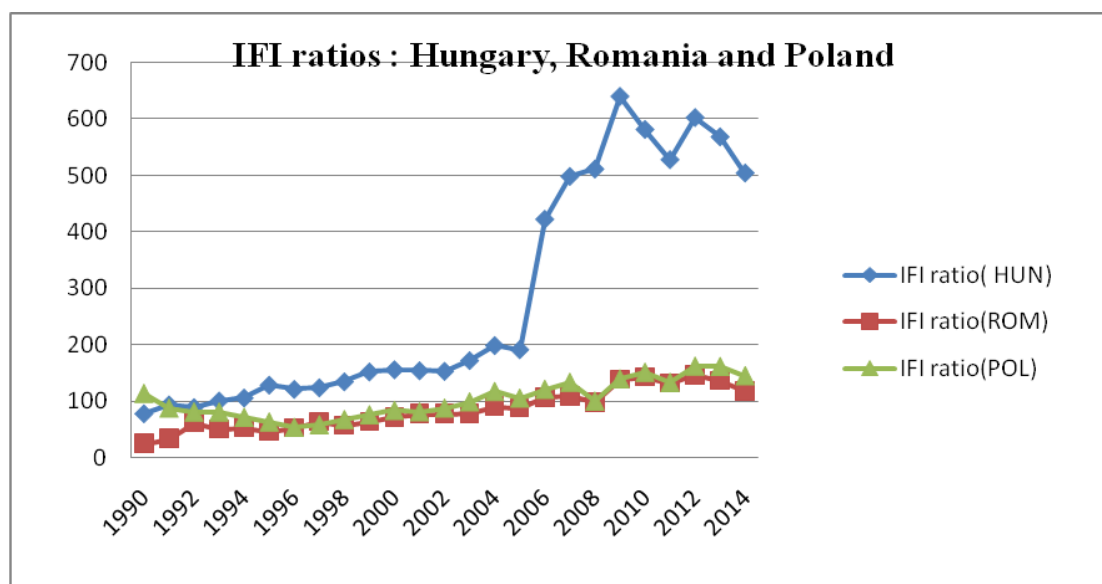
Source: Lane and Milessi Ferretti(2015)

Figure 4.1 : IFI ratios of Hungary, Romania and Poland

It is also important to note that whereas there is an increasing trend of larger financial integration with the international economy in Emerging Asia in the post global financial crisis period, the reverse seems to be the case with Emerging Europe, as reflected in the data on international claims of BIS (Figure 4.2). Many questions arise. Is finance on the retreat from Emerging Europe, or, did the retreat of finance during the global financial crisis prompt governments in the region to dampen capital flows through new regulations? Would these states ultimately surrender to the interests of finance over the productive sectors? Is Asia becoming the new region to which international finance is trying to move?
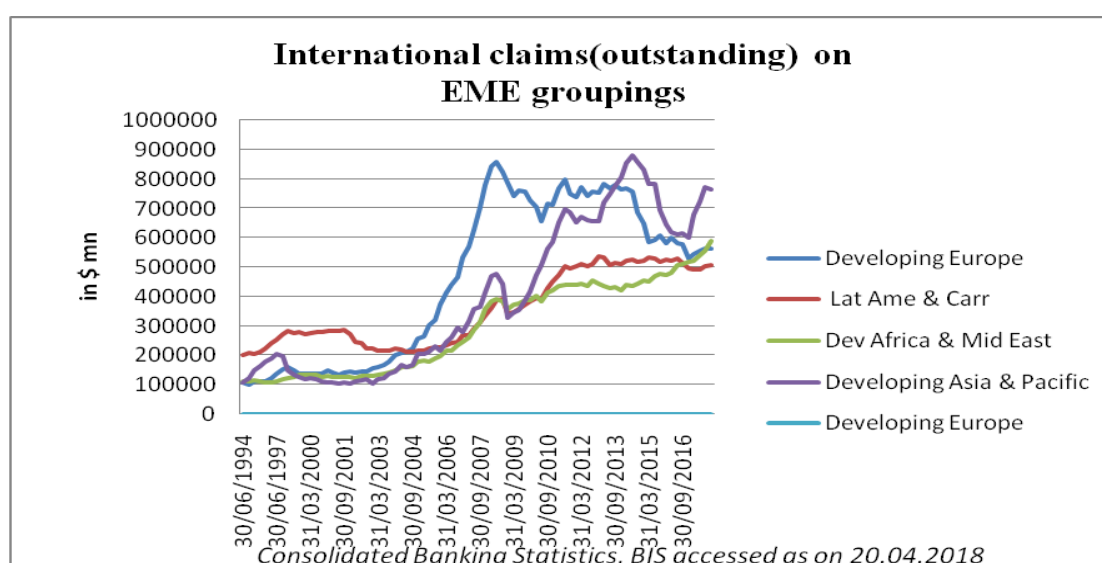
Figure 4.2: International claims(outstanding) on EME groupings

The international claims outstanding on Developing Europe have increased about six times from $142 bn in 2001 to $ 856 bn in 2008, whereas during the same period, in Developing Asia, it increased by over four times from $106 bn to $ 478 bn. On the other hand, since 2008, the international claims on Developing Europe had fallen to almost 60% of their peak, i.e., $ 563 bn in 2017, while those on Developing Asia had increased by 60%, to $ 768 bn (Figure 4.2). But, it is also to be noted here that the international claims on all emerging economy regions, other than for emerging Europe, increased after a dip and reached levels higher than that recorded in2008. In an index of international claims with Base 2008=100, the scores of Developing Asia, Developing Africa and Middle East, Latin America and Developing Europe, as of 2017, are 160.73, 150.75, 131, and 65.7

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respectively(author's calculations), which reveals that except for Emerging Europe, the other developing country groups have been experiencing increased capital flows after the global financial crisis.

Let us look at the rates of growth registered by these economies as reported in the World Economic Outlook Database. Figure 4.3 shows that the rates of GDP growth registered by these economies were extremely volatile. All of these economies experienced a major contraction in their rates of growth in the year 2009, just after the global financial crisis. Whereas the rates of growth of Romania and Hungary fell to negative levels of-6.56% and -7.07% respectively, that of Poland fell to 2.63% in 2009 from the higher rates of growth in the years before.
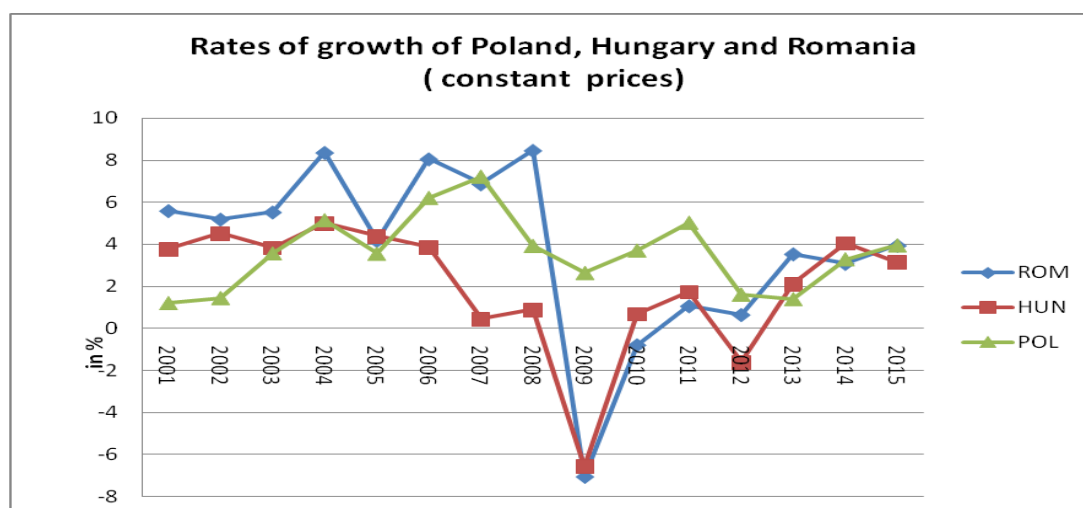
Source: IMF(2019) World Economic Outlook Database

Figure 4.3: Rates of growth of Poland, Hungary and Romania (constant prices)

If we examine how they fared in the period 2001-08, especially 2003-08, as against the period 2009-15 (Table 4-2), we find that the economies of Romania, Hungary and Poland were growing at the rates of 6.91%, 3.07% and 4.93% respectively during the 2003-08 period, which was the period of the high tide of global liquidity. Specifically, the steep increase in two-way flow of capital in Hungary does not reflect in rates of growth even in 203-08 period. The collapse of the rates of growth of Romania and Hungary, the average of which in the 2008-15 period was 1.6% and 0.55% respectively, was far more severe, as against Poland, which continued to grow at an average rate of 3.19% during the 2008-15 period. Having been exposed to large international banking flows, the sudden squeeze had a deleterious impact on the growth in the region, especially given its proximity to those

countries that were directly and indirectly affected by the European sovereign debt crisis.

Table 4-2: Average rates of growth of Poland, Hungary and Romania

	2001-07	*2008-15*	*2003-08*
ROM	6.25%	1.60%	6.91%
HUN	3.69%	0.56%	3.07%
POL	4.04%	3.19%	4.93%

(Source: (IMF,2019) WEO Database)

How did the current account of the region fare when compared with the emerging economies in Asia? As Figure 4.4 shows, all of these economies typically recorded a current account deficit before the crisis. Indeed, Romania had a current account deficit as high as 6 to 7% of GDP, though of course in 2007 it deteriorated significantly to touch 13.83% of GDP.   As against this, the emerging Asian region was characterized by current account surpluses. However, in the immediate aftermath of the crises, all of the European EMEs were witness to a big improvement in the current account, with Hungary even clocking a current account surplus from 2011. But, it should be noted that this improvement in the current account occurred in the backdrop of a reduction in the rates of economic growth.
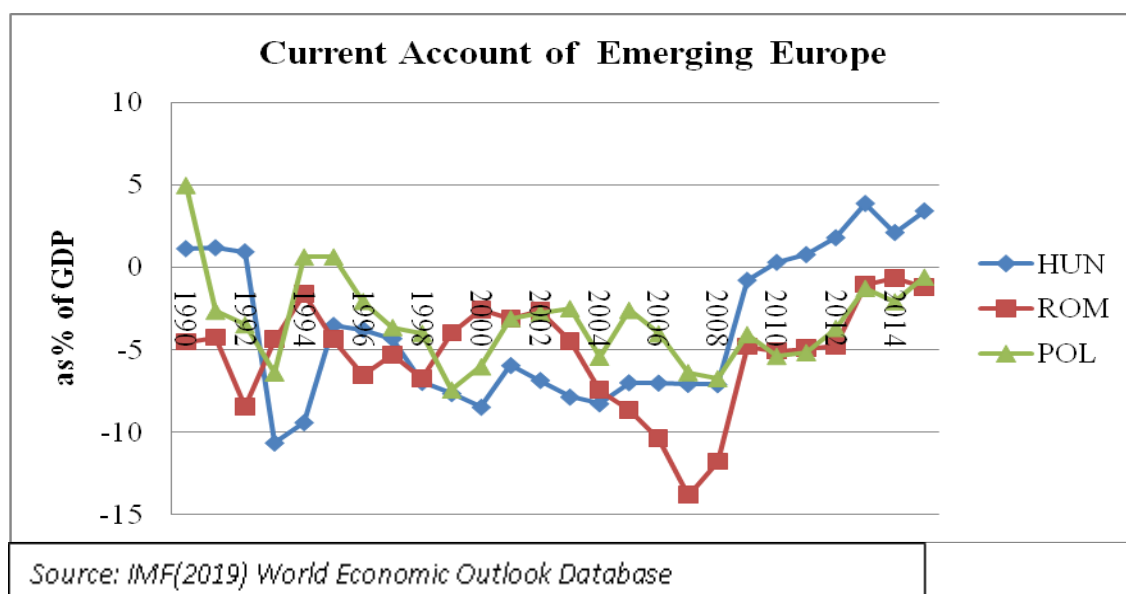
Figure 4.4: Current Account of Emerging Europe

Table 4-3 reveals that the average current account balance relative to GDP of Hungary, which was -7.41% in the 2003-08 period, turned to a surplus of 2.77% in the 2012-15 period. Though Romania and Poland continued to register negative current account balances in 2015 of   -1.22% and -0.62% of GDP, these figures reflected a large reduction in the deficit for these economies experiencing a growth downturn.

The exchange rates of these three economies were consistently depreciating in the period after 1989 till 2000. It should be borne in mind that reforms intended to introduce the market mechanism based on financial programming included measures such as flexibility of the exchange rate and removal of import restrictions. This was notwithstanding the fact that the policymakers in   emerging and developing economies were conscious of the high exchange rate pass through, which in the event of depreciation under a regime of floating exchange rates, would result in sharp increases in domestic prices. That is why there is a widely prevalent fear of floating even now in most of the EMDEs.

Table 4-3: Current account averages and investment-saving gap of emerging Europe (Source: World Economic Outlook Database)

Current account averages of emerging Europe				
	2001-07	*2003-08*	*2008-15*	*2012-15*
HUN	-7.16%	-7.41%	0.52%	2.77%
ROM	-7.24%	-9.44%	-4.30%	-1.93%
POL	-3.85%	-4.63%	-3.64%	-1.93%
Investment-Savings Gap in Emerging Europe				
in %	*2000-08*	*2003-08*		*2009-15*
HUNIVT	25.84%	25.34%		20.96%
HUNGDS	18.52%	17.76%		22.57%
ROMIVT	25.30%	27.14%		26.27%
ROMGDS	18.32%	17.72%		23.04%
POLINVT	21.44%	21.58%		20.68%
POLGDS	17.68%	17.37%		17.48%

The reform process of the nineties in these countries, to facilitate their transition to free market economies were guided by the financial programming approach, which had monetary tightening as its fundamental tenet, based on the premise that inflation was everywhere a monetary phenomenon. Inflation was perceived as demand driven problem, ignoring supply bottlenecks, which would only get worsened by the implementation of credit tightening polices. These economies were therefore witness to steep decreases in their credit to GDP ratios in the nineties. The credit tightening denied credit even to state firms which had the wherewithal to undertake production and sales, and had assured markets, resulting in a large decline in their levels of production, at a time when they were hurt by high import costs because of exchange rate depreciation. The increase in the domestic price level, which led to the appreciation of the real exchange rate of their currencies, adversely affected their balance of payments situation. Supply side bottlenecks too contributed to the increase in price levels. The transition towards independence of banking institutions from the centrally planned mechanism also had its adverse consequences. Rather than providing credit based on merits of the case, outright denial of credit was common in the banking system. This even resulted in the emergence of arrangements for inter-firm borrowings, under which some of the firms with surpluses used to lend to some other firms in need.

The output decline in these economies culminated in the collapse of some banking institutions at different points in time, paving the way for larger participation of foreign banks in the domestic financial system of these countries. In fact, the assumptions on which the programming approach was based made the process of transition far more painful for all economies, other than Poland, which we would see in due course did not adopt similar reform policies.
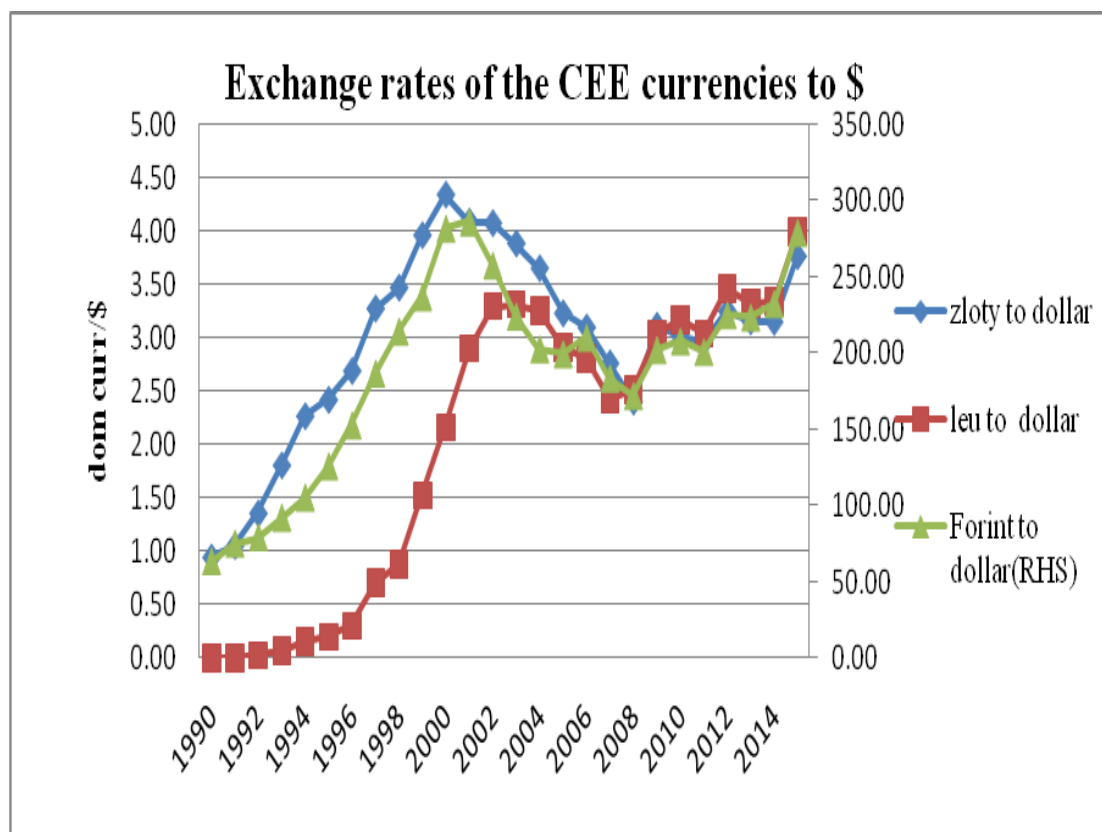
Source: IMF(2017b) International Financial Statistics Yearbook

Figure 4.5: Exchange rates of CEE currencies to $.

Figure 4.5 illustrates the extent of depreciation of these currencies in the course of the nineties, and their subsequent movements in the course of the first decade of the current century till 2007, when these economies were net recipients of capital inflows, and emerging Europe was particularly favoured as a destination for international capital. It needs to be noted that the economies in emerging Europe have been witness to large increases in capital flows on account of banking flows, particularly during the period of the liquidity surge, from 2003 to 2008, after which there has been a reversal. Figure 4.6 illustrates the total amount outstanding in international claims against the economies of Hungary, Poland and Romania, as per the Consolidated Banking Statistics of BIS. It shows that the total amount outstanding of international claims on Hungary and Romania, after a steady increase till 2008, have seen severe contraction since. In fact, Poland, which was the least financialised of these economies, has been affected much less compared to the other two.

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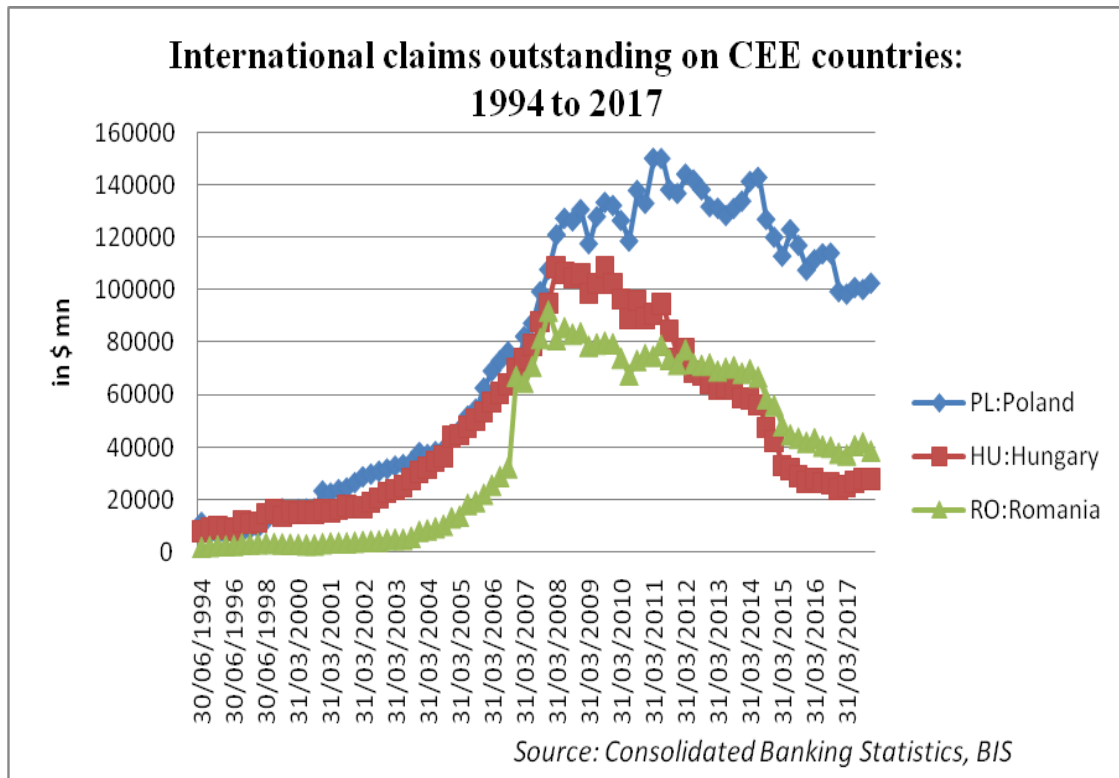
Figure 4.6: International claims outstanding on CEE economies

Whereas the outstanding international claims on Romania has decreased from $ 91.81 bn (53.5% of GDP) in 2008 to $ 41.71 bn (23.5% of GDP) in 2015 and that on Hungary had decreased from $102.64 bn (78.97% of GDP) in 2009 to $ 26.81 bn (i.e., 22% of GDP) in 2015, the international claims outstanding on Poland had declined only marginally from $ 132.31 bn (i.e., 30.3% of GDP) in 2009 to $107.64 bn (22.6% of GDP) in 2015. (Table 4-4)

Table 4-4: International claims ($ mn) on CEE economies

International Claims (in $ mn) on CEE Economies						
	Poland	% of GDP	Hungary	% of GDP	Romania	% of GDP
31/12/1995	6764	4.86%	9104	19.66%	2264	6.28%
31/12/2000	23413	13.67%	16084	34.07%	3048	8.14%
31/12/2005	62643	20.58%	53491	47.51%	21861	21.93%
31/12/2006	70284	20.47%	69837	60.83%	66936	54.18%
31/12/2007	107864	25.13%	95021	68.26%	91807	53.48%
31/12/2008	130759	24.66%	106061	67.43%	83474	39.81%
31/12/2009	132312	30.29%	102636	78.97%	79226	47.15%
31/12/2010	133097	27.78%	89497	68.71%	75125	44.72%
31/12/2011	136846	25.89%	73979	52.78%	71464	38.40%
31/12/2012	131850.6	26.33%	64362.38	50.61%	71615.87	41.72%
31/12/2013	133966.3	25.55%	58837.17	43.69%	68102.77	35.55%
31/12/2014	120162.1	22.05%	42406.26	30.43%	55750.07	27.94%
31/12/2015	107630.2	22.56%	26808.14	22.04%	41707.42	23.49%
Source: Consolidated Banking Statistics, BIS.						
GDP data from WEO Database. Author's calculations						

II

Hungary: foreign capital in banks in mid-nineties to Fair Banking Law after GFC

According to the World Economic Outlook Database, Hungary was characterized by low and even negative rates of growth in the period from 1990 to 1998. The GDP in current dollars grew during the long period from 1990 to 2015 at

10% per annum, and the per capita GDP in dollars grew at 6% per annum. Rates of inflation till the mid nineties were at levels ranging from 18% to 34%. Given the high levels of integration of Hungary with the international economy, both on account of trade openness as well as on account of international financial integration, the international economic environment, and in particular that of Europe, played an important role in determining the pace of growth of the Hungarian economy. Growth gathered momentum during the 2002 to 2007 period, only to experience a reversal as a result of the process of deleveraging in the aftermath of the global financial crisis

It is clear that unfavourable growth prospects had resulted in the investment-GDP ratio shrinking by five percentage points from 25.34% (in the 2003-08 period) to 20.96%(2009-15) in Hungary. In fact, this investment squeeze was accompanied by dramatic increases in the savings ratio from 17.76% average in the 2003-08 period to 22.57% in the post crisis period. Figure 4.7, which traces the decline in investment ratios in Hungary in the 2004-15 period, shows a fall from 24.07% in 2004 to 19.38% in 2012 , before a recovery marked by high volatility.
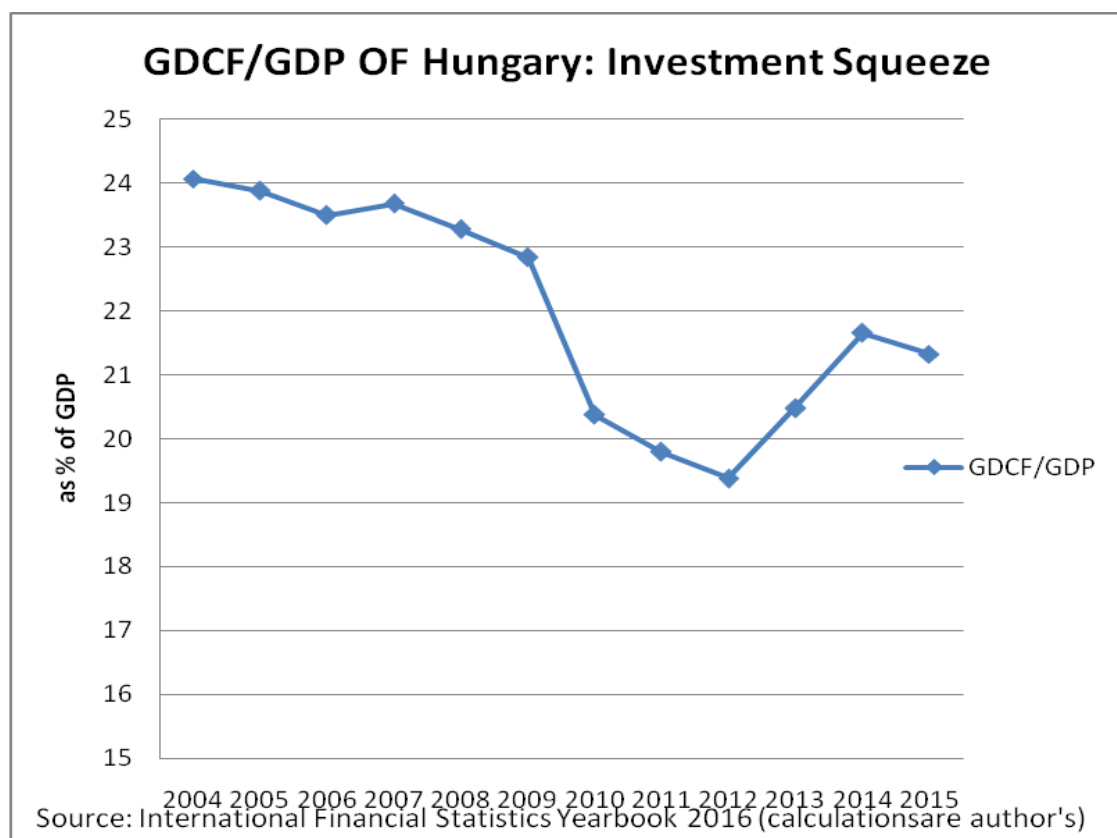
Figure 4.7: GDCF/GDP of Hungary: Investment Squeeze

A perusal of the balance of payments situation of Hungary during the period 2008 to 2015 is instructive (Table 4-5). The negative numbers under the financial account indicate that there has been a net inflow of funds from abroad and the capital minus financial account as a percentage to GDP captures the extent of net capital inflows/outflows into/out of the economy[2].

Table 4-5: Balance of Payments of Hungary: 2009 to 2015

	Balance of Payments of Hungary: 2009 to 2015							
	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Current Account	-10931	-992	346	1132	2189	5094	2765	3946
Curr account/GDP	-6.95%	-0.76%	0.27%	0.81%	1.72%	3.78%	1.98%	3.24%
Capital Account	1673	2286	2365	3267	3250	4846	5126	5504
Financial Account	-16662	-3862	-2783	-4622	5318	-8	4724	13572
Cap-financial/GDP	11.66%	4.73%	3.95%	5.63%	-1.62%	3.60%	0.29%	-6.63%
Net Errors and Omissions	-3231	-1191	-1331	-3472	501	-1606	-1968	-1267
Reserves	4173	3965	4162	5550	621	8342	1199	-5389
Source: Balance of Payments Statistics Yearbook 2017 IMF								

Symptomatic of the declining trend in world trade has been the steep decline of exports of goods from Hungary from $ 105.86 bn in 2004 to $ 88.28 bn in 2015. Imports too declined more or less to the same degree from $ 107.22 bn to $ 83.43 bn. Given the declining investment ratios and low rates of growth, imports were declining at a faster pace, resulting in the current account balance moving from $(-)10.93 bn (-6.95% of the GDP) in 2008 to $3.95 bn(3.24% of the GDP) in 2015 as shown in Table 4-5. The BOPS data reveal that Hungary had a high ratio of export of goods and

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[2] Since the reporting of balance of payments under the financial account in the Balance of Payments Statistics of the IMF is done using the assets-liabilities approach, inflows are shown as negative and outflows as positive. This implies that a negative financial account balance implies capital inflows are more than outflows. The overall inflows under the capital and financial account is reflected in the capital minus financial account.

services to GDP. It increased from 75.5% in 2009 to 86.9% in 2012 and stood at 91.55% in 2015. But, it should also be noted that the ratio of imports of goods and services to GDP has also been very high moving from 71.3% in 2009 to 80.1% in 2012 and 82.5% in 2015. The high export and import ratios also reflect the production undertaken in Hungary by multinationals as part of a larger global value chain. A large part of its trade is directed to Germany, Netherlands and different countries of emerging Europe like Romania and Poland. Hungary also had trade relationships with Russia. Some part of the slowing down of Hungary's trade can be traced to the larger economic crisis in Europe.

Throughout this period there has only been a marginal increase in the balance on the invisibles or services account. But the outflows on account of primary income, i.e., the payments made on account of dividends and interest to foreign investors in the country, have been remarkably high. For instance, in 2010, the payment of $25.4 bn made on this ground amounted to approximately 19.5% of the GDP. In fact, by virtue of being aggressive on investment on direct basis abroad, Hungary has also received $ 19.31bn, or approximately 14.82% of the GDP, as primary income. It is pertinent to note that some of the EMDEs like Hungary and Argentina hold a significant share of risky assets. In the case of Hungary, it could be on account of the large presence of banking firms like OTP in the Baltics and CIS. Moreover the global production value chain has also resulted in a number of firms headquartered in Hungary undertaking production on a segmented basis in different parts of the world. In fact, the balance on primary income in all of these recent years amounted to at least (-) $5bn every year.

Figure 4.8 represents the current account of Hungary in percentage terms for the time period 1989 to 2015. It should be noted that, other than the post 2010 period, Hungary has had a deficit on the merchandise trade front. Invariably, across the years it had a surplus on the services account though this was characterized by a high level of volatility. But most importantly, given the dependence of its economy on foreign capital, there has been a deficit on the primary account reflective of the net outflow on account of investment incomes as well as royalty payments. In fact , in most of the years, balance on primary income has been in the range of -4% to -6.5% of the GDP of Hungary. Given the large capital inflows into the economy in the period since

2001, Hungary has been invariably recording current account deficits of more than 5% in the period from 1998 to 2008.
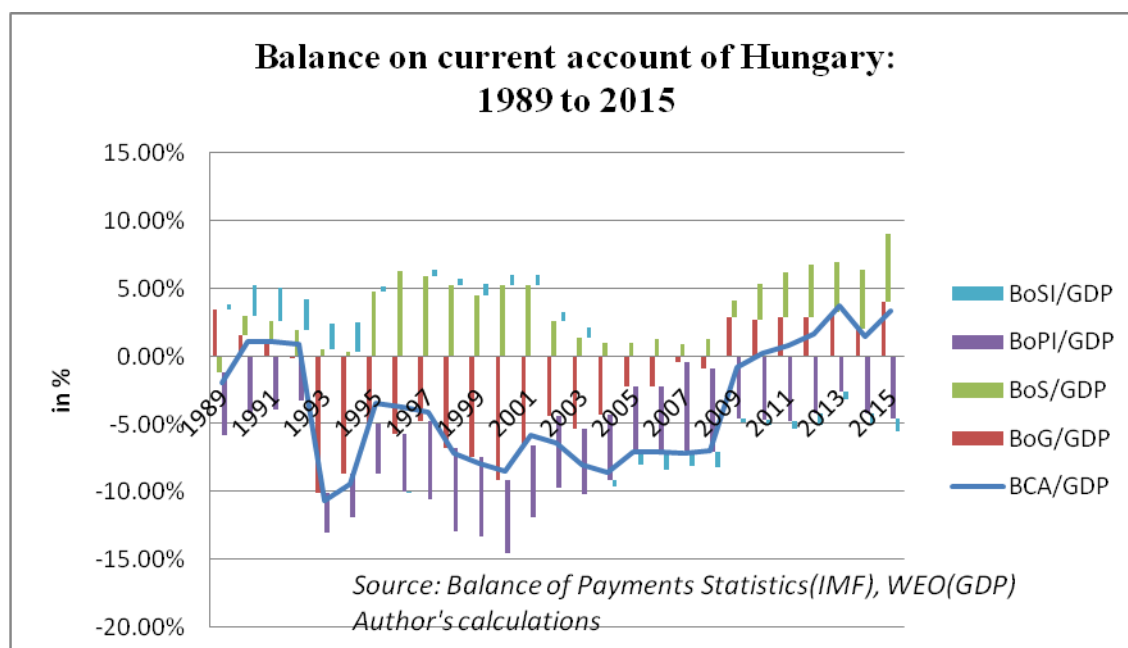
Figure 4.8: Balance on current account of Hungary: 1989 to 2015

Figure 4.9 shows that after a period of large net capital inflows, in the periods from 1992 to 1995, 1998 to 2000 and 2003 to 2008, there occurred a steady reversal of capital inflows after the global financial crisis, especially after the European Sovereign Debt Crisis. On account of the other financial investment (banking) flows, the net financial account as a proportion of the GDP moved from -16.7% in 2007 to 0.9 % in 2015. During 1998 to 2008, when there were current account deficits in Hungary of over 5% of its GDP, the balance on the financial account as a percentage of the GDP was in the range of -8.8% (1998) to a high of -13.2% (2005) (Figure 4.9). After reaching -10.5% of GDP in 2008, there has been steep decline of net capital inflows. The large scale retrenchment of the assets by banks headquartered in Western Europe has also resulted in outflows of finance from Hungary. Prior to its being net recipient of financial flows in the 1998 to 2008 period, for a brief period from 1993 (-15.2% of its GDP) to 1995 (-10.7% of its GDP), Hungary had similarly recorded large net inflows on the financial account.
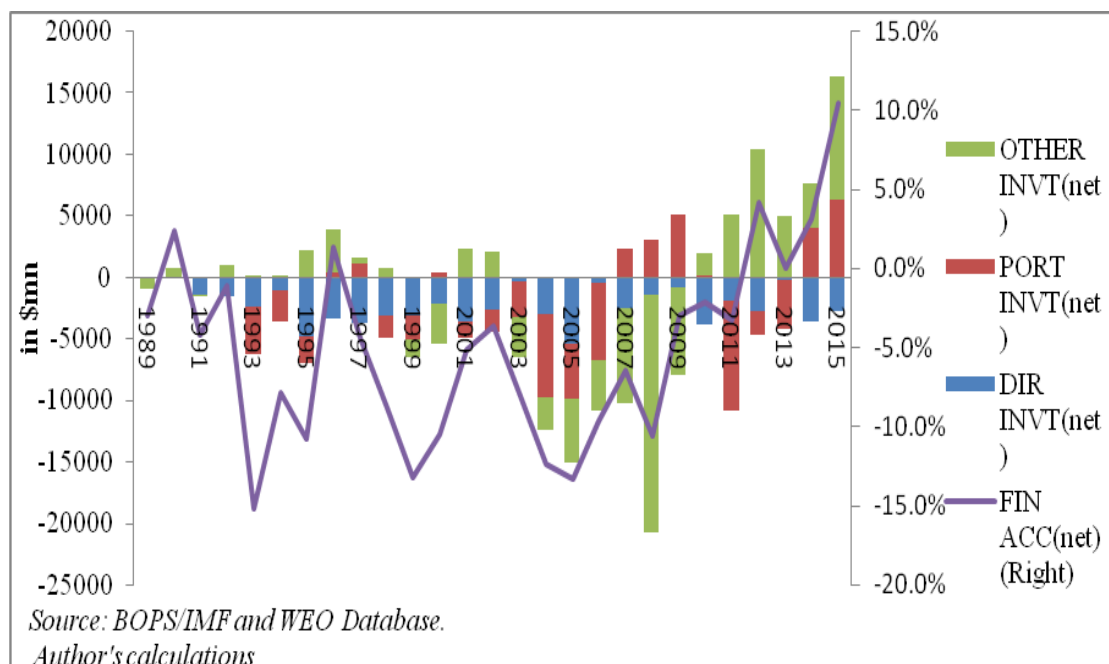
Figure 4.9: Financial Account of Hungary : 1989 to 2015

To be more specific, during 2008 to 2015, we find that in the years 2009, 2010 , 2013 and 2015, Hungary recorded large retrenchment of FDI assets invested abroad, as also even larger retrenchment of investment done by foreigners within Hungary, with net FDI inflows being positive. In 2009, 2010 , 2013 and 2015, they are positive precisely because the retrenchment done by Hungarians of the foreign investment done abroad was far more than the retrenchment done by the foreigners of FDI in Hungary.

This two way retrenchment of capital occurred not just on the direct investment front, but also on the portfolio investment front : in 2009, there was net sale of FDI liabilities within Hungary of $ 4084 mn and in 2015 of $ 5856 mn . On the other hand, from 2011 to 2013, every year witnessed Hungarians being net sellers of their portfolio assets held abroad. In other words, net FDI outflow was happening from Hungary and retrenchment of the portfolio investment made abroad was making its entry back to Hungary. Under the other investment category, which include the debt instruments held by deposit creating corporations like banks, there have been two way sales of liabilities and assets, by the foreigners as well as by Hungarians, from 2011 to 2014. In fact, the retrenchment of the liabilities in this category has been

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far higher, reflecting the process of bank deleveraging in advanced Europe with ramifications for the Hungarian economy. All of this cumulated to ensure that the net inflows on the capital minus financial account moved from $183.4 bn in 2008 to $7.9 bn in 2011, and further to crash to $ -8.07 bn in 2015. In 2015, the balance on financial account (net) was 10.4% of GDP, implying a net outflow on the financial account of $12834 mn. Ever since the entry of Hungary into the European Union, there have been transfers amounting to 2% of the GDP till 2013, after which it has been 3.5% of the GDP. It seems the this is the only stable component of the Hungarian balance of payments. There had been a significant run down of reserves to the tune of $ 5.43bn in 2015, with the Hungarian forint to dollar rate collapsing from 172.11 per $ (2008) to 225.10 per $ (2012), and further to 279.33 per $ in 2015.

The depreciation of the forint in the aftermath of the global financial crisis is of particular significance given the growing share of foreign currency denominated liabilities in the portfolio of households as well as non-financial corporations in Hungary in the period till 2008. From a position of being highly leveraged on account of debt financed residential purchases during the years of easy credit prior to the crisis facilitated by the large cross-border banking flows, households began deleveraging in the post-global financial crisis period.. There had been a seven-fold increase in international banking liabilities from $ 6.78 bn (12.63% of GDP)) in 2002 to $47.87 bn (34.7% of GDP) in 2008. This was followed by a reduction of international banking liabilities from $ 47.87 bn in 2008 to $ 40.46 in 2010 (Figure 4.10). Further, in the period from 2010 to 2015, there has not just been a steep decline in international banking liabilities, but also of assets. After the steep rise in both banking liabilities as well as assets till 2008, there has been a steep descent in both ever since. While deleveraging by banks based in advanced economies is forcing them to call funds back home, pushing liabilities down, the unsustainable exposure to risk of the banking sector abroad forced Hungarian bankers to reduce their exposure. The data reveal that the balance sheets of the banks in Hungary have been getting leaner.

International assets and liabilities of deposit taking corporations($ mn): Hungary
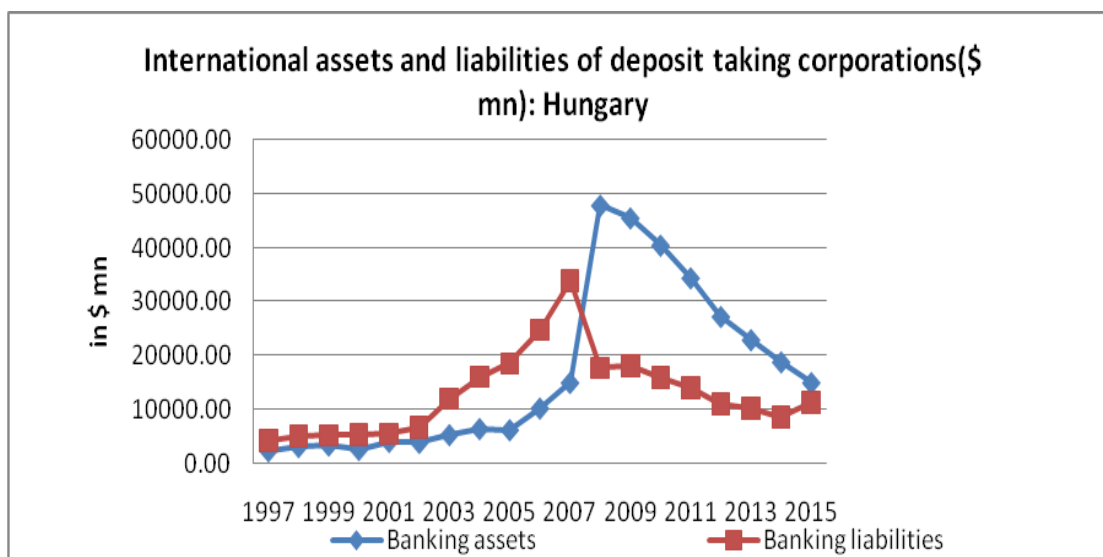
Figure 4.10: International assets and liabilities of deposit taking corporations ($ mn): Hungary

A brief historical excursus into the entry of foreign banks into Hungary in the mid nineties, when the strategy of privatization was initiated by Hungary, would be appropriate here. The period from 1994 to 2007 was witness to large scale privatization and entry of foreign banks.

Though banks owned by foreign investors were present in Hungary since the mid-eighties, through the nineties the share of banking assets held by the foreigners increased substantially. Banai, Király and Nagy(2010) draws attention to the changing contours of banking in Hungary through the nineties[3]. In 1990, the share of foreign ownership was merely 5%, but with successive entry of Australian, Italian, German and Benelux banks, this figure recorded a consistent increase.[4] By the early 2000s, the ownership share of foreign banks increased to 70%.

Given that their focus in the initial stages was to cater to the emerging corporate sector, they did not pose any sort of threat to the local banks which were well entrenched in the retail sector. The local banks continued to dominate the retail

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[3]This section has benefited from this article, particularly, from the overview provided on the changing dynamics of Hungarian banking. (Banai, Király, & Nagy, 2010)

[4] The major players included the Italian banks Intesa and Unicredit, Austrian banks Raiffelsen, Erste and Creditanstalt, , the German bank BLB and the Belgian bank KBC, and well before that Dutch bank ABN Amro.

market, given their awareness of the credit history of the borrowers. Moreover, an extensive banking network was required to address the demands of the retail sector, and given the opportunities available in the corporate sector due to the large entry of multinationals into Hungary in the early part of 2000, the retail sector looked far less lucrative. Income from interest spread was the main source of income for banks in Hungary.

Over a period of time, with competition in lending to the corporate sector intensifying, the foreign banks too were attempting to enter the market for retail loans. Through the opening of new branches, increase in the number of ATMs, as well as increase in advertisement expenditure, the foreign banks subjected the local banks to strong competition. Despite that, the local banks continued to hold on to a larger share of the mortgage backed loans. The return on the mortgage backed loans was determined more by the subsidy extended by the government to forint denominated loans than by the market rates. Indeed, the profitability of the local banks depended heavily on the subsidy extended by the state on the forint denominated loans. Though, over time, a small share of that accrued to the foreign banks, the oligopoly of sorts of OTP (National Savings Bank) and FHB (Hungary's largest mortgage bank) continued for some more years.

When the subsidy extended to forint denominated mortgages came to an end, there was an increase in the foreign currency loans, denominated in Swiss francs, which was initiated by the foreign banks within the country. The lower interest rates prevalent in the international market gave momentum to this phenomenon. To keep up with the tendency among the foreign banks, and to keep their costs at competitive levels, the local banks initiated loans denominated in foreign currencies, by adding to their foreign liabilities. All of this resulted in the increase in the share of loans denominated in foreign currency in Hungary exposing the balance sheets of not just the corporations, but also the households to the risks associated with exchange rate fluctuations.

The total claims of BIS reporting countries on Hungary increased from $36.3 bn (53.7% of the GDP) in 2002 to $163.9 bn(104.2% of the GDP) in 2009. With the

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deleveraging of banks headquartered in different economies of Europe, the total claims on Hungary recorded a continual and steep decline thereafter to $60.17 bn (49.5% of the GDP) as on December 2015. It is pertinent to note here that the claims of German banks on Hungary declined the most from $32.04 bn in 2007 to $6.29 bn in 2015. Those of Austria, Belgium, France, Japan and UK too declined in absolute terms, though not in terms of relative shares (Figure 4.11).

This, in turn, was accompanied by a cutback in domestic lending. The data relating to assets and liabilities of different sectors provided by Magyar Nemzeti Bank (hereinafter MNB) reveals that, in the aftermath of the global financial crisis, whereas the credit extended to the corporates as a proportion of GDP decreased from 40.6% to 19.3% between 2009 Q2 and 2016 Q2, those of households decreased from 46.8% to 20% (Figure 4.12).
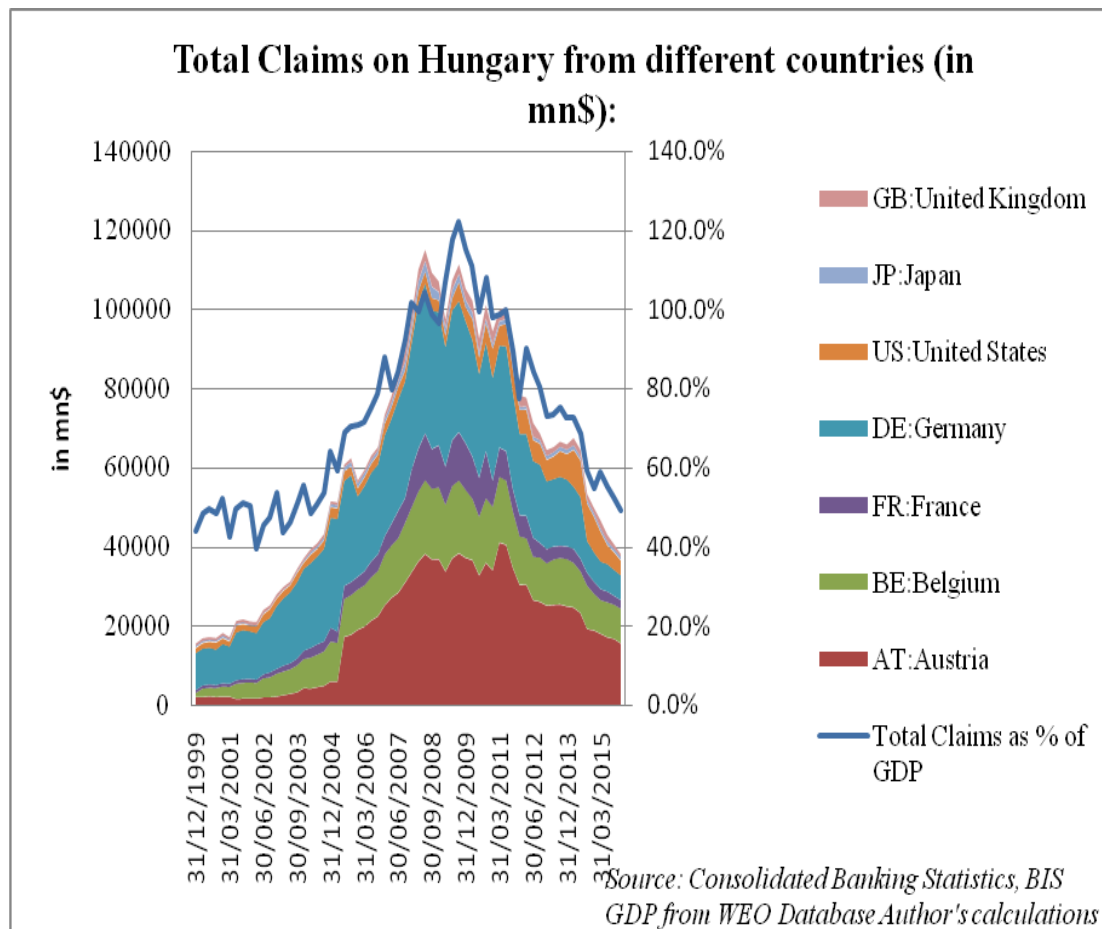
Figure 4.11: Total Claims from different countries (in $ mn)
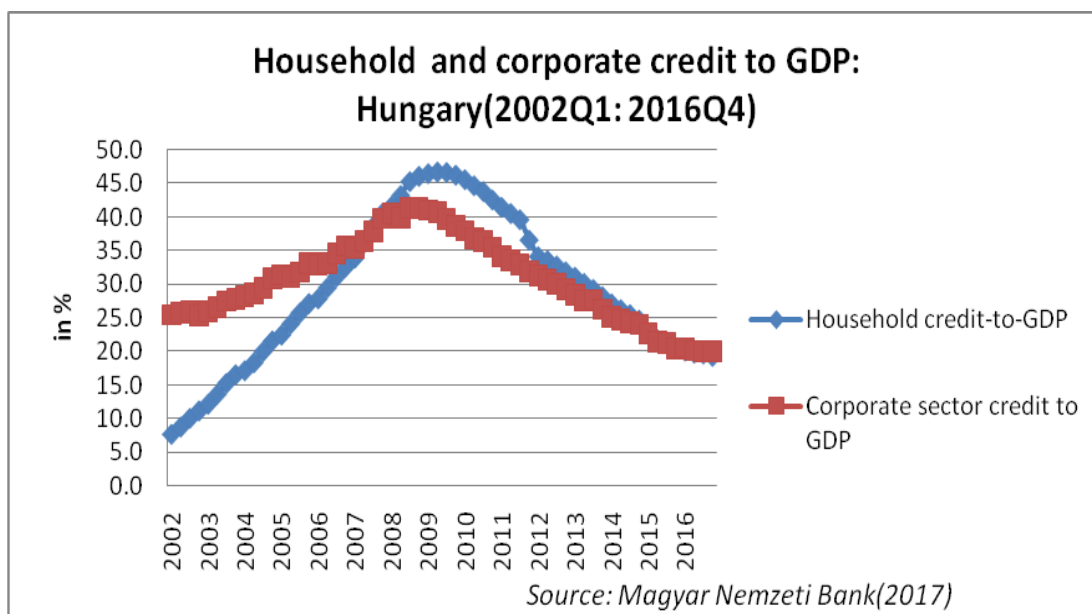
Figure 4.12: Household and corporate credit to GDP in Hungary

(2002 Q1: 2016Q4)

Not only have interest rates in Hungary declined in tandem with those in the international economy, but also the interest rate differentials have fallen drastically. Figure 4.13 illustrates the changes in interest rates in the Hungarian economy during the period 1989 to 2015. However, as Hungarian forint interest rates were higher when compared to that of the euro, the dollar or the Swiss franc, the share of foreign currency denominated loans in Hungary witnessed an increase.
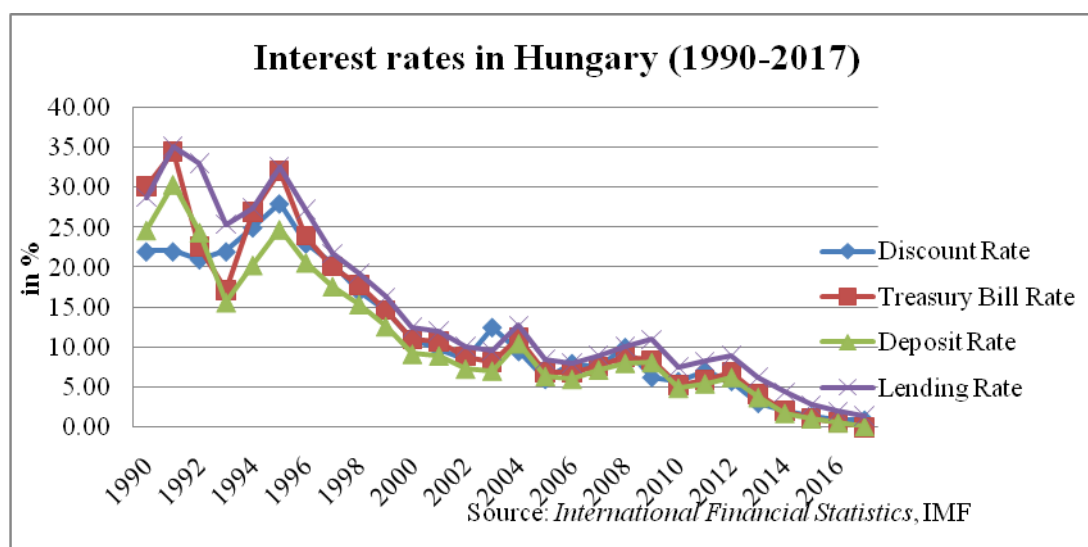
Figure 4.13: Interest rates in Hungary (1990-2017)

Figure 4.14 illustrates the steep increase in the share of loans denominated in foreign currencies in loans issued   in the   period from 1996 to 2009, when it increased from 532.8 bn HUF(i.e., 10% of total loans) to 8785.7 bn HUF (i.e.,73%). Ever since, due to various legislative measures, which came in the aftermath of the global financial crisis, there has been a steady decline, both in the share of loans mobilized(liabilities) and loans issued (assets) of financial institutions.

It is to be noted that the associated exchange rate risks first came to the surface in the course of the global financial crisis, when the forint depreciated vis-à-vis the major currencies. The households had also incurred liabilities in foreign currencies, given the highly favourable interest rates in the international economy and the depreciation of the forint in the aftermath of the global crisis resulted in household balance sheets being adversely affected.
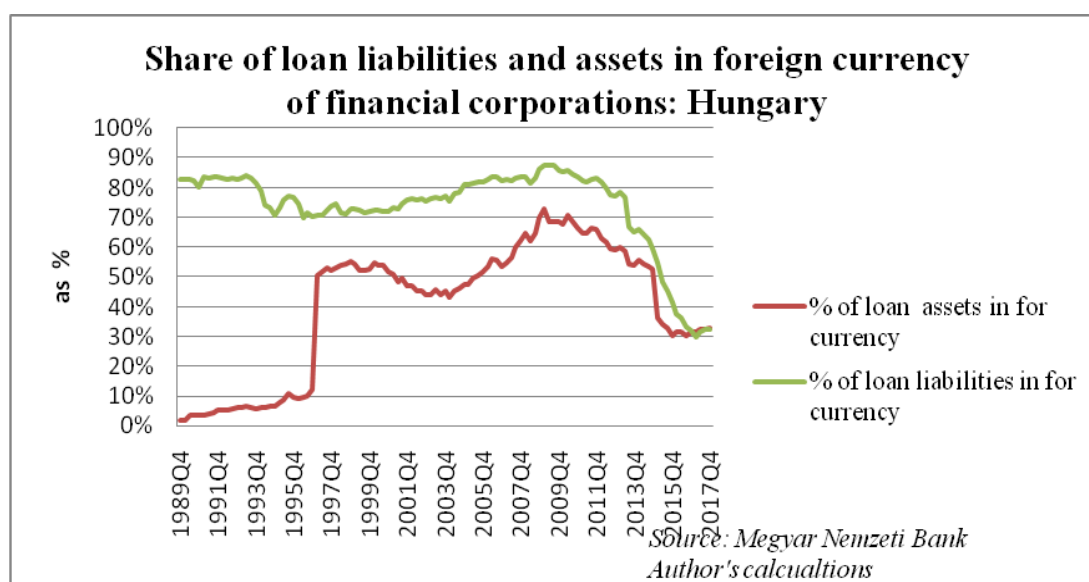
Figure 4.14: Share of loan liabilities and assets in foreign currency of financial corporations: Hungary

There was a strong argument which gained momentum in the aftermath of the global financial crisis, when the Western European bankers resorted to large retrenchment of liabilities, that the consumers ought to be safeguarded against exchange rate risks associated with their liabilities. In fact, there were efforts underway on the part of the government as well as MNB towards reducing the share of the total loans of the households denominated in foreign currencies. While the

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share of foreign currency denominated loans in the total loans of households increased from 13% in 2001Q4 to 70% in 2009 Q1, subsequently there has been a steady reduction (Figure 4.15)

The government had initiated steps towards the conversion of foreign exchange loans to loans denominated in forint. As a result, from being a country which had the highest household foreign exchange exposure in the EU, Hungary became the one with the lowest.[5] From very high levels, the share of foreign liabilities in the loans of households fell to just 2% in 2017. Different legislations introduced by the Hungarian state and Parliament were instrumental in this process.
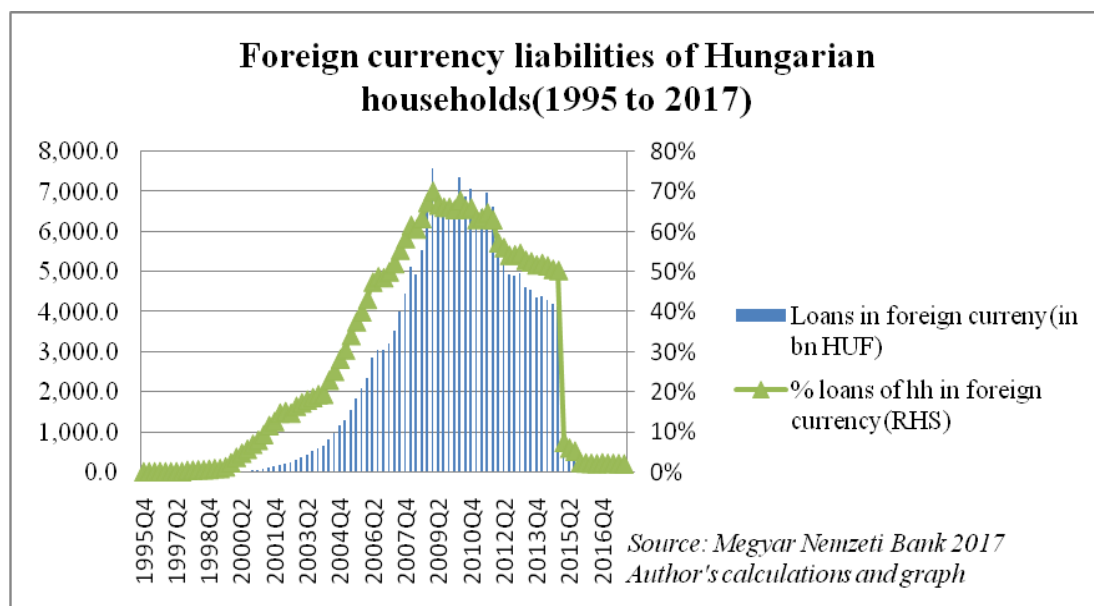
Figure 4.15: Foreign currency liabilities of Hungarian households (1995 to 2017)

With the credit financed boom coming to a halt, and the expenditure of the households and non-financial corporations recording a steady decrease, as reflected in the data, the government was forced to initiate policy measures to stimulate the economy through different programmes. A perusal of the assets and liabilities database of MNB reveals that the net financial worth of households and non-financial corporations as a share of GDP has increased from 58.8% in 2008 to 102.07% in 2016 and -124% to -108% respectively, implying that there has been deleveraging in

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[5]For converting the foreign exchange household loans into ones denominated in forints, the Central Bank provided funds to the tune of nine billion euros to counterparty institutions in order to close their open foreign exchange position at market rates. See Country Report on Hungary (EC,2017)

both of these sectors[6](MNB, 2017). Though government expenditure has been on the increase, the extent of the increase has been found to be wanting.

And most importantly some efforts made by the government to scale up its *Public Works Scheme,* with an intent of employing 223000 workers (5% of the total labour force), had met with criticism. Though employment in the scheme is primarily at below minimum wages, it is at a level which would meet reasonable standards.[7] In 2016, the fiscal expenditure incurred for this purpose amounted to almost 1% of the GDP of Hungary. Even while a report of the IMF has given due credit to the efforts made by the government to redress skill gaps in the economy by putting workers into employment in public infrastructure development, it has been critical of the impact which the programme would have on the increase in unit labour costs on the economy of Hungary ,and therefore, on its competitiveness.[8] (p. 39).

Hungary has been able to find some relief from the effects of the deleveraging process, through the stimulus provided by the government, as well as the partially funded programmes of support from the EU to member states. To expect the government to go slow on spending, when the other sectors are deleveraging and the external sector is hardly buoyant, would, to use Joan Robinson's words, be nothing short of succumbing to the "humbug of finance."[9] And, second, to make an issue of any increase in unit labour costs on the grounds that it would result in a loss of competiveness of the economy, is to underestimate the deleterious effect of such

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[6]This implies that according to the flow of funds summary of the economy, overall the tendency of savings increased amidst households,i.e., they saved more on the net compared to the past., i.e., spending on the decline. And, for non-financial corporations whose net borrowings on a stock basis was 124% reduced to 104%, that is there was distinct case of deleveraging among the non-financial corporations, with their stock of net borrowings decreasing.

[7] This information is reproduced here from IMF(2017) p.38. All data can alternatively be accessed at Ministry of National Economy, Hungary, which reports that the expenditure in this regard has increased from 58.8 bn forints (2010) to 340 bn forint(2016).

[8]The Report observes ….. PWS would tend to add to wage rate pressure if they remove a substantial part (in the case of Hungary about 5 percent) of the labour force from the primary job market's bottom pay scale ….. would lead to rapid increase in minimum wages,…….This would have adverse implications for unit labour costs (ULC) and See IMF(2017)

[9]Lloyd George's proposal of a public works programme to be financed through a fiscal deficit, when unemployment in Britain has reached a million, was shot down by the Treasury on the basis of ill-founded logic of which Joan Robinson(1962) refers to in her book Economic Philosophy as "humbug of finance" , For a discussion of the same read (Patnaik, 2003)

beggar-my-neighbour strategies when pursued simultaneously by the different economies.

The transfer of funds in the form of European structural and investment funds has worked significantly in favour of Hungary, which receives an amount approximately equal to 3.1% of its GDP.[10] An addition to this fillip received by the economy is the Funding for Growth Program of the central bank, initiated in 2013, under which it extends credit to commercial banks at zero percent rate of interest, towards meeting the demands for funds of the small and medium enterprises at a minimum interest of 2.5%. In fact, as per reports, around half of the loan stock of the SMEs in Hungary have benefited from such preferential conditions.[11]

The government has also taken consistent steps to extend direct ownership in the Hungarian banking sector. The Country Report 2015 of the European Central Bank mentions initiatives to nationalise banks by taking them over from private capital and bringing in regulations which address consumer concerns relating to interest rates charged.The state acquired minority stakes in two small lenders, Szechenyi Bank and Granit Bank in 2013. It purchased MKB (the fifth largest bank in the country in terms of balance sheet) from BayerischeLandesbank, paying a price of around 0.05% of the GDP. In another effort, in February 2015, it acquired Budapest Bank, the eighth largest commercial bank from GE Capital for a price equivalent to 0.6% of Hungarian GDP.[12] This was a bank in the government sector providing support to activities like mining, energy and service industries, which was privatized and sold to GE way back in the mid-nineties.[13]

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[10] As per the Country Report of the EC, in the period from 2014 to 2020, it is expected to get an amount of 25 billion euros, which would amount to 62.3% of the public investment in the country.p.10

[11] See EC(2017) Country Report Hungary p. 24. Although state owned enterprises were vested with a moral and financial interest in maximising their profits , the chronic loss makers among them were not allowed to fail . They were also bailed out with financial subsidies or other instruments. Firms could count on surviving even after registering chronic losses .This is the soft budget constraint, now the concessional loans extended to SMEs has to be seen in this regard See Kornai(1979).

[12] See page 30 and 31 of European Commission(2015) Country Report Hungary 2015 Including an In-Depth Review on the prevention and correction of macroeconomic imbalances.

[13]The commercial banks initiated by the state towards providing credit services for different sectors in the eighties were Hungarian Credit Bank(MHB) (manufacturers), National Commerce and Credit Bank (OKHB) (for agricultural producers) and Budapest Bank(BB)(for mining, energy and service industries).

The government has established a new complex financial centre with the extensive network of the 2700 branches of Hungarian Post,1600 units of savings associations and the Hungarian Development Bank Group. Under the Funding for Growth Program, the banks have been encouraged to extend loans to credit starved small and medium enterprises. Under the scheme, the banks are granted zero cost financing for further lending to small and medium enterprises at a fixed cap margin of 2.5%.

The initial round of forex conversion on mortgages was followed with a "Fair Banking Law". The Fair Banking Law enacted by the Parliament has established strict conditions on changes in interest rates and fees charged. Most importantly, the legislation passed has limited the interest rate spread above the three month inter-bank money market rate (BUBOR) for converted mortgage loans at 1-4.5% and, on other consumer loans at 1-6.5%,[14] though the suggested band is very high. Fortunately for Hungary, it was just weeks before the Swiss Central Bank decided to unpeg the franc that the decision in this regard was taken. The costs of compensating the borrowers for the losses entailed in the course of exchange rate fluctuations were jointly borne by the commercial banks and the Hungarian state.[15] The government had also initiated steps to exercise its authority with respect to arbitrary invalidation of the private contracts entered into with the commercial banks.

The Hungarian government has also taken a decision to nationalize pension funds. Most importantly, in yet another move, the government has decided to impose a tax on banks on the basis of the value of their past assets. The bank rate proposed in Hungary is far higher compared to that in other countries. Increasing the share of national ownership of the assets of the banking system has been an important consideration of the government as well as the Central Bank. In the Financial Stability Report 2015 it was argued that domestic ownership should be at least be 60%(MNB, 2015).

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[14] For details relating to the ACT CCXXXVII on Credit Institutions and Financial (Fair Banking Act) see
[15] For further details see Box 2.2.1 (p.28) of EC Country Report of Hungary

After providing a glimpse of the transition of finance in Hungary from a state-centred one to a market-driven one in the mid-nineties, this section highlights the developments in the aftermath of the global financial crisis, which point to a reversal of the earlier trend. The risks posed by the rising share of foreign currency liabilities with households and firms, and the consequent reduction of policy space for the government, forced the authorities to initiate efforts towards reducing the share of loans extended by the banks in foreign currency to the domestic sectors. There have also been efforts for renationalisation of some banks which were sold long back to the private sector as well as efforts to increase the share of state ownership of the banking system through purchase of stakes in private banks. This coupled with various other legislative efforts at tilting the terms of trade against the profits of the financial sector could improve the fortunes of the real sector in Hungary. The efforts at the direction of credit to the SMEs are of particular importance from the angle of development finance.

The B W II system, despite being a regime characterised by free mobility of capital, has also been witness to a set of economies trying to benefit by adhering to a set of desirable controls, like China did. Events in Hungary post-crisis seem to be pointing in the direction of such desirable controls. This could be paving the way towards consolidating the position of not just Hungary, but also other economies in eastern Europe in the global value chain of production.

III

Romania: From Laissez Faire Banking to Consumer Protection

When one looks at the balance on current account of Romania during the period 1989 to 2015, some aspects stand out. (Figure 4.16) All through these years, Romania had a deficit on the current account, with the deficit reaching a high of 13.94% of its GDP in 2007. The current account deficit was largely on account of merchandise trade and the primary income account. There was a surplus in the both the secondary income as well as invisibles accounts in most of the years.

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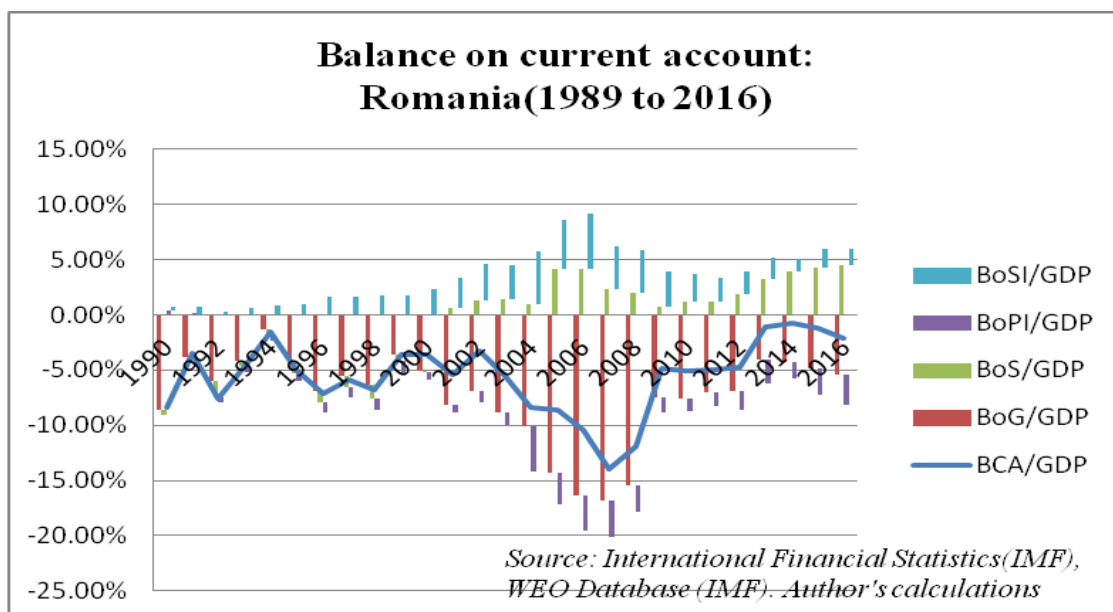
Figure 4.16: Balance on current account: Romania (1989 to 2016)

As per the Direction of Trade Statistics of the IMF, more than 60% of Romania's exports are to advanced economies, with Germany accounting for 25% of its exports. Romania engages in the export and import of equipment, machinery, IT services and food and agricultural products. It is largely dependent on the foreign corporations within its territory for its exports, and, therefore, records a significant payment outflow under investment income in the current account on account of dividends, royalty and interest payments. As per the Financial Stability Report 2016 of the National Bank of Romania (NBR), multinational corporations accounted for at least 67% of the exports of goods and 64% of the country's imports.[16] Romania is an important link in the global value chain, dependent heavily on the technology and organisation of production of advanced economy multinationals, and, hence, has a large net outflow on the primary account. That outflow rose from $ 4533 mn in 2009 to $ 6752 mn in 2015.

It is indeed the inflows on the financial account that enabled Romania to sustain such high levels of the current account deficit over a long period of time, before the process of global deleveraging began. Figure 4.17 on the financial account reveals three important trends. First, the financial account was characterised by net

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[16]An empirical study gives further evidence to the fact that 70% of the Romanian exports and 60% of the imports are generated by multinationals and their subsidiaries based in Romania, and gives emphasis to the role played by the same to the trade deficit of Romania. (Liliana,2014)

inflows in most of the years. In the period from 2002 to 2008, the balance on financial account to GDP moved from -8.8% to -16.7% of the GDP. The net capital inflows during the period far exceeded the deficit on the current account. Secondly, the large fluctuations in the financial account were influenced by volatile banking flows. The net position on account of other foreign investment moved from $(-)2569 mn in 2002 to $(-)19578.7 mn in 2007, implying that there was huge surge of banking inflows into Romania during this period. Thirdly, though net FDI inflows are far lower in the post 2010 period, contrary to trends in the other investment flows which have turned largely negative, they continue to trickle in. This raises the question whether the net FDI inflows could possibly continue to remain positive, taking advantage of the depreciation of the lei in the post crisis period. As of 2015, even as there are outflows under the sub-headings of other foreign investment and portfolio foreign investment, the inflows on the FDI front are higher than those of outflows.

At 6.91%, the rate of growth registered by Romania in the period of the surge in global liquidity was one of the highest in Europe, and was comparable to the high rates of growth of economies in other parts of the world. In 2009, the rate of growth slipped to -7.07%. Though the average rate of growth of the economy in the 2008-15 period of 1.6%, is better than the 2009 figures, it has remained very low. (See Table 4-2& Figure 4.3)
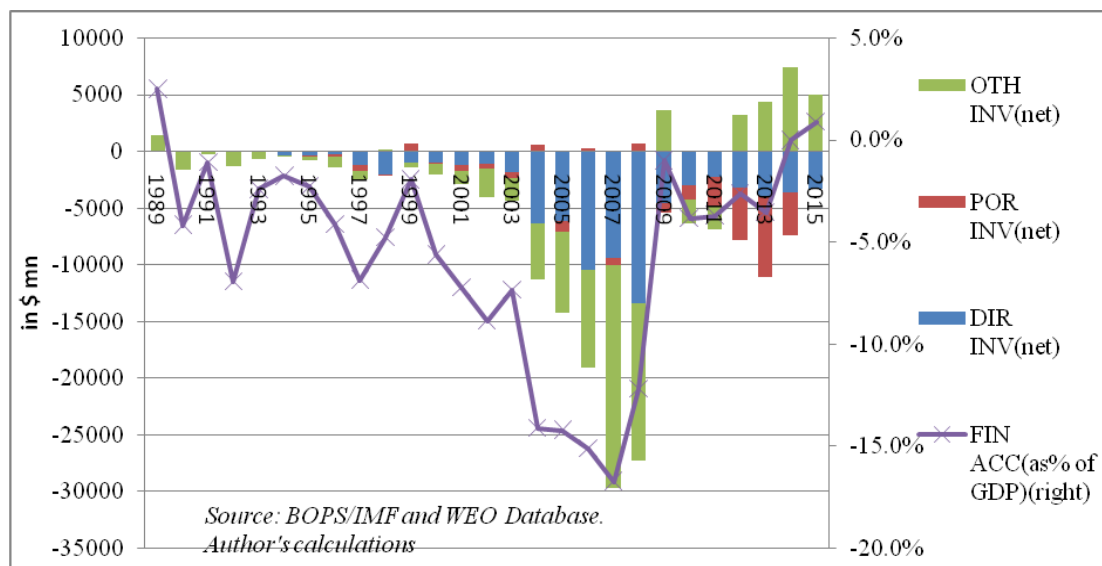
Figure 4.17: Balance on financial account: Romania

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In fact, the balance on current account worsened to -13.8 % of GDP in 2009 , after which Romania, which had got used to reasonably high levels of current account deficits, has been witness to a sharp improvement of the current account. As against the average current account deficit of 9.44% of GDP in the 2003-08 period, the figure was at an average of 3.22% in the period after the global financial crisis. (Table 4-3)

The investment ratio had decreased from 27.14% (average over 2003-08) to 26.27% (average 2009-15), which is not such a big decline, but coupled with a reduction in consumption,   contributed to the improvement on the current account. The concomitant increase in the gross domestic savings ratio from 17.19% (2003-08 average) to 23.04% (2009-15 average) has contributed to the reduction in the current account deficit (Table 4-3).

The period from 2009 to 2015 was witness to the balance on current account moving from -11.92% to -1.18%. Even as the current account deficit declined (Table 4-6), the net financial account inflows were not sufficient to cover the current account deficit in any of the years other than 2008 and 2013. In fact, only after including capital account flows, a substantial portion of which came from the European Union as transfers, could the demand for current account financing be met. In other words, the net inflows in the financial account, even when combined with the net transfers under the capital account could enable the financing of the current account only for two of the years: 2008 and 2015.

Table 4-6: Balance of payments of Romania

Balance of Payments of Romania								
	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Current account	-24986	-8234	-8479	-9276	-8199	-2077	-1382	-2096
Current account/GDP	-11.92%	-4.90%	-5.05%	-4.98%	-4.78%	-1.08%	-0.69%	-1.18%
Capital account	815	868	258	991	2423	4048	5206	4337
Financial account balance	-26109	-1747	-6392	-6781	-4478	-6754	3	1609
(Cap-fin account)/GDP	12.84%	1.56%	3.96%	4.18%	4.02%	5.64%	2.61%	1.54%
Net errors and omissions	-1988	952	673	1706	1529	100	139	263
Reserves change	-51	-4667	-1156	202	230	8825	3960	895
*Source:*IMF(2017) Balance of Payments Statistics Yearbook. Calculations are of the author's								

To explore where the trouble lay, let us look at the disaggregated figures in the financial account. For here is a country, whose current account has improved but yet couldn't find sources to support the same through net financial inflows. On the net direct inflows front, in all of the years we find that the net FDI inflows have been positive. In some of the years, i.e., 2012 and 2013, since there was attrition of assets held abroad by Romanian nationals, it served as an additional inflow for Romania. On the portfolio account, though there were net sales of portfolio liabilities in 2009, in all the other years there were net portfolio inflows, which indeed grew from $2525 mn in 2011 to $7476 mn in 2013, after which there was a decline. And Romanian nationals also did increase their exposure to portfolio investments abroad, but the quantum of outflows on this account was far lower: $601mn(2012), $296mn(2013),$ 130mn (2014) and $330 mn (2015).

It is, in fact, in flows in the banking account, categorized under 'other investments' that the mayhem occurred. There was a large scale winding up of the debt liabilities which happened, when in the context of bank deleveraging worldwide, parent countries called back funds. In fact, this was what reignited the debate on the need for caution with respect to cross-border flows, and underlined the importance of the regulation of such flows. Other than the years 2008, 2010 and 2011, all the years

witnessed foreign bankers resorting to large scale disposal of the assets they held. Over the years, this has resulted in the stock of banking liabilities of Romania showing a steep decline.

During the period of surge in global liquidity, the banking liabilities increased by over thirty six times in the course of six years, from $1bn (amounting to 2.17% of GDP) in 2002 to $ 36.39mn (17.36% of GDP) in 2008 (Figure 4.18). The exchange rate of the Romanian lei per dollar depreciated during this post-global financial crisis period from 2.519 lei per dollar in 2009 to 4.006 per dollar in 2015.
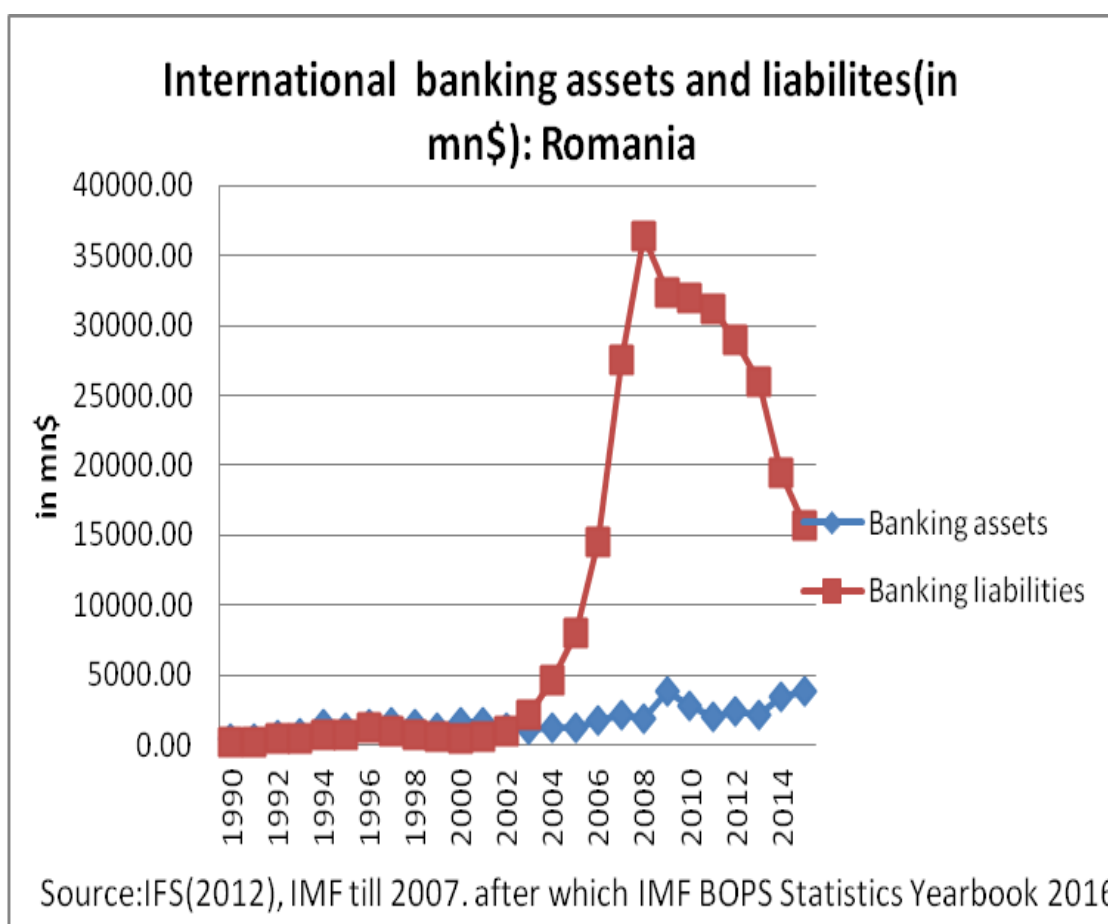
Figure 4.18: International banking assets and liabilities (in $ mn): Romania
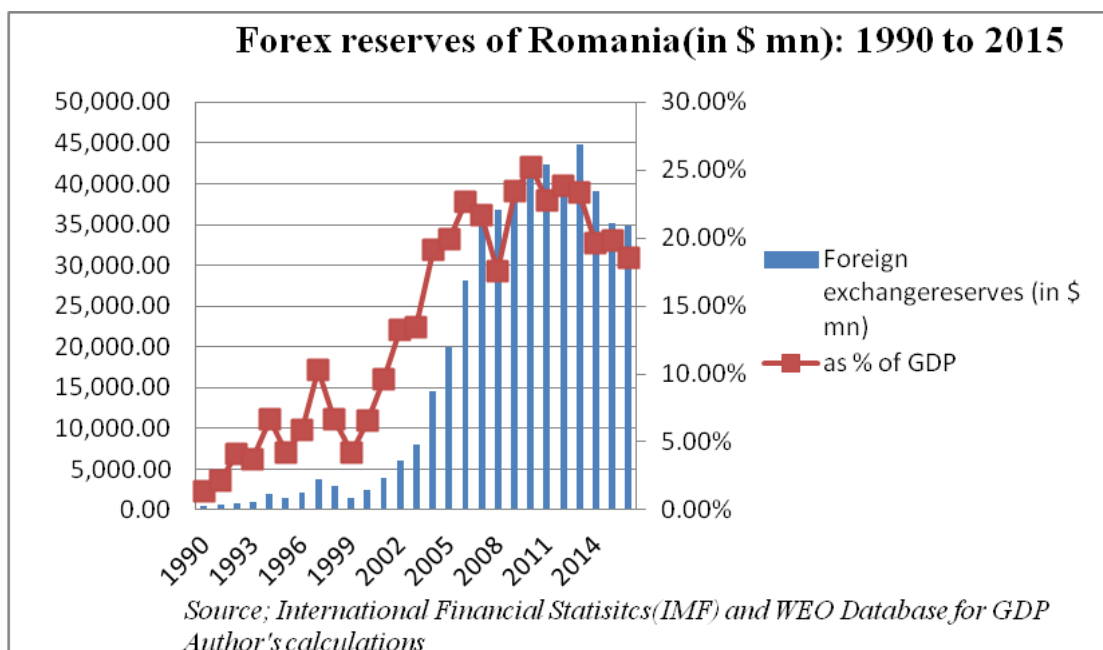
Figure 4.19: Forex Reserves of Romania ($ mn): 1990 to 2015

Given that in the last two decades prior to 2015, there has not been any year in which there was a surplus on the current account, the forex reserves accumulated have been on account of the inflows on the financial account. The forex reserves recorded a steep increase from $ 6.12bn (13.26% of GDP) in 2002 to $ 42.30 bn(25% of GDP) in 2010, and fell to $ 35.16 bn (19.8% of GDP) in 2015 , due to the net capital outflows on the banking account (Figure 4.19).

As per the Country Report for Romania for 2015 of the ECB, foreign banks accounted for 76.4% of the assets of the banking system in 2009 (EC, 2016). There has been a decline in this share to 69.2% in 2013. In fact, there has been a large attrition of banking capital in the economy due to flows back to the parent country in the backdrop of the global financial crisis as well as the European sovereign debt crisis. But, since the foreign banks continue to hold a significant proportion of the total assets of the banking system, their control over the Romanian financial system faces no serious challenge.

In various reports on the banks which share more than 80% of the market, the names of a very few banks of Romanian origin figure.[17] The only banks

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[17] The information has been taken from www.export.gov/article?id=Romania-us-banks and thebanks.eu/banks-by-country/Romania. BCR (Erste Austria), BRD – SocieteGenerale (France), Raiffeisen Bank (Austria), UnicreditTiriac Bank (Italy), Alpha Bank, Bancpost and Piraeus Bank(

headquartered in Romania, which figure in the list, are BancaTransilvania and CEC (a state owned bank). The total consolidated claims on Romania from different economies had increased from $9.99 bn , i.e., 16.7% of GDP (2000) to $130.39 bn, i.e., 75.95% of the GDP(2008). The consolidated claims on Romania fell to70% of the GDP in 2009 and to 44.6% of GDP in 2015 (Figure 4.20). More than the decline in the aftermath of the global financial crisis, the sovereign debt crisis in Europe took a toll on banking flows to Romania.
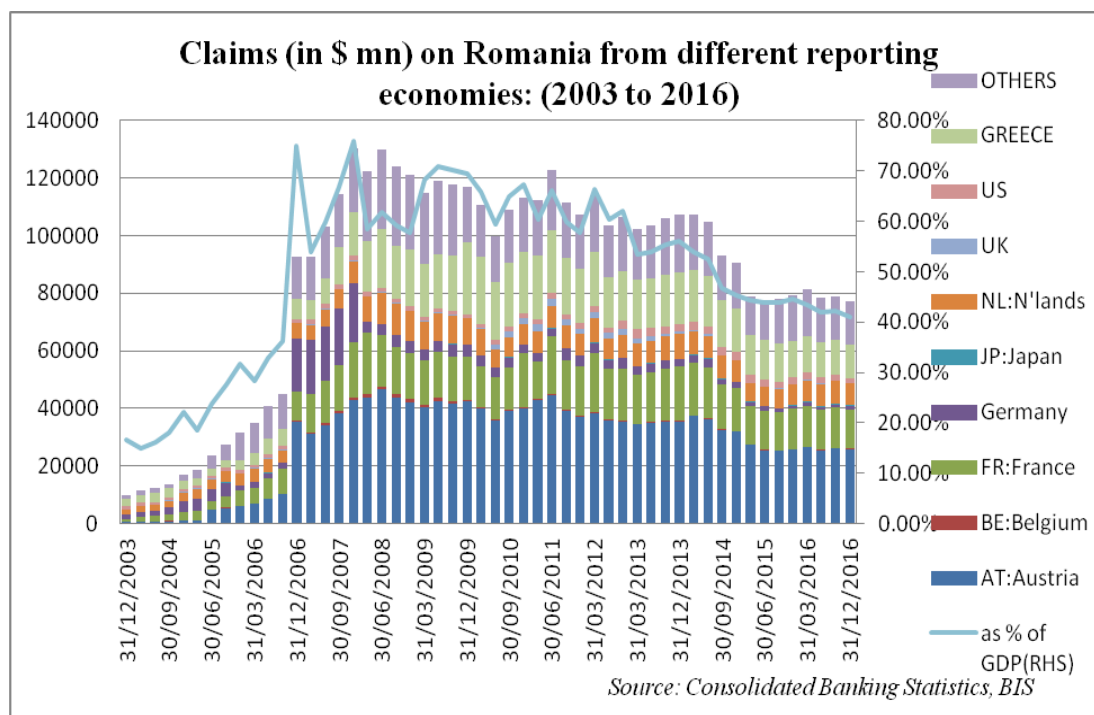
Figure 4.20: Claims (in $ mn) on Romania from different reporting economies: 2003 to 2016

Data from BIS reveal that of the total international claims on Romania of $ 64.58 bn(2007), 60 % was of short term maturity of less than a year.[18] In the aftermath of the global financial crisis, a set of economies including Romania had approached the European Union to press for an agreement with respect to the renewal and rollover of short term liabilities in order to ensure financial stability. The Vienna Initiative was the result (NBR, 2010).

Greece) Garanti Bank (Turkey) and OTP Bank(Hungary) are the main banks which figure in most of the lists.

[18] Though the international claims of less than one year have since declined and are at 26% in 2015, the level is still risky.

It should be noted that though the pathetic performance of the banks during the nineties was attributed to "government   failure", the financial programming approach of the IMF based on monetary tightening and exchange rate liberalization played an important role in   driving the industrial economy of Romania to lower levels of output through a credit squeeze.[19] The crisis of 1998-99 was a pretext for further liberalization with capital account convertibility. Since then, the role of banks as facilitators of long term finance has given way to that of short term asset management, with the motive of making quick returns. Insofar as the decisions of NBR were antithetical to the interests of foreign banks based in Romania, they were able to reverse them by holding the system captive.[20] In fact, pursuing independent economic policies with a focus on domestic issues became virtually impossible in Romania. Contrary to the other eastern European banks, when NBR went slow with respect to the issue of sterilization bonds in 2005 as a response to the speculative games resorted to by foreign banks, large capital outflow was the fallout, resulting in the depreciation of the Romanian leu. The central banks in eastern Europe had to provide for safe investment avenues for foreign commercial banks to keep capital captive in the region (Gabor, 2010).

As per the records of the Central Credit Register of the National Bank of Romania, the loans extended by the different credit institutions in the country had increased from 7103 mn lei (Jan 2000) to 331143 mn lei (Dec 2015)(Figure 4.21). The loans outstanding figure has increased at a far faster pace, in the period from 2000 to 2008, with 258960 mn lei of loans recorded in the Central Credit Register of NBR, as on December 2008, more than thirty times higher than in January 2000.[21] In fact, the ability of the Romanian financial system to provide credit both in domestic and foreign currencies through its multinational banking system based on increased leverage, the reduction in loan to value ratios and the issue of debt securities, resulted in the enlarged credit offtake in the period prior to 2008.

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[19]See for details on Romania, (Gabor, 2010). For the theoretical engagement with the contractionary impact of the policies of adjustment see (Chandrasekhar, 1995).

[20] Gabor's study brings out the political economy compulsions of decision making in central banks, in Romania.

[21] The data has been accessed from (NBR, 2018)
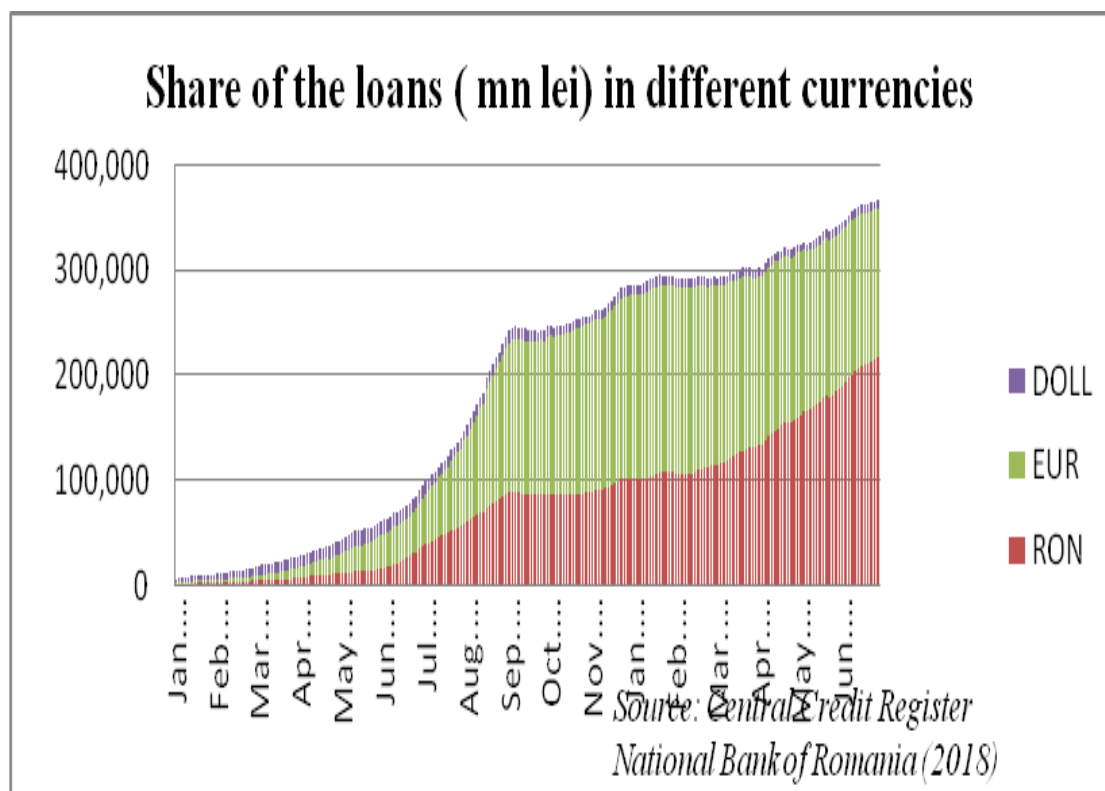
Figure 4.21: Share of the loans(mn lei) in different currencies

It is important to note that the share of loans denominated in foreign currencies in Romania rose significantly in the years from 2000 till 2016. Starting from a share of just 16% in January 2000, almost half of the total loans outstanding in 2015 were denominated in euros. In the period from January 2000, it was only in June 2016, that more than 50% of the loans outstanding was denominated in the national currency. Though attention was drawn to the exchange rate risks posed by the foreign currency denominated mortgages on household balance sheets by the various reports of the NBR, it was only with the Swiss franc appreciation in 2015 that a legislation promoting forcible conversion of foreign currency denominated mortgages into lei was enacted. This resulted in the share of lei mortgages, which were as low as 4.5% (2012) increasing to 61.6 %(2018) (Figure 4.22). Since the swiss franc appreciation of 2015, there has been a perceptible increase in the share of lei-denominated assets in the Romanian banking system.
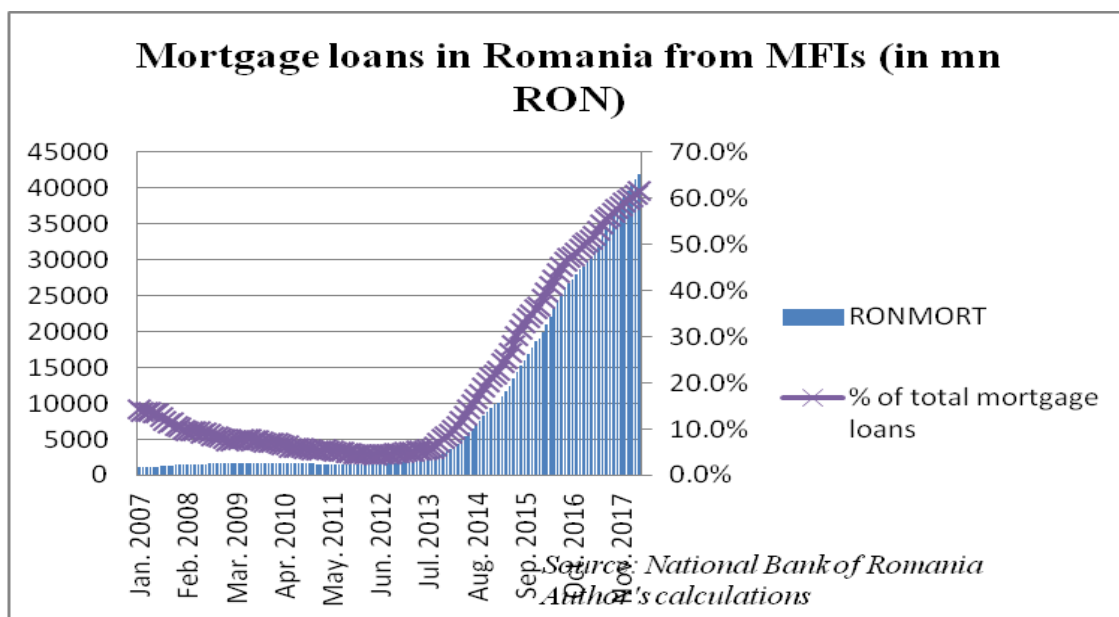
Figure 4.22: Mortgage loans in Romania from MFIs (in mn RON)

Since 2001, there has been a large expansion of the external assets and liabilities of Romania. Like a typical trade account economy under the Bretton Woods II regime, Romania has its assets largely in the form of foreign exchange reserves, whereas its liabilities have been in the form of debt-creating banking inflows and foreign direct investment. From less than 5% of GDP (1999), the forex reserves have risen to 25%(2011). But the reserve accumulation has been on account of debt-creating inflows, since there were few years when Romania had a current account surplus. Yet another initiative from the legislature of Romania (*datio in solutum*) that was passed by Parliament, was the provision of rights to persons to hand over assets procured with debt back to the bank concerned, so that the latter bears the brunt of any decline in the price of the asset.[22] Indeed, this is legislation of an unprecedented sort, and court litigations apart, pioneering.[23]

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[22] Law 77/2-16 on *datio in solutum* : inasmuch as the value of the loan relating to an immovable residential property worth less than 250000, the consumer has the right to transfer the titles to the property to accept the full discharge of the mortgage backed debt. For there has been severe depreciation of the properties acquired on account of depreciation of the currency, the law should also be applicable to the existent contracts. The bankers felt that the retrospective application of the laws was in violation of the constitution.For a letter written to the Commissioners in EC protesting against their letter to the Romanian Minister for Public France, Ms Anna Dracu see http://www.beuc.eu/publications/beuc-x-2016-042_mgo_ms_anca_dragu.pdf

[23] Even the law intended with respect to the conversion of swiss franc have met with some objection from the court, though the majority of the new loans , as per the recent reports of NBR, have been denominated in leu.

NFA and NFA/GDP of Romania
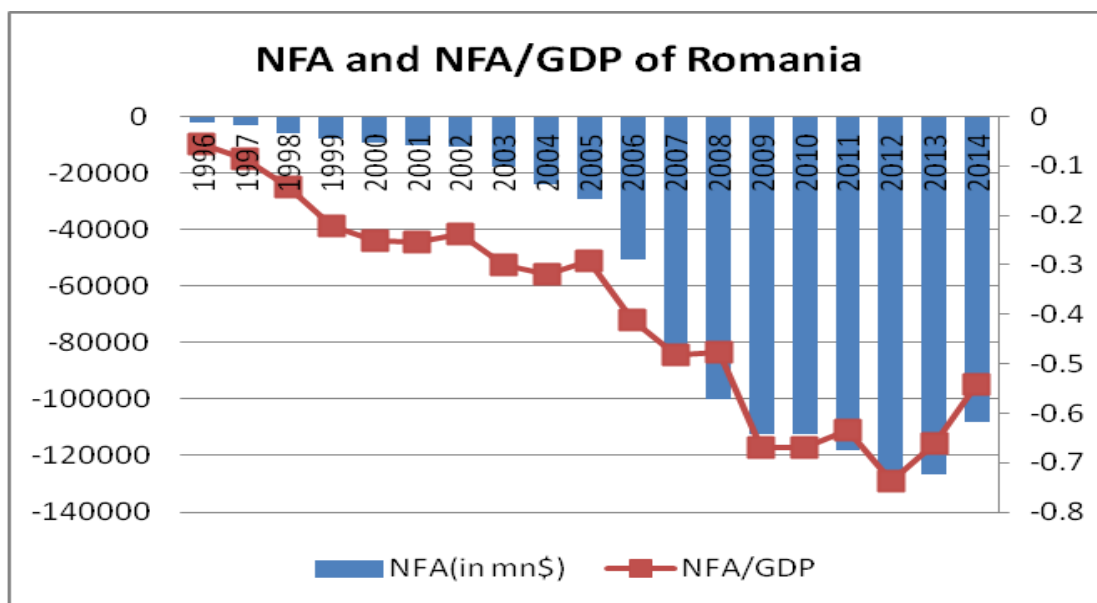
Source: IMF(2017)Balance of Payments Statistics Yearbook & IMF(2019) WEO Database. Author's calculations

Figure 4.23: NFA and NFA/GDP of Romania

The NFA of Romania had worsened from $(-) 50 bn in 2005 to $(-)127.07 bn (i.e. from -30% to -73.86% of the GDP) in 2012. The various inflows on the financial account, both of a debt-creating kind like loans and non-debt creating kind like FDI have been adding to the liabilities of the country. Ever since 2012, there has been a reduction in the NFA. In 2014, it became $ (-) 107.92 bn (i.e. -54.2% of GDP). (This comes in the backdrop of a reduction in the current account deficit, due to the process of household deleveraging, the outflow of banking capital over the years due to deleveraging in the parent country, as well as due to the depreciation of the lei as against dollar from 2.52 to a dollar in 2008 to 3.35 to a dollar in 2014. Inasmuch as the improvement in the NFA position has not been due to the underlying strengths of the economy like buoyant rates of growth, or growth of exports, not much needs to be read into this.

The volatile nature of growth in Romania is inextricably linked to the volatile nature of global liquidity. The links of the Romanian economy with the international economy through the global banks was total till at least the global financial crisis. The preponderance of banking capital flows from abroad has made the policy establishment in Romania captive to the interests of the foreign banks in the economy. Though there has not been a substantive decline in the share of foreign banks in the

assets of the Romanian banking system, certain developments like the steep reduction in the foreign currency denominated loans, increase in local claims as well legislations with an intent of protecting consumers, mark a big departure from the overtly financialized regime in Romania, in the period prior to the global crisis.

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IV

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Poland : Increasing share of public and domestic banking

The rates of growth registered by Poland in the course of the last two decades have resulted in its catching up with the rest of Europe. Poland registered an average rate of growth of 4.93% between 2003 and 2008. Even during the growth slowdown elsewhere, the Polish economy grew at the rate of 3.19% over the 2009 to 2015 period (Table 2). The programmes of the European Union like the European Structural and Investment Funds (ESI Funds) and the European Fund for Strategic Investments, have bolstered infrastructure capacity in Poland in a big way.[24]

What does the data relating to the balance of payments of Poland from 2008 to 2015 reveal? The current account deficit as a percentage of GDP has in this period decreased from 4.63% (2003-08) to 3.19% (2009-15), but this comes in the backdrop of the decrease in the investment to GDP ratio by 1% over the same periods. The current account has improved significantly from -$ 35.83 bn (-6.76% of GDP) in 2008 to -$2.93 bn (-0.61% of the GDP). But, given that this is coming in the backdrop of falling investment ratios, it is certainly not encouraging. Gross domestic capital formation had increased from 19.65%(2006) to 22.72%(2010), only to decline to 20.14%(2015)[25].

Riding the tide of buoyant inflows on the financial account, Poland had current account deficits in most of the years. The deficit was within 6% of GDP. In most of the years, Poland had a deficit on the goods front, which was more than 6% of GDP in some of them. On the other hand, it recorded surpluses on the services account in all of the years. In fact, it is one of the few economies in the eastern

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[24] See European Commission(2017a): Country Report: Poland
[25] IFS Yearbook 2016. Author's calculations.

European region which had a surplus on the invisibles front. As an economy highly dependent on foreign capital, Poland, invariably, had a deficit on the primary account. Though, till 2008, there used to be a small surplus on the secondary account, the same turned into a deficit, possibly signalling changing trends in labour mobility, in the light of the relatively better performance of Poland in the region (Figure 4.24).
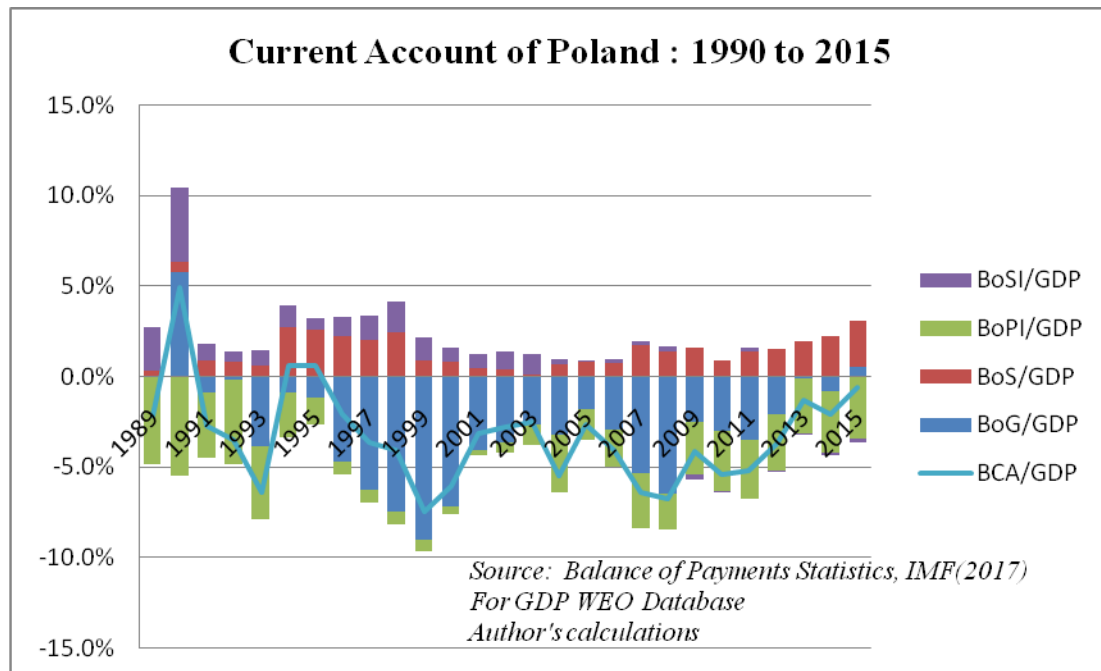
Figure 4.24: Current account of Poland: 1990 to 2015

Of the total exports of goods of $202.65 bn in 2015, $147.17 bn(or 75.7% of the total) was directed to the advanced economies. As per the DOTS data of the IMF, 75% of the exports are to the advanced economies, of which Germany($50.5bn), United Kingdom($13.13bn) , Czech Republic ($12.48bn), Netherlands($ 8 bn) and France ($11.29 bn), account for the major share (IMF,2017a). In fact, the imports of Poland are also from these economies. There is a growing export-import trade among the economies of Poland, Romania, Lithuania, Hungary and Turkey in the emerging Europe region. In fact, Poland has continually had a surplus with the emerging Europe region on the trade in goods front over the years from 2007 to 2015. All of this points to the fact that most of the production in Poland is part of a larger global production value chain. Germany, Austria and Netherlands, (as reported in Country Reports of the EC), are the major countries with foreign direct investment in Poland. The trade openness ratio of Poland has increased to 49.7% (2015), up from 38.2% in 2009. All

of this also points to the possibility of Poland being well placed to becoming an export platform of the advanced European economies in the eventuality of the appreciation of the euro against the dollar.

Table 4-7: Balance of Payments of Poland

Balance of Payments of Poland								
	2008	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*
Current account	-35829	-17867	-25785	-27355	-18605	-6749	-11444	-2932
Curr account/GDP	-6.76%	-4.09%	-5.38%	-5.18%	-3.71%	-1.29%	-2.10%	-0.61%
Capital account	6115	7040	8612	10020	10958	11962	13305	11331
Financial account balance	-39125	-34826	-46219	-33604	-22662	-6963	-6709	388
(Cap-fin account)/GDP	8.53%	9.58%	11.44 %	8.25%	6.71%	3.61%	3.67%	2.29%
Net errors and omissions	-11368	-9239	-13757	-10155	-3827	-11230	-8199	-6913
Reserves change	-1957	14759	15109	6114	11188	946	371	1098

Source: IMF(2017) Balance of Payments Statistics 2016 Yearbook.
Calculations are of the author's.

In the period from 1995 to 2015, notwithstanding the huge volatility in net inflows of financial as well as portfolio investment, Poland has been a net recipient of FDI. It came to 3 to 5% of the GDP in the period from 2001 to 2007. (Figure 4.25)

In fact, the financial cum capital account of Poland, as Table 4-7 shows, records a surplus. The surplus has, however, shrank from $445.24 bn (8.53% of GDP) in 2008 to $10.94 bn (2.29% of GDP) in 2015. It is pertinent to note that financial account inflows have declined during the period while the current account has improved.[26]

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[26]The negative signs on the financial account balance is on account of the BOPSM6 reporting , which is on a net assets basis, implying that a negative value on this account implies net financial inflows
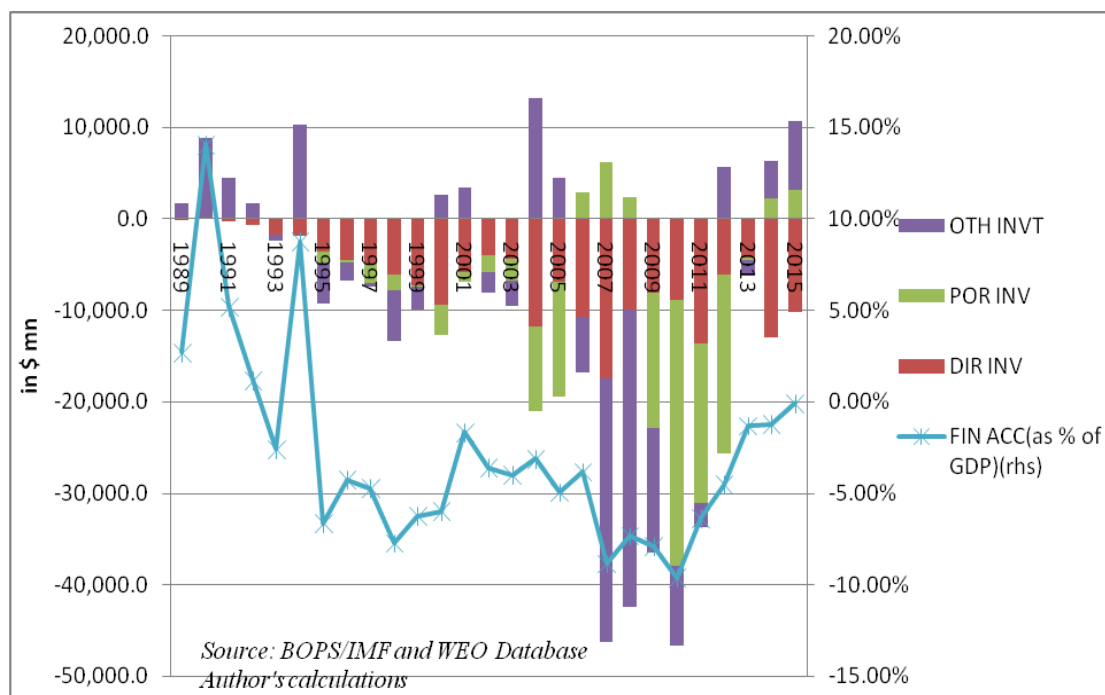
Figure 4.25: Balance on financial account of Poland (1995 to 2015)

The balance on financial account (net) of Poland changed from -1.67% to 9.63% of GDP from 2001 to 2010, implying a large outflow in the aftermath of the crisis. The balance on financial account changed from of $(-)39.13 bn (2008) to $(-) 378 mn (2015). The disaggregated figures of 2015 reveal that this is on account of portfolio outflows at $11.049 bn, which were higher than the portfolio inflows of $ 7.76 bn. Moreover there was selling off of debt liabilities in the "other investment" category to the tune of $2.54 billion dollars. This has to be seen in the context of the purchases of ownership from foreign investors by the state owned enterprises.

Yet another matter of significance to note regarding the financial account of Poland is that there have been two way flows of FDI, in contrast to the other emerging market economies, characterised as trade account economies in the BW II model. In other words, as against the growing FDI liabilities in different emerging market economies, combined with increased assets in the form of reserves or debts assets, Poland has had a fair share of FDI outflows in its external assets.

Given that Poland never had a current account surplus in the fifteen years till 2015, the foreign exchange reserves of the country were largely driven by the surpluses on the capital account. This is also unlike the Asian economies

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accumulating forex reserves through current account surpluses in the BW II model, though of course, in their case too, net financial inflows made a contribution.

The sluggish demand in the world economy has had an impact on the Polish economy too. In fact, the expenditure of the government registered a decline from 44.39% of GDP (average of 2003-08) to 43.36%(average of 2009-15), though there was an increase in the deficit on the government's budget from 4% to 4.74% of GDP, by virtue of the government revenue to GDP ratio decreasing from 40.21% to 38.62% of the GDP.

During the time of transition from socialism in the early nineties, Poland was witness to large scale privatization of public assets. But, the attempt to continue with the policies of privatizing state owned enterprises during the high tide of global liquidity met with a lot of opposition. In fact, the age old debate in Poland with respect to the privatization of state-owned enterprises had come to a close with the January 2017 Reform Proposal. It advocated restructuring state owned enterprises, whose profitability had been lower than their private counterparts, by pumping in significant resources.

In the aftermath of the global financial crisis, the large ownership of the assets of the banking system in Poland by foreigners has been viewed as a big macroeconomic risk. Since then, the state controlled enterprises have taken over the shares of private investors in different foreign and private banks. With the acquisition of the Pekao Sa by PZY S.A in 2016, the share of government bank controlled assets in the banking system has increased from 16% in 2010 to 36% in 2016.[27]In the aftermath of the global financial crisis, it was argued in certain circles that the banks should be brought under public ownership as no amount of regulation of private banks would suffice (Chandrasekhar, 2009). The increasing share of banking assets with the state alone would be able to provide some amount of autonomy to the policymakers in developing countries. This policy reversal in Poland seems to send out a signal that the public was only too willing to bear a limited amount of "government failure" given the uncertainties they had to go through in the aftermath of the crisis.

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[27] See European Commission(2017) Country Report: Poland.

After the crisis, legislative initiatives towards improving regulation of banks had been initiated in different parts of the world. In Poland, apart from the programme of conversion of the forex denominated liabilities of the households into local ones, efforts were initiated, with the patronage of the government, to reduce the share of assets in the banking system controlled by the foreign banks.[28]

Concerns were raised with respect to the growing liabilities of households denominated in swiss francs, a sizeable portion of which was on account of housing mortgages. There were efforts initiated by the National Bank of Poland to convert these swiss franc denominated loans to zloty ones due to the macroeconomic risks posed to the system on account of the volatility in the exchange rate of the swiss franc. The efforts bore fruit. As per the records of Banking Sector Advances of Narodaway Bank Polanski, the share of total household loans denominated in foreign currency was reduced from 36.5% (2010) to 21.6% (2017). The stock of loans denominated in zloty increased between 2009 and 2017 from 28.6% to 65.1%, whereas that in swiss francs has decreased from 69.4% to 27.4% (Figure 4.26). And as per the Financial Stability Report 2018, a far larger share of the total new housing loans initiated by the banking system is denominated in zloty.
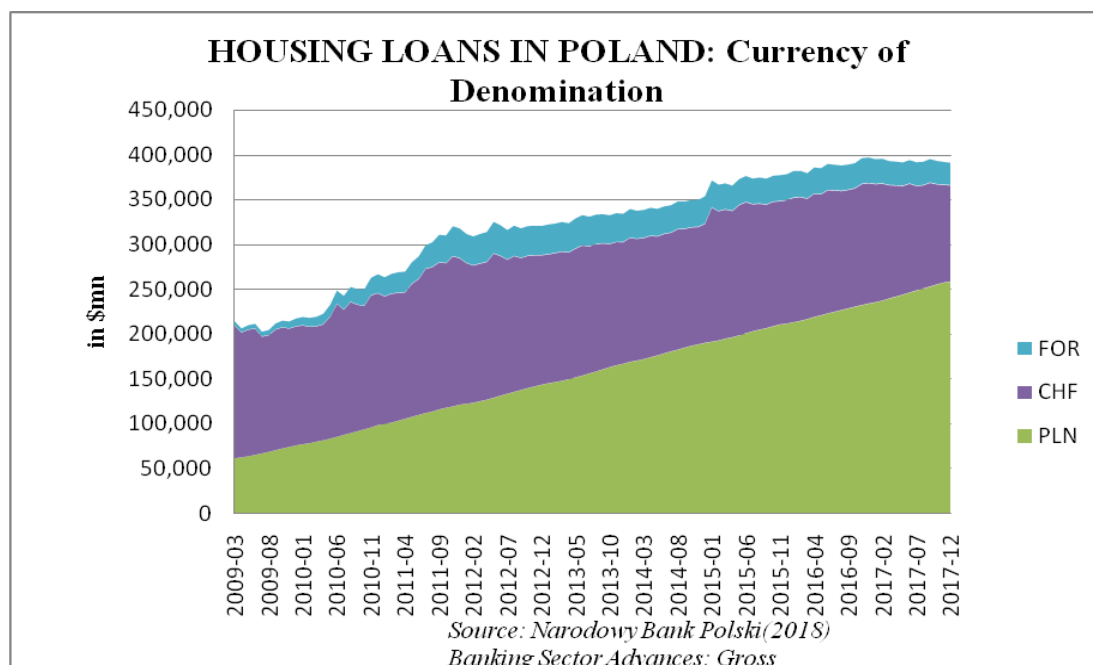
Figure 4.26: Housing Loans in Poland : currency of denomination

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[28] See NBP(2018) Financial Stability Report June 2018

Poland has been encouraging state owned enterprises (SOEs) to purchase stakes in different banks. As of 2016, the assets of the banking system in Poland amounted to approximately 1920 bn zloty, i.e., almost 92% of the GDP of the country. The main banks in Poland which hold a substantial share of the assets are: PKO BP (277.78 bn zloty) (the largest bank in Poland and largely state owned), Bank Pekao(182.08 bn zloty), which is largely state owned after Italian bank Unicredit sold its 59% stake in 2016, Bank Zachodni WBK (132.86 bn), owned by the Spanish Bank Santander Group since 2011, mBank (124.57 bn), ING Bank Slaski (122.11bn), BCZ BNP Paribas (71.9 bn), Bank Millennium (70.64 bn) (in which Banco Commercial Portuguese is a strategic investor), Alior Bank(69.38 bn), Bank Handlowy (42.86 bn), Idea Bank (24.33 bn) and BOS Bank (19.41bn). (all in million zloty).[29] According to the Financial System of Poland 2016, the ratio of domestic financial system assets to GDP of Poland is at 126.3%, with more than two-thirds being accounted for by the commercial banks.

Though the foreign banks have had a larger share of the total assets of the banking system, ever since the crisis, that share has been on the decline, from 67%(2008) to 61.5% (2014), whereas the share of ones with larger domestic equity has increased. The ratio held by foreign owned banks in the assets fell further to 49% in 2016, with the acquisition of Pekao Sa by PZU SA.[30] Moreover, in Poland, a good share of the assets of the banking system is held by the state-owned or controlled banks too. With the acquisition of Pekao Sa by PZU Sa, the share of government through the direct and indirect state controlled banks has increased to 36% of the sector's total assets. After a long gap the largest two banks are directly or indirectly under state control.

As per the Financial Stability Report of 2018 of NBP, the share of swiss franc loans , both as a proportion of the GDP as well as a proportion of the total loans have been on a continuous decline. It fell from 13% of total loans (2008) to 6%(2017), and, from 9% of GDP(2008) to 5% of GDP(2017). This is the outcome of the implementation of the recommendations of the *Financial Stability Committee,* which had suggested forcible conversion of swiss franc loans due to the risks they would pose in case there is a depreciation of the polish zloty: first, on account of the

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[29]https://www.export.gov/article?id=Poland-us-banks
[30]For Country Report of Poland (European Commission, 2017a)

households, whose balance sheets would be in disarray, and, second, on account of the higher reserves, which the banks that have a large forex portfolio, would have to set apart. The bill establishing a Restructuring Fund provides for costs arising from banks' contribution to the Fund, whose levels would be on the basis of its share in the foreign exchange portfolio. Though different reports, including that of NBP, have been flagging the implications for the cost and growth of credit, the attempt has to be seen from the perspective of financial stability too.[31]

There have been a number of financial stability reports relating to the economies covered here, which argue that the levels of risk for the banking system due to net foreign exchange exposure are near zero, as the banks have hedged against the risks in the forward outright market or the forex swap market. But, any depreciation of the currency increases the amount in terms of the local currency which must be paid by the borrowing consumer or household, that would not have hedged against the currency risk, and , this poses the risk of increasing the volume of non-performing assets in the system. The recommendations relating to conversion of forex-denominated loans by the central bank have to be seen in this light.

If the share of liabilities denominated in foreign currency crosses a particular threshold, the policymakers would be caught between a rock and a hard place. In case of an appreciation of the currency due to, say, a surge in capital inflows, the competitiveness of exports would be lost, but, at the same time, the incentive to take loans in foreign currency would be high. And, in case of a depreciation, it would have detrimental effects on the balance sheets of the banks, and might end up posing severe risks for financial stability. So, to be able to manoeuvre the exchange rate to suit macroeconomic outcomes, the policy regime in a country should not be burdened with a large volume of foreign currency liabilities.

The efforts of the government to levy a tax on the assets of the banks have been decried by the bankers as affecting their profitability.[32] In fact, the exclusion of

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[31]One of the viewpoints which puts forward the arguments of the bankers is (Tomasz & Mielus, 2016)

https://financialobserver.eu/poland/the-new-polish-bank-taxs-side-effects/
[32] The levy was introduced as part of the 15 January 2016 Act relating to Tax on Certain Financial Institutions

government bonds and debt securities from the purview of the levy has resulted in an increase in their share in the portfolio of the banks. Figure 4.27 shows that the share of the government debt securities in the assets of the monetary and financial institutions has increased. Though some part of the increase has happened since 2013, much before the levy was introduced, there has been a steep increase since 2016.
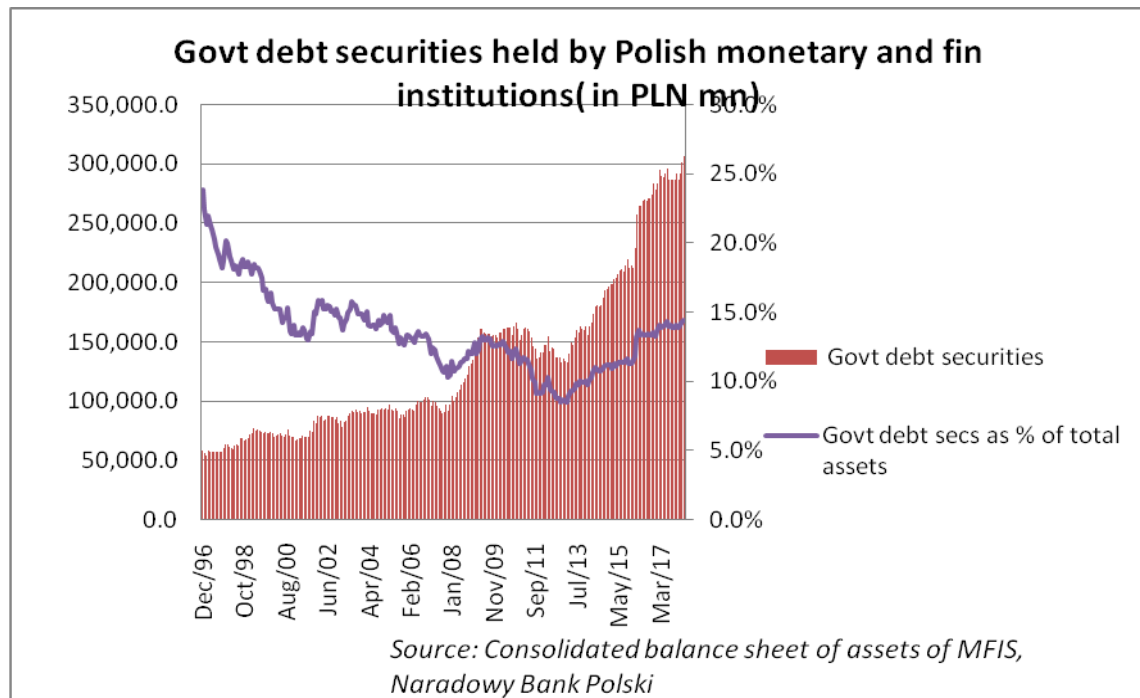
Figure 4.27: Govt debt securities held by Polish monetary and financial institutions (in PLN mn)

An important initiative in the area of development finance launched in the aftermath of the global financial crisis is the guarantee provided for loans below a specified ceiling taken by small and medium enterprises, which were subjected to severe credit rationing. This took the form of a *de minimis* guarantee programme, under the Vienna Initiative. The programme is for meeting working capital requirements as well as for purchase of machinery and technological upgradation.

In Poland , Bank GospodarstwaKrajowego (BGK), a state bank, has provided *de minimis* guarantees amounting to approximately PLN 7 billion (€1,672 million), which enabled the grant of loans to about 38,906 SMEs amounting approximately to PLN 12.1 billion (€2,890 million).[33] The economies of Romania and Hungary too

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[33] See (Vienna Initiative, 2014) Also for the details about the *de minimis* programme in Poland see (National Bank of Poland, 2017)

have extended credit to the extent of more than 1% of their GDP under this scheme. These initiatives in development finance come at a time when the SMEs are in desperate need for credit.

The total amount of bank claims outstanding on Poland from all reporting countries was witness to a steep increase during the period from 2000 to 2013. It rose from $50.78 bn (30% of GDP) in 2000 to $292.56 bn (67% of GDP) in 2009. Though in absolute terms, it increased further till 2013, there has been a decrease ever since to 49% of GDP in 2016. Most importantly, the share of the local claims in the total international claims of banks in Poland had increased significantly from 10% in 1995 to 62% in 2017

As of 2017, the countries with which the claims outstanding are maximum are Germany(22.5%), France(16%), Spain(16%) and Netherlands(14%). In terms of relative shares, till 2015, Italy had a large share of 12%.But the Italian banking group Unicredit had sold its stake in one of the banks in Poland in 2016, substantially reducing that country's share in the amount outstanding in 2017. While the German share in the total outstanding fell from a high of 31.2% in 2000 to 22.5% in 2017, it continued to be the single largest holder of outstanding claims (Figure 4.28).
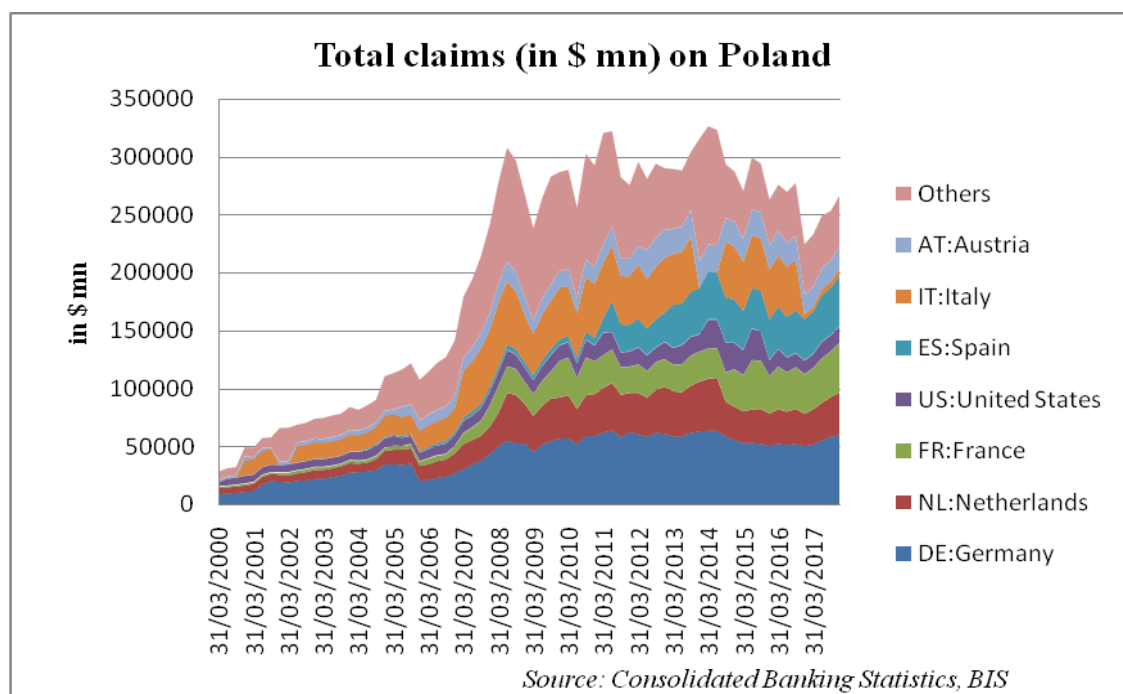
Figure 4.28: Total claims (in $ mn) on Poland

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In the post-global financial crisis era, Poland seems determined to change the approach to economic policy, both from the angle of reining in finance as well as consolidating the same through development plans. With respect to increasing state ownership in the banking system, the government has been promoting state owned enterprises to increase stakes in banks owned by the private sector. While the discourse on privatisation is continually gaining credence elsewhere, Poland has its focus on improving competiveness of the firms in the public sector. Coupled with programmes like the *de minimis* support to firms, and the Responsible Development Plan proposed by the government towards boosting innovation and improving Polish competiveness in the international arena, Poland is trying to rebuild the developmentalist state. Its efforts towards systematically addressing the infrastructural bottlenecks could result in its current position in the global value chain of production centred around Germany improving

V

In the previous three sections, we have looked at the three economies in the Emerging and Developing Europe category as they traversed from the period of the high global liquidity through a period marked by three important crises : the Global Financial Crisis, the European Sovereign Debt Crisis and the associated process of deleveraging from which the region suffered severely , and the Swiss franc crisis of 2015. It should be remembered that these economies were part of the socialist bloc in the period prior to the nineties.

The global financial crisis, which has resulted in the region being witness to large scale retrenchment of banking liabilities, with many banks headquartered in Europe, which were the intermediaries of dollar liquidity across the world, being forced to go in for deleveraging. With the European sovereign debt crisis, which was a fallout of the bad debts of banks being taken over by the governments, the problem worsened. The appreciation of the Swiss franc had resulted in the domestic borrowers of the regions, who had borrowed in the same, being badly hit due to their increasing liabilities in local currency terms. Incidentally, as per the reports of the BIS, in a

worldwide comparison eastern Europe and the Baltic states had higher amounts of domestic credit denominated in foreign currency.[34]

Growth has invariably suffered during this period. But different reports reveal the conflict of opinion which prevailed between the central banks of these economies and the European Commission on the one hand, and the governments of the economies, on the other hand. Primarily, the austerity policies advocated in the form of fiscal consolidation through the various Country Reports of the EC as well as the Financial Stability reports of the Central Banks notwithstanding, some of the governments have gone ahead with fiscal spending. The transfers from the European Union, amounting to 2 to 3.5% of their respective GDPs, towards facilitating infrastructure spending, have also been a source of relief during such times. To begin with the region is characterized by higher levels of government expenditure relative to GDP in comparison with other parts of the world. Table 4-8 provides a comparative chart on fiscal indicators of a set of emerging market economies for various sub-periods. The size of government activity in the economies of emerging Europe is high in comparison with the other emerging market and developing regions.

The government revenue to GDP ratio of the countries in emerging Europe have all been about 30%, with that of Hungary rising from an average level of 42.63% before 2007 to an average of 46.12% in the post-2007 period. Even on the expenditure side, that of Hungary has always been close to 50%. The lowest figure in the sub-group is that for Romania, the average of which in the 2008-15 period was 35.65%. Neither the government revenue to GDP figures nor the government expenditure to GDP figures of east Asia are comparable to the numbers for Emerging Europe. Over a period, it seems that the former numbers have stagnated at lower levels. Whereas the revenues range from 16.62% for Indonesia to 20.10% for Thailand, the government expenditure to GDP ratios range from 18.11% (Indonesia) to 27.68% (Malaysia). Both the revenue and expenditure figures of China have risen sharply (10% points approximately)in the post global financial crisis period. But the Indian revenue and expenditure numbers are not just lower than their Chinese counterparts, but even lower than all of the different emerging market economies in our study from the Latin American as well as the east Asian region. The Latin American economies of Argentina and Mexico have also significantly stepped up

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[34] See (BIS, 2016)

government expenditure, with the ratio increasing from 24.75% to 34.12% for the former and from 22.35% to 27.33% for the latter.

Table 4-8: Government revenues and expenditures of EMDEs (as % of GDP)

	Gen. Govt Revenue as % of GDP			General GovtExp as % of GDP		
	1995-2000	2001-07	2008-15	1995-2000	2001-07	2008-15
Argentina	21.73	24.89	31.45	24.38	24.75	34.12
Brazil	33.03	35.07	34.25	38.36	38.72	38.20
Mexico	17.77	20.44	23.68	22.58	22.35	27.33
Chile	22.54	24.02	23.18	21.72	21.18	23.50
Colombia	22.48	25.65	27.06	25.61	27.39	28.85
China	11.45	16.29	26.21	12.89	17.97	27.10
India	17.02	19.02	19.42	24.99	27.62	27.45
Hungary	44.69	42.63	46.12	50.38	49.57	49.53
Poland	41.78	40.28	38.90	45.70	44.59	43.50
Romania	29.83	30.40	31.82	34.16	32.75	35.65
Indonesia	13.34	17.61	16.62	14.03	18.16	18.11
Malaysia	23.84	23.33	23.75	24.30	26.85	27.68
Philippines	19.76	17.99	18.28	20.79	20.28	18.78
Thailand	18.92	20.10	21.07	21.09	20.35	21.55
Source: World Economic Outlook April 2019, IMF (Author's calculations)						

As the data from 2009 to 2015 reveal, the economies of east Asia, had favourable balances on merchandise trade. In the Emerging Europe group, only Hungary had a surplus continually on the merchandise trade front from 2009 to 2015. Moreover, that surplus was far lower than that of Malaysia, Thailand or Indonesia. All of the east European economies are linked to the global value chain of multinationals. But on the invisibles front, all of the Emerging Europe economies in our sample record surpluses (Table 4-9). Only Thailand records a surplus in this category in the east Asian region. When the shift in the geography of trade becomes an outcome of the strategies of the core economies to set up export platforms, given the background of the economies of emerging Europe, the chances of their serving as the periphery of a new arrangement which could emerge, cannot be ruled out, given the fact that they are an important part of the global value chain centred around Europe. If in response to international pressures, Germany is forced to increase

domestic wages in tandem with productivity improvements, eastern Europe could emerge as a vibrant export platform.

Table 4-9:Balance On Commodity Trade ($mn) : East Asia And Emerging Europe

Balance On Commodity Trade ($mn) : East Asia And Emerging Europe							
	2009	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*
POL	-10275	-14495	-18555	-10496	-452	-4291	2464
HUN	3738	3472	4072	3731	4430	3161	4855
ROM	-12591	-12740	-13077	-11889	-7733	-8608	-8605
MAL	40731	38404	45938	36643	30577	34605	28051
INDO	32287	30003	33825	8680	5833	6983	13289
THAI	31202	26678	12186	109	55	17263	26841
PHI	-13860	-16859	-20429	-18926	-17662	-17330	-23309
Balance on Invisibles ($mn) : East Asia And Emerging Europe							
POL	6995	4361	7221	7715	10141	12046	12113
HUN	1621	3487	4605	4865	4981	6528	5988
ROM	1302	1984	2290	3183	6246	7786	7538
MAL	819	2031	498	-2768	-3037	-3264	-5327
INDO	-11096	-9791	-9803	-10564	-12070	-10010	-8301
THAI	-4226	-6993	-4552	4051	11374	10289	19241
PHI	4898	5765	6562	6178	7015	4576	5641
Source: Balance of Payments Yearbook 2017. IMF(author's calculations)							

The study by Hagemejer and Muck(2019) finds that the Central and Eastern European countries have been transformed into being the manufacturing backbone of Europe, with the exports to GDP of these economies doubling in the course of the last two decades. The growing level of negative net exports of this set of economies has to be seen in the context of persistently strong demand for imports of capital goods. The study finds that the import of technology, rising GVC participation, as well as capital deepening has played an important role in this process[35](Hagemejer & Mućk, 2019).

In another study on the increasing participation of the post-communist economies in global value chains, it is observed that the share of re-exported

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[35] An abridged version of the same is available at (Hagemejer & Mućk, Export-led growth in Central and Eastern Europe. ., 2019)

intermediates as a share of total intermediate imports into these economies have been witnessing a steady increase in the post-2000 period. The study compares the relative location of the emerging European economies as against their East Asian counterparts. With respect to transport and equipment, while the economies of emerging Europe like Hungary, Czech Republic, Romania and Poland are far higher and producing upstream, with respect to electrical equipment GVCs they are far behind their east Asian counterparts(Cieślik, 2014). The concerted effort made by the states in eastern Europe in the field of infrastructure, supported by the financial and technical transfer from European Union is also likely to make an impact on growth in the region.

Moreover, these economies in Emerging Europe have at least a currency of their own and their monetary sovereignty has not been surrendered like the other countries who have directly joined the euro. This may help, given that through intervention in the foreign exchange markets, they would be able to resist any appreciation of currency in the wake of a surge in capital inflows.

The 2015 Swiss franc appreciation and its impact on the balance sheets of the households and corporations in the Baltic/east European region made clear that in an economy with a good proportion of its liabilities denominated in foreign currency, manipulating the currency to get out of a problem could exacerbate problems of other kinds. That option is no more available.

But most importantly, as we have seen in this chapter, there have been diverse developments with respect to the regulation of finance. The initiative on the part of the government of Hungary to buy up the Budapest bank, enhancing government ownership in various banks, and increasing the share of the loans denominated in the local currency; the efforts on the part of the government of Romania to bring forward legislation in the form of *datio in solutum* for the redressal of consumer grievances in the banking system and regulation of interest rates; or, the efforts on the part of Polish SOEs to takeover the ownership of certain private banks resulting in the reduction in the banking assets owned by foreign banks between 2007 and 2015, are all attempts towards enhancing national control over finance. The merit of these moves notwithstanding, the Financial Stability Reports of the central banks of these countries have been characterizing these measures as ones which could have a negative impact

on the profitability of finance and the banks. Indeed, the various Country Reports of the European Commission also air the same opinion. But, surprisingly the governments are holding on to their positions.

The efforts at enhancing the control on finance with the best interests of the economy in mind come at a time when the governments of the region are going ahead with public expenditure intended to enhance transport and telecom infrastructure, supported by the European Union through grants. All these appear to be signs of a reverse transition of sorts to a *dirigiste* regime. If so, given the attainments on the social front, it could be that the region could evolve along the lines east Asia did in the nineties.

The growth process of the east Asian region picked up momentum when US and Japan started looking upon these countries as export platforms, thus trying to seek an escape route out of the problem of the relative appreciation of their respective currencies, which was undermining the competitiveness of goods produced at home. Given the possible appreciation of the euro in the medium term, in the contemporary world, the current investors may enhance their stake in these countries in emerging Europe, with the aim of enhancing their cost competitiveness. Possibly, the European Union too would think in terms of expanding the scope and scale of the resource transfers under technical support to these economies, through a programme like the Marshall Plan on the part of the advanced eurozone economies, targeting not just the emerging Europe region, but even the affected eurozone economies . In the context of euro   being a reserve currency, these economies in emerging Europe would serve as reserve accumulators of euros.

It is to be seen what the structure of Bretton Woods II would be. Would it be US alone at the centre? Could it be mainland Europe/US at the centre. The possibility of India stepping into the place of China/east Asia has been put forward by the proponents of BW II(Dooley, Folkerts-Landau & Garber, 2014). Given that already the centre country has a problem with one country, China, cornering a large part of the surpluses, the possibility of these economies in peripheral Europe stepping in is high. In the course of a reserve currency competition between the dollar and euro, the transition economies of Europe could finally emerge. But from financial

globalization, emerging Europe is surely going through a process of fragmentation of finance, i.e., finance with controls.

The current trends point towards large increase in international claims on emerging Asia and Latin America. As against which the same on emerging Europe is muted. Finance, post-GFC, has been relatively less restricted in Asia than in emerging Europe. The controls on capital (limited though) combined with the bolstering of the productive sectors through the various efforts of the state, and, in certain cases, supported by the European Commission has resulted in the possibilities of the region emerging as an export platform with strong resilience. Only time would tell whether these would result in the economies of emerging Europe being catapulted into being the trade account economies of the Bretton Woods II in its new avatar

Chapter 5

German Current Account Surplus and GIIPS: Global Liquidity, Relative Unit labour costs and Eurozone imbalances

"Thus inflation is unjust and deflation is inexpedient. Of the two, perhaps, deflation is, if we rule out the exaggerated inflation such as that of Germany, the worst because it is worse, in an impoverished world, to provoke unemployment than to disappoint the rentier."

(Keynes, 1972) Essays in Persuasion p. 75

Introduction

In the first chapter on the changing trends in global imbalances, we had drawn attention to the emergence of Germany as one of the leading exporters of the world. It has one of the largest current account surpluses in the world. This surplus goes against the grain of the argument advanced by the proponents of Bretton Woods II that it is the late industrialising economies that would, while taking an export oriented route to growth, resort to the accumulation of large reserves. What we have here is Germany, an advanced nation, which through a reduction of relative unit labour costs, resulting from productivity increases unmatched by wage increases, managing to record a current account surplus. Moreover, capital flows during the high tide years of global liquidity have pushed a set of advanced economies in Europe (Greece, Ireland, Italy, Portugal and Spain) into deflationary mode. The financing concerns and precautionary moves of these economies have resulted in the accumulation of foreign exchange reserves by these advanced economies as well.

Export-oriented growth strategies based on real exchange rate depreciation, either through intervention in foreign exchange markets, or by keeping wages from growing in tandem with productivity, have been pursued by countries over the last two decades. This strategy of enhancing international competitiveness has resulted in a decrease in the share of labour in the income of economies with its associated impact on aggregate demand. In the case of countries in developing Asia, given the large cross-border flows of capital in the global economy, they can ill-afford to leave their exchange rates to be determined by market forces, since that, through domestic currency appreciation, can have negative effects on their exports sector and

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industrial growth. However, it has been alleged for some time now that China has been resorting to currency manipulation as a strategy for increasing its exports and current account surplus, ignoring the fact the country's competiveness could very well be traced to the lower unit labour costs resulting from its large labour reserves. On the other hand, it is Germany, which shares the euro, a reserve currency, with a number of economies, that has been treading the path of restricting its wage increases relative to productivity improvements, and, thus, generating through real exchange rate depreciation one of the largest current account surpluses in the world economy.

With Germany, the leader country of the Euro zone, pursuing this strategy, the very sustainability of the Eurozone project and its own position on labour standards, on which it leads advocacy in international policy circles, is brought into question. While the policy measures to bring the Eurozone out of its crisis should have been wage reflation in tandem with productivity improvements in Germany, the prescription offered to Greece was a 22 per cent reduction in minimum wages in that country. While the Bretton Woods system allowed for correction through alterations in exchange rates, the countries in the euro area, with no currency of their own, have to resort to forceful reduction of wages and, through that prices, to increase their trade surplus. The price flexibility principle which was dumped between the mid-nineteenth and mid twentieth century in Europe has been given a new lease of life with the birth of the euro.

This chapter is divided into five sections. As we have drawn attention to the issue of global imbalances in the previous chapters, the first section tries to bring out the links between the large current account deficits of the GIIPS(Greece, Ireland, Italy, Portugal and Spain) and the financial account flows in the period since the inception of euro to 2010, and contrasts the experience of Germany. The focus of the next section is on the divergence between gross value added and unit labour costs in the GIIPS as against Germany. The third section gives an overview of the Hartz reform implemented in Germany, and the next one attempts an empirical investigation into the links between the bilateral trade balance of Germany with the countries badly affected by the European Sovereign Debt Crisis and the relative unit labour costs, using panel data for the period 1998 to 2015. The chapter ends with some concluding observations.

Financial account flows and the current account of the GIIPS

The introduction of the euro was accompanied by mixed expectations. Some expressed hope that it would pose a challenge to the dominant reserve currency in vogue, i.e., dollar. There were policymakers who felt that convergence and catching up would be faster within the euro area. Others were sceptical of the outcome of the euro's creation, since the currency was bringing under the same umbrella economies with varied macroeconomic histories. They were concerned as to whether the euro area would meet the conditions required for an optimum currency area, as conceptualized by Mundell.[1]

The initial sense of scepticism which was nurtured about the euro, that it would widen the divergences in the region, was contested by referring to the capital flows that would be made possible within the Eurozone. With capital flowing downhill, to the southern economies, it was thought that at least within Europe, the thesis proposed by Feldstein and Horoika with respect to the high correlation between investment ratios and saving ratios would be disproved.[2] There were various empirical studies which provided evidence in this regard.   In fact, the weaker countries in the Union were thought to be catching up with better off ones, and economic stories of convergence were making headlines.[3] But, this logic did not hold for long, since the share of industrial output produced by the advanced economies in the course of the years since the inauguration of the euro recorded an increase, implying that the bigger economies were benefiting from a process of cumulative causation.[4] Moreover, the capital flowing to the periphery was directed to non-tradable sectors and construction. In the international economy, Europe was largely a surplus region. Few bothered with the disaggregated data. Among economies in the euro area were both surplus and deficit economies. But given the ease of financing,

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[1]See (Mundell, 1961) in this regard.

[2]Based on the high correlation between investment ratios and savings ratios across economies, (Feldstein & Horoika,1980) argues that there has not been much of benefit derived from international capital flows.

[3] One important study which contests the same is (Blanchard & Giavazzi, 2002)

[4]Pisani-Ferry(2013) notes that there were large agglomeration effects from the European Monetary Union, with the share of northern Europe (Germany, Austria, Finland and Netherlands) in the euro-area manufacturing output increasing from 46% in 2001 to 51% in 2011(Pisani-Ferry, 2013).

the intra-eurozone imbalances were not reckoned to be an important issue. But with the global financial crisis, the capital flows to the euro-periphery experienced a severe setback, and the economies concerned could no more afford the current account deficits. The gross capital inflows on the financial account to the euro periphery was not forthcoming, like before. The unified euro area with the same currency was witness to the equalization of interest rates across Euroland, resulting in a large reduction in the risk premium faced by different economies. The figures with respect to the interest on government bonds of Germany along with GIIPS economies are illustrated in Figure 5.1.[5] In the period prior to the introduction of the euro, large differences existed between the interest rates of the other economies when compared with that of Germany. In fact, in 1995, the risk premium difference between Germany and Greece was as high as 14%. As can be seen from the figure below, the risk premium literally disappeared in the period from 2000 to 2009, rising again in the aftermath of the global financial crisis, and, the European Sovereign Debt Crisis, which followed.
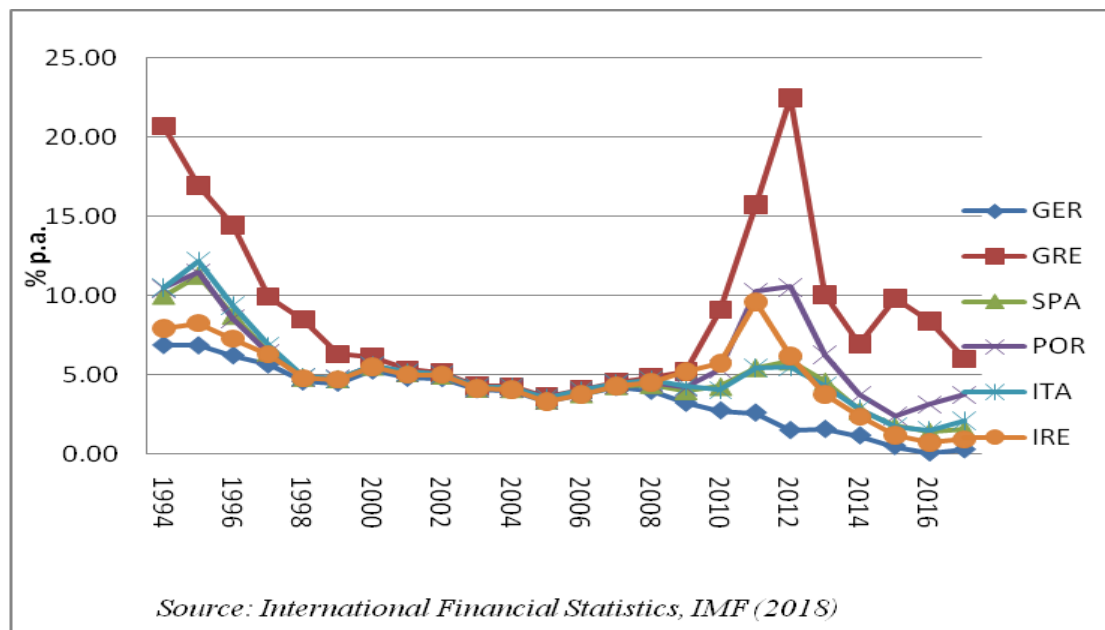
Figure 5.1: Government bond interest rates per annum: Germany and GIIPS (1994 to 2017)

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[5] Continuous data with respect to number of economies on money market rates were not accessible, therefore the data related to returns on government bonds from IFS in the IMF Datawarehouse is included here.

The ECB, which was largely focused on inflation targeting, has been setting interest rates on the basis of the Taylor's rule, giving larger weight to the conditions prevalent in Northern countries. Given the higher levels of inflation in the southern economies, in particular, GIIPS ,for any given nominal rate of interest, the real rate of interest in the latter was too low and the demand for credit was far higher, which was easily met through cross- border lending within the euro area. As can be seen from Figure 5.2, the consumer price index (Base: 2010=100) of Germany moved at a far slower pace than that of the other economies. While it increased from 57.01 in 1995 to 100 in 2010 for Greece, the corresponding figures were 80.48 to 100 for Germany. In fact, the rate of inflation in all of the GIIPS countries was higher than that of Germany during this period. Given the relatively lower levels of inflation, the real rates of interest in Northern economies were higher than those of their counterparts in the South. And, the bankers in western Europe were only too happy to exploit this opportunity through resort to cross-border lending.

Source: International Financial Statistics, IMF(2018)
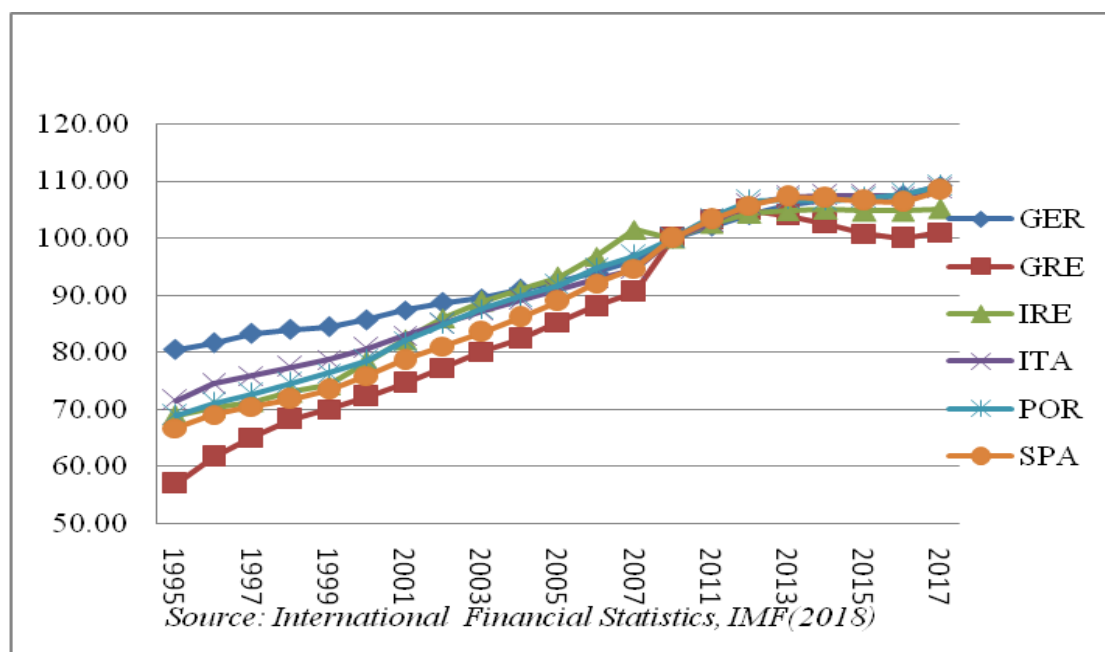
Figure 5.2: Consumer Price Index of Germany and GIIPS : Base year 2010

The cross-border flows from the western European banks catered to the growing demand for credit.[6] As various studies reveal, the funds which entered the GIIPS went to the non –tradable sector, and in particular, to construction. The relative price level of these economies increased vis-à-vis their counterparts in the Northern

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[6](Lane & McQaude, 2014) provides details in this regard.

region, resulting in an appreciation of the real exchange rates of these economies. The larger demand triggered in the region based on the growth of the non-tradable sector also resulted in further demand for imports, triggering even larger demand for credit, easily financed through cross-border banking flows. While growth in the South was based more on non-tradables, that in the Northern economies was based more on enhanced productivity within the tradable goods sector. Concerted efforts on the part of the government, enterprises and research institutions in the Northern economies that facilitated productivity improvements, combined with structural reforms to induce labour market flexibility, to help them to sell their goods at extremely competitive prices. In fact, structural divergences in the form of increasing trade surpluses in the North and rising trade deficits in the South were visible, with doubts being expressed as to whether the forces of cumulative causation were widening disparities within Europe. Figure 5.3 reveals that driven by the debt flows which occurred in the period, the growth rates of Greece and Spain were higher after the introduction of euro, though this was not true of Italy or Portugal.

Figure 5.3: Rates of growth of GIIPS(in constant prices)(1995-2015)

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While the average rate of growth of Italy and Portugal declined during the 2001-07 period to 1.2% and 1.17% respectively, that of Greece registered an increase. The rates of growth of Spain too witnessed a marginal decline as Table 5-1 shows. This suggests that the debt flows through the banks t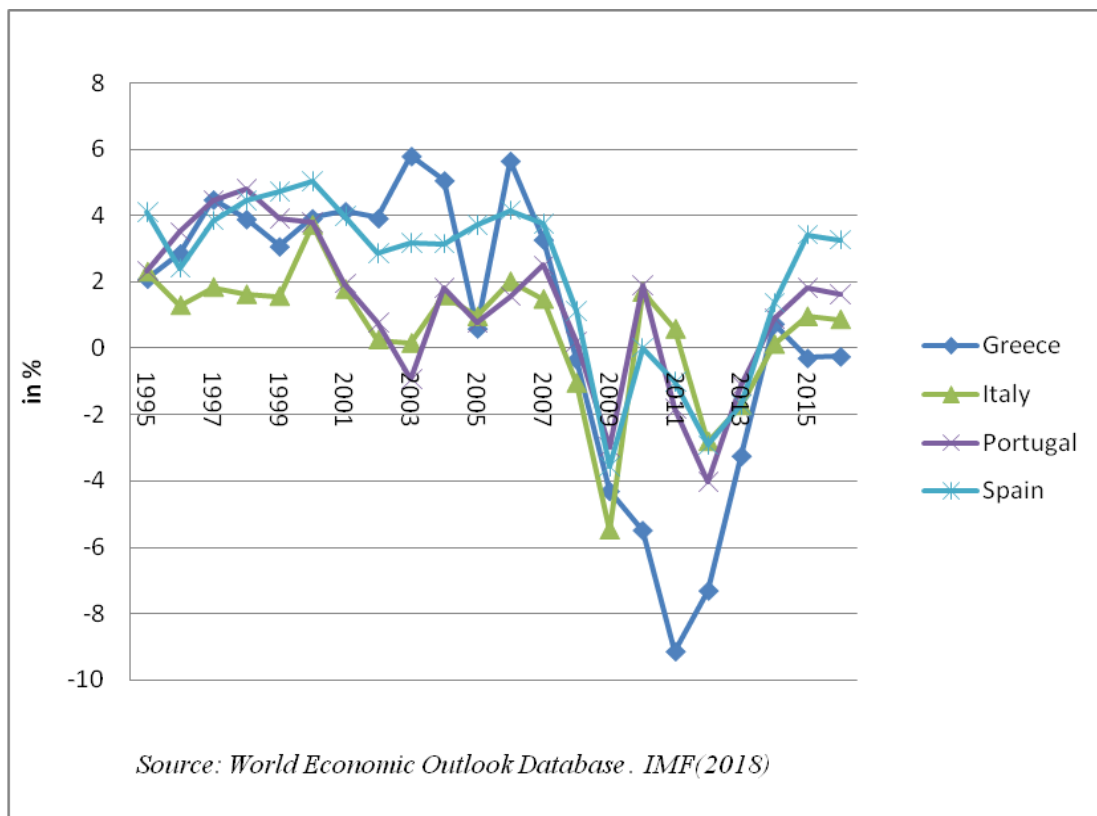o the region, to begin with, did not have a favourable outcome on the growth of these economies. It should also be noted that the rates of growth of all these economies in the period 2008-15 were far lower than that registered even in the 1995 to 2000 period.

Table 5-1: Average rates of growth and current account balance of Germany and GIIPS

AVERAGES OF RATES OF GROWTH AND CURRENT ACC BALANCE OF GERMANY AND GIIPS							
RATES OF GROWTH (constant)				Balance on Current Account (as % of GDP)			
	1995 - 2000	2001- 2007	2008-2015	1995-2015	1995-2000	2001- 2007	2008-2015	1995-2015
GRE	3.39	4.06	-3.67	0.93	-3.61	-9.13	-7.07	-6.77
IRE	9.69	5.54	3.94	6.12	1.52	-2.08	-0.2	-0.34
ITA	2.05	1.17	-0.97	0.61	1.87	-0.64	-0.87	-0.01
POR	3.78	1.2	-0.64	1.24	-6.31	-9.24	-4.84	-6.73
SPA	4.11	3.56	-0.41	2.21	-1.97	-6.25	-2.14	-3.46
GER	1.9	1.42	0.95	1.38	-1.05	3.49	6.65	3.4
Source: World Economic Outlook Database, IMF(2018)							

Figure 5.4 on the balance on current account with respect to GDP reveals that Germany made a transition into a economy with a current account surplus in the post 2000 period. Greece, Spain and Portugal were witness to large increases in their current account deficits in the period till 2007. Whereas the average current account balance of Greece changed from -3.61% to -9.13%, that of Spain changed from -1.97% to -6.25% between1995-2000 and 2001-07. The current account deficit of Greece reached a high of 15% of the GDP in 2007. It should also be noted that the average current account surplus of Germany, which increased to 3.49% in the 2001-07 period, further improved to 6.65% in the 2008-15 period.
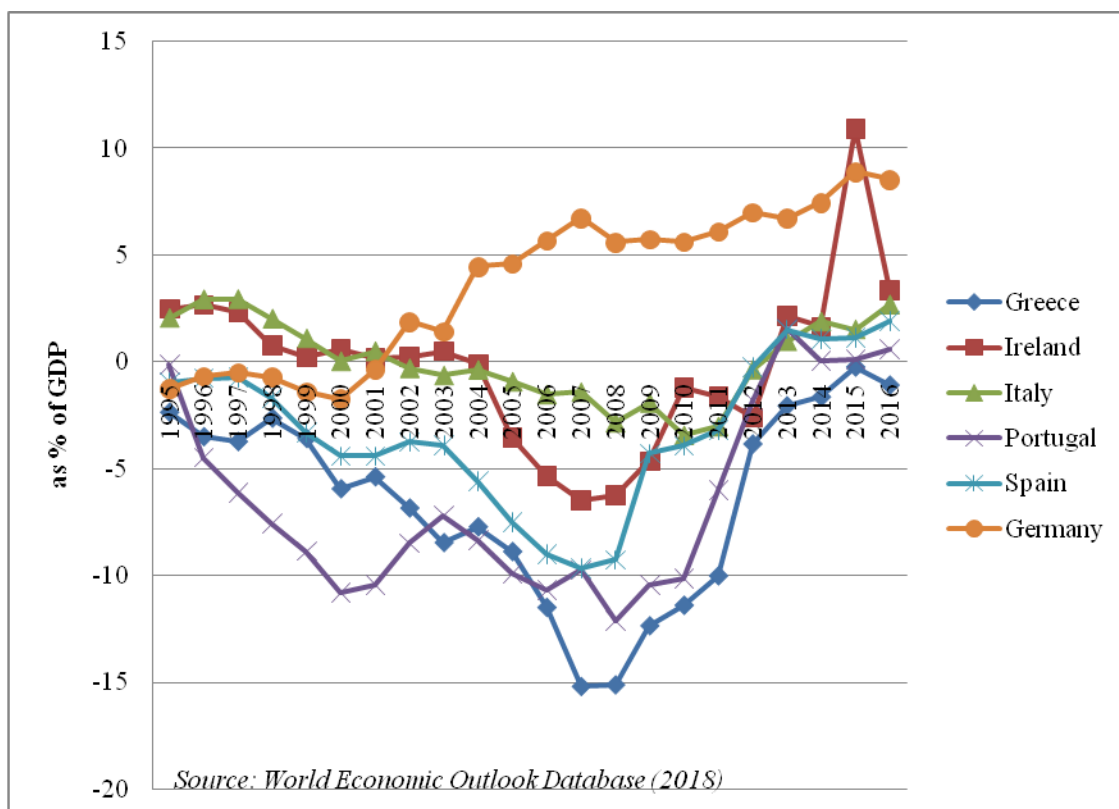
Figure 5.4: Balance on current account: Germany and GIIPS(1995 to 2015)

The exogenous shock to the system occurred in the form of a crisis in the market for asset backed securities, in which western European bankers had significant investments. This forced them to retrench their exposures in loans to the southern economies, pushing the latter into a severe crisis. That crisis in turn exposed the fissures in the eurozone, which had neither a proper mechanism for fiscal transfers of a countercyclical nature, nor a banking union, with countries left to fend for themselves with banks collapsing. The governments were now forced take onto their balance sheets the bad debts of the banks to keep them liquid, resulting in the conversion of a crisis in the banking sector into a sovereign debt crisis. To begin with, not all of these economies had unsustainable public debt ratios. But with the onus of these debts being shifted on to the   government, the public debt to GDP ratio reached unsustainable levels, and the spread between the borrowing rates of these economies and those of Germany widened.

Studies on Greece have drawn attention to the high rates of growth registered by that country in the course of its integration into the euro. As a result of that growth, the per capita GDP of the country was just 10% less than that of the rest of euro area

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by 2009. This growth was driven largely by an increase in public and private consumption, and, in particular increases in residential investment. All of this would not have been possible without the large debt flows into the country that followed financial integration, and the reduction of interest rate premia, which that made possible. The period was witness to a large increase in the private credit to GDP ratio, with the capital being largely diverted to the non- tradable sector as well as the residential sector.

Figure 5.5 reveals that the current account deficit was largely on account of the goods trade. As the average rate of growth of Greece improved from 3.39 %(1995-2000) to 4.06 %(2001-08), the current account deficit widened from 3.6% to 9% of GDP as recorded in Table 5-1.
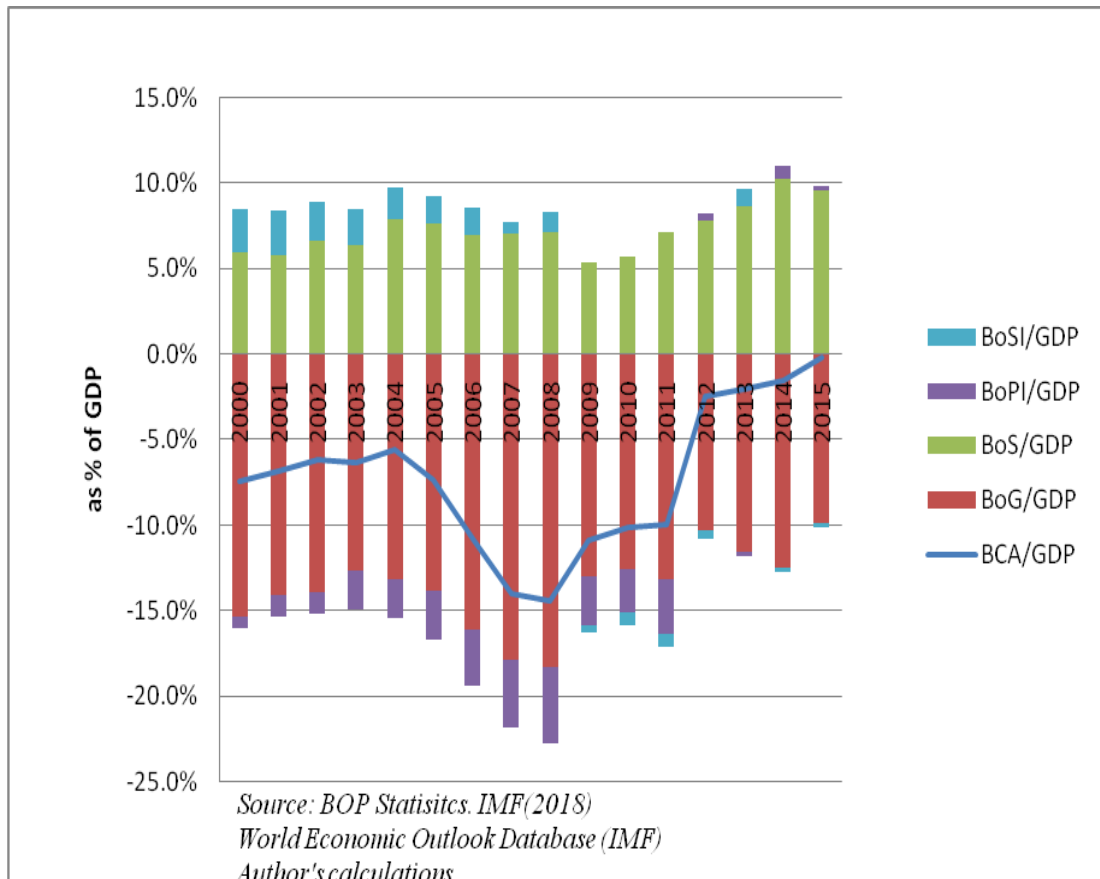
Figure 5.5: Balance of current account: Greece
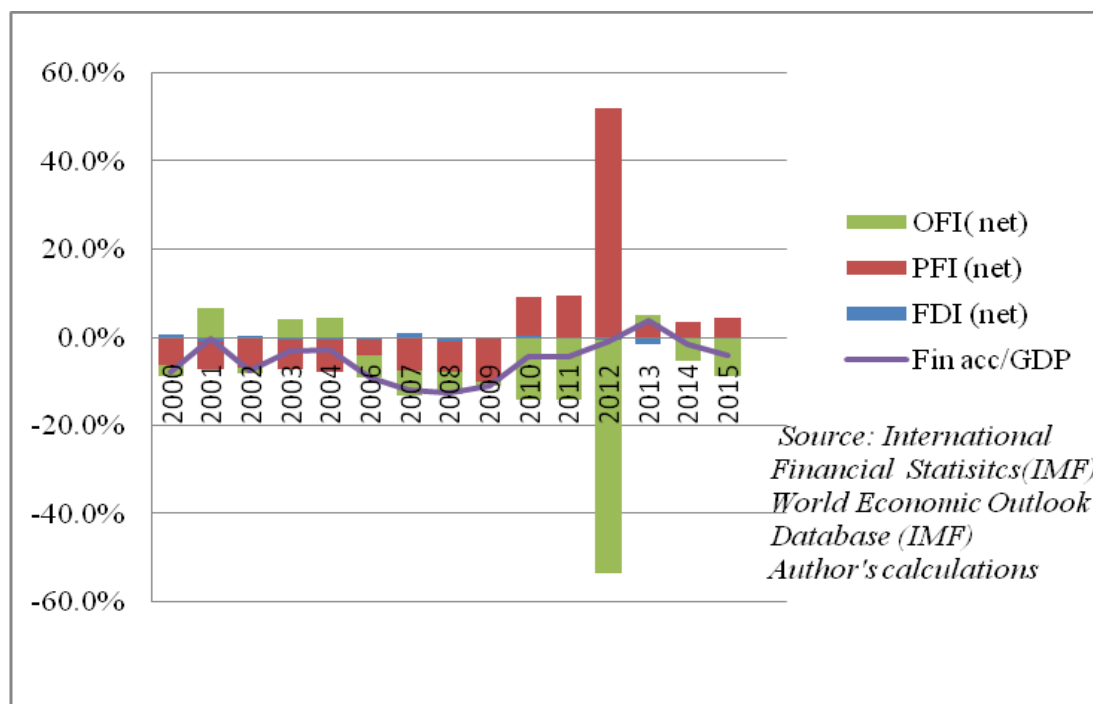
Figure 5.6: Net financial account flows(as % of GDP) (2000 to 2015): Greece

It can be seen that the current account deficit increased from 7.7% of GDP in 2000 to 14.4% in 2008. It is also pertinent to note that financial inflows, i.e., liabilities, were dominantly in the form of portfolio and other foreign liabilities. For a representative year 2006, as against FDI inflows of $ 5409 mn, there was PFI inflows of $ 18737 mn and OFI inflows of $ 21539 mn (Figure 5.6). In fact, the liabilities of Greece were dominantly of debt creating nature, which made its external account far more vulnerable. Data from BOPS reveal that retrenchment on the portfolio account rose from$43 bn in 2010 to a high of $54 bn in 2012. The chart depicting the net financial account, shows that the net portfolio outflow was to the tune of 52% of the GDP. Retrenchment of banking liabilities picked up momentum in 2013 with the sovereign debt crisis, with retrenchment of Greek assets abroad accompanying the withdrawal of funds from Greece. The sharp recovery of the current account from -14% in 2008 to -0.2% in 2016 has to be seen in the context of strong deflation in Greece.

The high rates of growth of Ireland started well before it joined the euro. Its average growth rate of 9.6% in the 1995 -2000 period was far higher than the 5.54% recorded over the period of 2001-07. Ireland has had a high trade openness ratio, with a positive balance of goods ratio. The entry into the euro area which resulted in large

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reduction in risk premium permitted it to experience debt financed growth. To begin with, the growth of the Ireland economy has been driven by its ability to attract FDI to its shores by providing highly favourable tax concessions to multinational capital and resorting to light regulation. The credit to GDP ratio increased sharply from 120% in 2002 to 300% in 2009.[7] In fact, the banking system in Ireland financed this credit boom with large scale mobilisation of funds in the wholesale market, exposing the banking system to high levels of risk. As per the BOPS figures, Ireland's other financial liabilities increased from $119.7 bn in 2005 to $227.8 bn in 2008, fuelling an increase in credit to GDP ratios. With the two way squeeze of capital flows in the international financial markets from 2009 to 2013, there has been continual retrenchment of liabilities in Ireland, with outflows of funds from Ireland. Figure 5.7 shows that net outflow under the other investment flows head from Ireland was to the tune of 50% of the GDP in 2010 and 2015.[8]

Figure 5.7: Financial Account of Ireland

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[7](European Commission, 2017)

[8]For the remarkable growth performance of Ireland, (Walsh & Honohan, 2002) is highly informative. For details relating to the banking crisis in Ireland, the Report of the Joint Committee of Inquiry into the Banking Crisis proves to be repository of information and evidences. This also provides a good amount of data on the Irish economy. (House of Oirechtas, 2016)

The average rate of growth of Italy of 1.17% in the 2001-07 period was lower than the 2.05% recorded in the 1995-2000 period. A perusal of Chart 9 on the country's current account reveals that the balance on merchandise trade as a share of GDP was continually on the decline: from 1.3% of GDP in 2001 to -0.7% of GDP in 2006. In fact, the real exchange rate appreciation faced by Italy in the wake of capital inflows had an unfavourable impact on the goods sector. When the balance on the current account moved from 0.5% to -3.4% of the GDP , the net financial inflows increased from -0.8% to 5.1% of the GDP. The net financial inflows were far more than required to finance the current account in most years. The Balance of Payments Statistics of IMF reveal that in the period 2008 to 2010, there was not just retrenchment of banking liabilities in the country, but Italy too had resorted to sale of banking assets abroad. The net inflow on account of other investment in 2010, of 9% of GDP, is on account of large scale retrenchment of banking assets abroad to the tune of $69 bn (Figure 5.8).
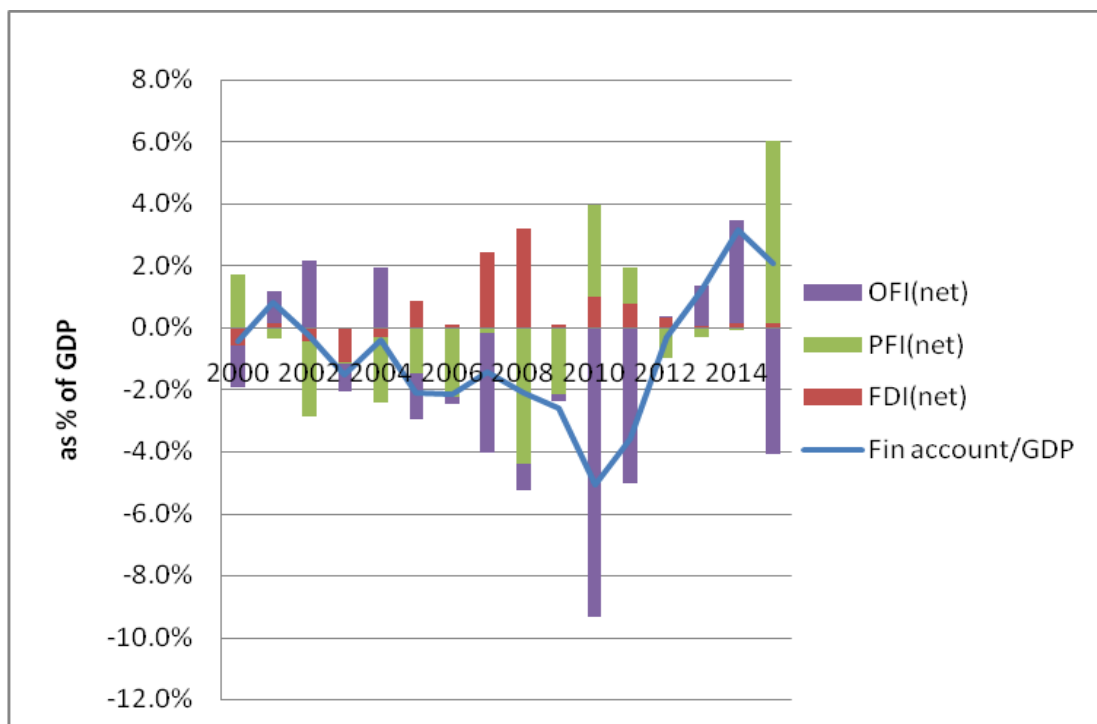
Source: BOP Statistics. IMF(2018)
World Economic Outlook Database (IMF)
Author's calculations

Figure 5.8: Financial Account of Italy

Portugal grew at a far lower average rate of 1.2% during 2001-07 when compared with the average rate of growth of 3.78% recorded in the 1995-2000 period. The distinct lack of efforts at productivity improvement even in its own traditional industries coupled with growth in wages made its goods highly uncompetitive.[9] It is also to be noted that even in the pre-2000 period, the average current account deficit was high at 6.3%, which increased further to 9.2% in the 2001-07 period. In fact, the current account deficit crossed 13% in 2008.

 Most importantly, a substantial part of Portugal's external liabilities was in the form of debt. Given the ease with which debt can be withdrawn, the external sector of Portugal was highly vulnerable. Though there was no property price bubble like in the rest of Europe, Portugal was also witness to a huge increase in the credit to GDP ratio during the 2001-07 period. With the loans to deposits ratio at 1.6, it was necessary to rely on borrowings to finance its loans. This made the banking system vulnerable when the renewal of liabilities in the wholesale funding market got affected as a result of the interbank markets getting frozen.

In the financial account of Portugal, debt instruments constituted a large share of the portfolio liabilities. Though there was no steady increase in inflows under the other investment category in the post 2000 period, the retrenchment of banking liabilities in 2008 was indeed large (Figure 5.9). In any case, the net financial inflows, which rose from 0.8% of GDP to 10.8% between 2003 and 2008, was most often lower than   the current account deficit incurred by Portugal, which was widening during the 2001-07 period. Nonetheless, there is a high correlation between the balance on current account to GDP (BCA/GDP) and financial account to GDP (FINACC/GDP) figures of Portugal in the time period 2000 to 2015 of 0.83.

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[9](Reis, 2013) draws attention to the far low rates of growth in the Portuguese economy, even prior to the crisis.
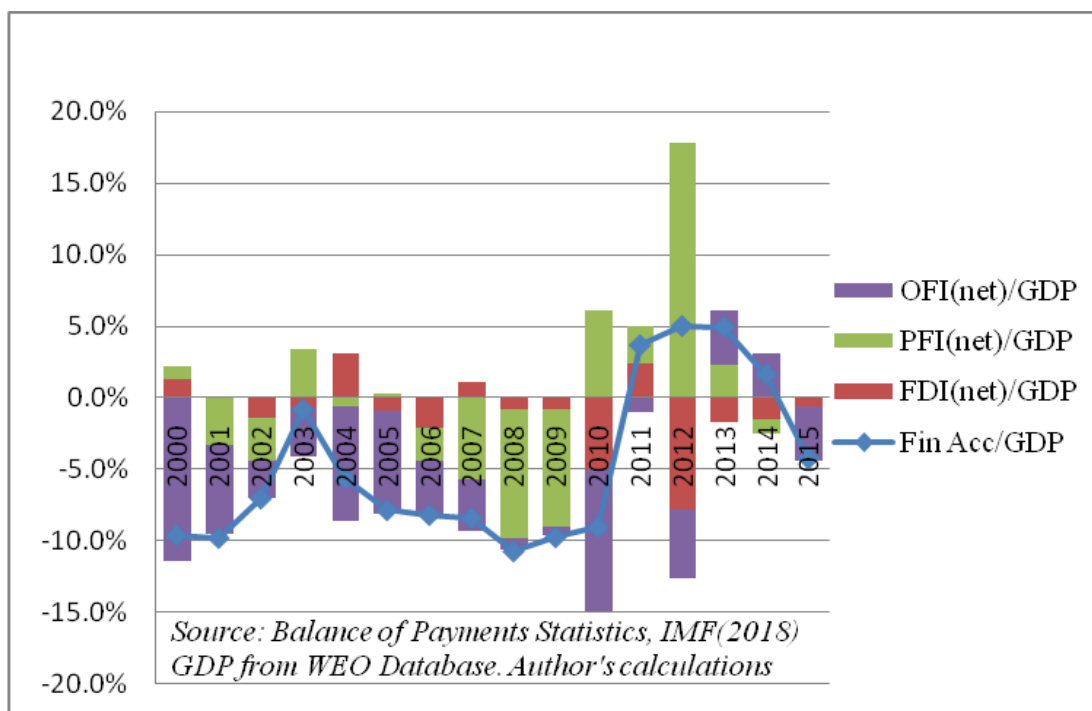
Figure 5.9: Financial Account (as % of GDP) : Portugal

The average rate of growth of Spain in the period from 1995 to 2015 at 2.21% was highest of all the GIIPS economies, other than Ireland. While the average rate of growth in the 1995-2000 period was 4.11%, even in the 2001-07 period, it registered a rate of growth of 3.56%. Its current account deficit increased from 4% in 2001 to 9.7% of GDP in 2007. Externally financed through debt creating inflows, housing was the major avenue of activity, which brought with it, issues of volatility. Figure 5.10 captures the highly volatile nature of the financial account of Spain. Even the concerns of the central bank with respect to the unsustainable credit to GDP ratios in the pre-2009 period, for which certain restrictive measures were about to be taken could not work, for the foreign banks were ready to breach the same. Fearing that the policy could hurt the homebuyers, the government had dissuaded the central bank from any such move.[10]

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[10](EC, 2015)
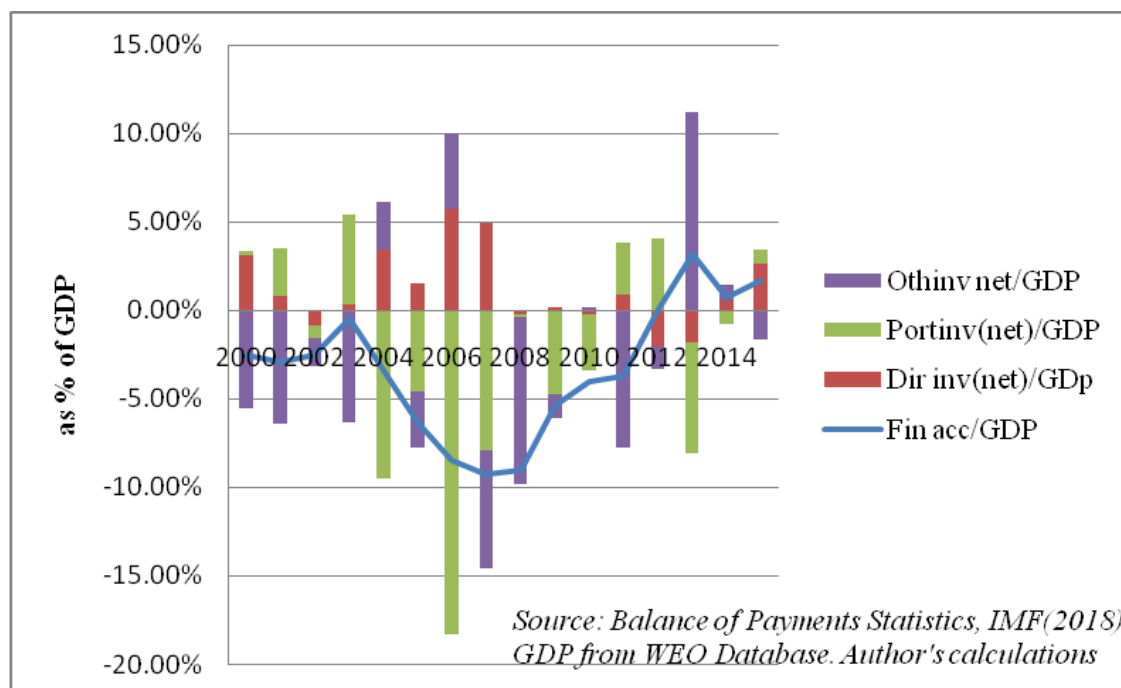
Figure 5.10: Financial Account of Spain

In the case of these five economies, we have seen that the favourable tide of capital inflows, supported also through the emergence of euro, reduced risk premia, led to higher current account deficits. Let us now look at the current account and financial account of Germany during the same period.

During the period 1996 to 2015, Germany had a surplus on the merchandise trade front. It moved to a positive balance on the current account in the course of the 2000s. The current account surplus increased from 1.9% of GDP in 2002 to 6.8% in 2007, with a large merchandise trade surplus (Figure 5.11). During this period, it had large increases in net financial outflows too. In fact, the financial account balance increased from 0.6% (2002) to 7.3% of GDP (2007), implying a net outflow in 2007 of $252.1 bn. In fact, in contrast to the large increases in credit to GDP ratios of GIIPS during the period, there were far smaller changes in the credit to GDP ratio of Germany. It should be noted that with the introduction of the euro, though the rates of interest converged across the region, the low rates of inflation prevalent in Germany resulted in the real cost of credit being far higher, resulting in lower demand for credit. As is evident from Figure 5.12, under the category of Other investment (OFI), we find that in the period from 2001 to 2008, there has been a continual outflow of

capital. In the year 2007, other investment (net) as a percentage of GDP peaked at 7.3%.
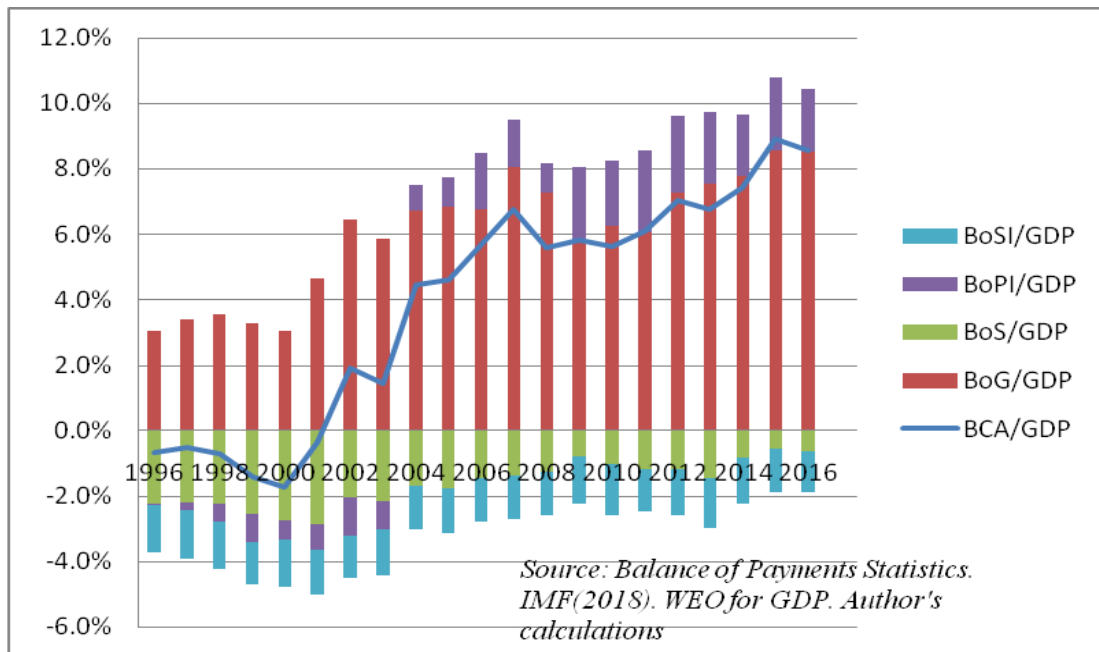
Figure 5.11: Balance on current account: Germany
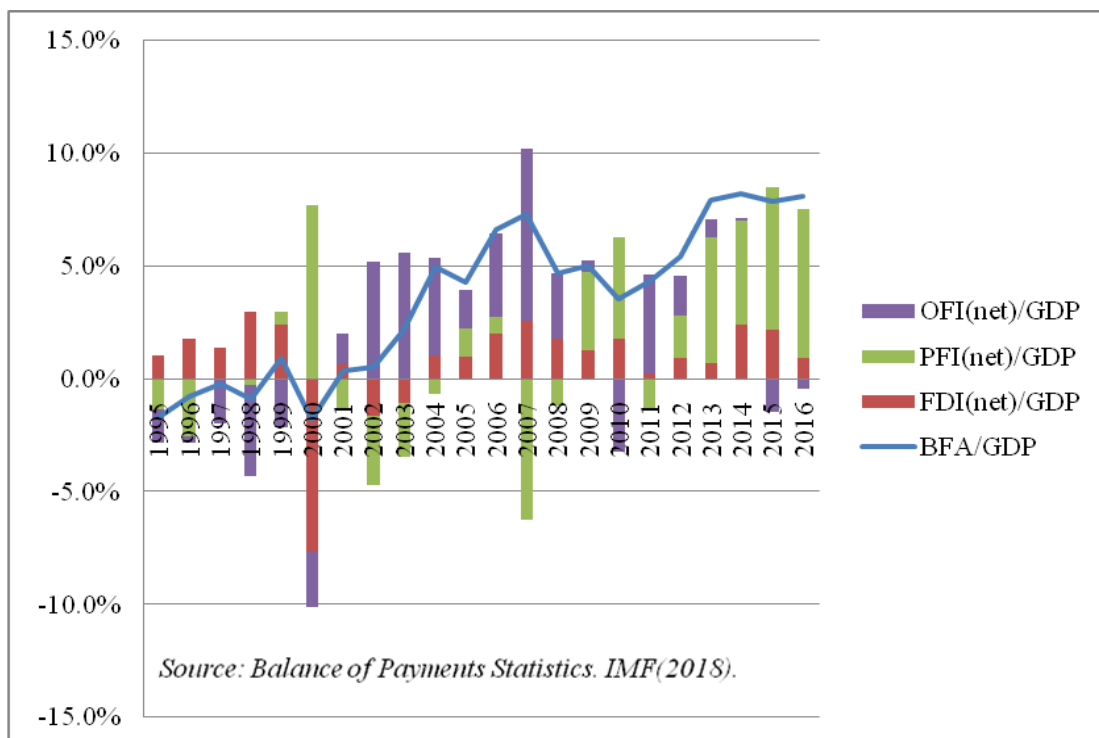
Figure 5.12: Balance on financial account(Germany)

II

Gross value added per worker and unit labour costs in Germany and GIIPS

The decrease in the share of labour in the income of countries, in the course of the last few decades, has been a matter of concern in various reports as well as research studies. This sudden reversal of trend has to be seen in the light of the fact that a stable share of wages had been treated as a stylized fact for decades(Kaldor, 1957).Arthur Bowley drew attention to the share of wages remaining constant in England for a long period till the first world war, and Kalecki adduced an explanation for that trend arguing that this was the fallout of two opposing factors: the degree of monopoly which resulted in a mark-up pricing, which was counterbalanced by the reduction in relative price of raw material relative to unit wage costs.[11] But, "The Global Wage Report 2012/13" of ILO has drawn attention to the decrease in the share of labour in the national economy, particularly since the early nineties(ILO, 2013).

This tendency of the share of labour to fall across advanced and developing economies is attributed to various factors, in particular, to the growing financialisation of the global economy, wherein there has been a rise in the proportion of financial assets held and bought abroad by citizens worldwide, reflected in higher international financial integration ratios. (Stockhammer, 2004) had drawn attention to the role played by financialisation in reducing the share of labour in the national economies of countries. Given the option of capital moving and relocating production to different countries, due to the growing integration based on global value chains encouraged by the liberalization of trade in the world economy, even with the presence of trade unions and other labour institutions, their ability to influence wage trends has become very feeble. (Epstein & Burke, 2001) argue that the mere threat of capital moving abroad is sufficient, even when it does not really move abroad, to keep labour from exercising its bargaining power. In fact, keeping the unit labour costs low to compete in the international arena has been a strategy which has been pursued by countries across the world.

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[11]This information is from (Patnaik, 2018), where he tries to trace the *differentia specifica* of Ashok Mitra's argument vis-à-vis that of others,   stating that he argued that it was possible for trade unions to increase real wages, even by keeping the degree of monopoly under control.

For a set of thirty-six advanced countries, the Global Wage Report 2012/13 estimates that the average labour productivity had increased more than twice as much as average wages since 1999. It notes that whereas there has been a close connection between labour productivity growth and wage growth in the economies of Denmark, France, Finland, UK, Romania and Czech Republic, as far as United States, Japan and Germany are concerned, wages rose far less when compared to improvements in productivity. It should also be noted that, in the period prior to 2010, in Greece and Ireland the growth of real wages far outstripped productivity improvements, and, countries like Spain and Portugal were witness to increases in wages despite labour productivity growth being negative.[12]

In the contemporary world economy, China and Germany have emerged as major exporters (Figure 5.13 & Figure 5.14). In fact, China started from a far lower base compared to Germany, but witnessed a steep increase both of exports and imports since 2002.
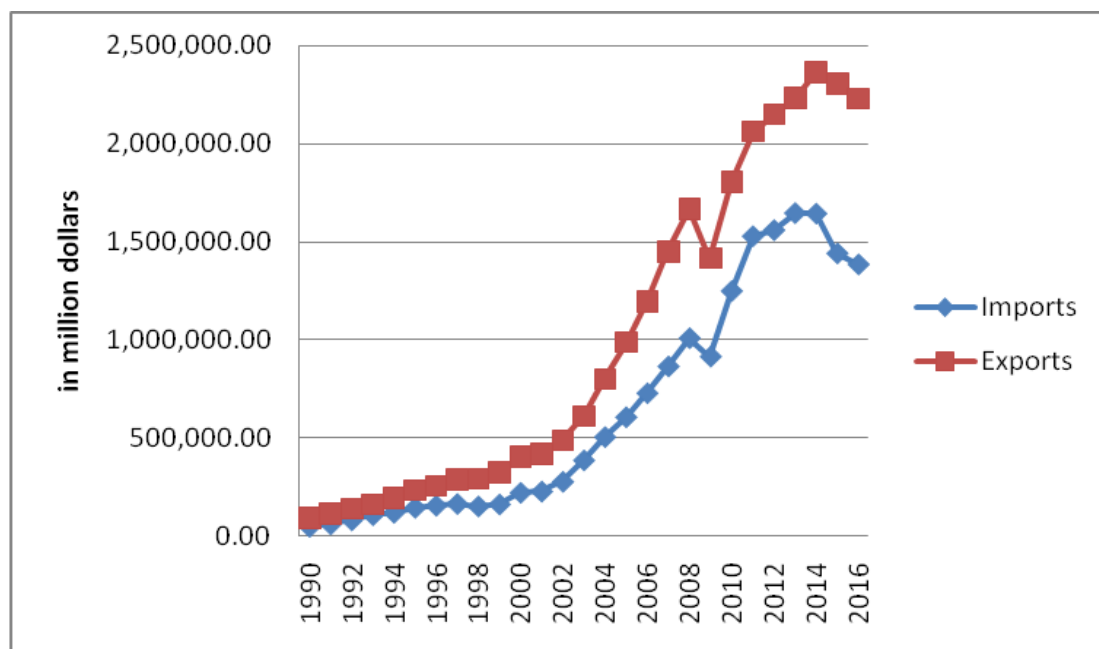
Source: IMF(2017a) Direction of Trade Statistics

Figure 5.13: Exports and imports of China (merchandise) (Source: DOTS, IMF)

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[12](ILO, 2013) p. xiv

Figure 5.14: Exports and imports of Germany(merchandise)

In the year 2015, whereas the value of China's exports was $2.31 trillion, that of Germany was $1.31 trillion. Relative to the total exports in the world of $16.32 trillion, the share of China and Germany were 13.99% and 8.12% respectively. The imports of Germany and China in the same year were $1.04 trillion and $1.44 trillion respectively or 6.35% and 8.79% of total world imports of $16.39 trillion.

The change in the Gross Value Added (hereinafter GVA) per worker and the unit labour costs (hereinafter, ULC) (Base Year: 2010) of Germany and GIIPS is illustrated below based on data extracted from the Statistics Database of OECD (OECD, 2017). It is clear that the pace of increase of unit labour costs in Germany has been far lower than in the GIIPS group of countries (Figure 5.15).Over the period 1995 to 2009, there has been a steep increase in GVA per worker as against which the unit labour costs were stagnant or even declining.

In the Greek case, one can specifically find that while the index of ULC has increased from 53.7in 1995 to 100 in 2010, the GVA per worker has increased only from 77.5 to 100, during the same period. And as the graph illustrates, ever since the crisis, Greece is going through a deflationary spiral with the ULC reaching 90.6 by 2016. Similar are the cases of Ireland, Spain and Portugal (Figure 5.16 to Figure 5.20. In the case of Ireland, till before the crisis, there had been a steeper increase in the ULC compared to the GVA per worker. As against the faster pace of increase in unit labour costs in Ireland in comparison to productivity in the period prior to the crisis, after 2010, there has been a steep decrease in unit labour costs compared to the steep

increase in productivity. In fact, the wedge between both of these has increased substantially in the recent periods.
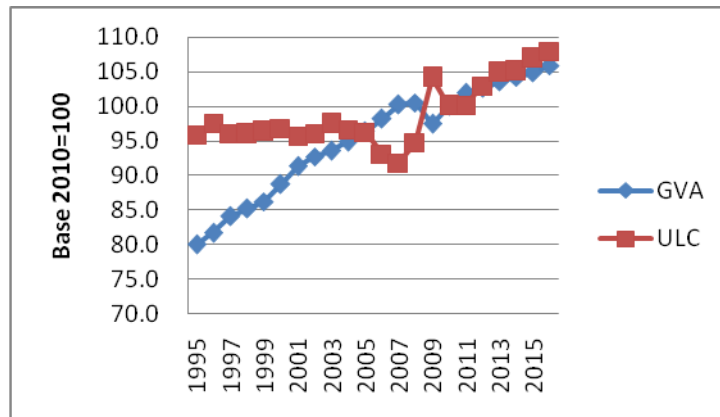
Figure 5.15: GVA and ULC of Germany (OECD,2017)
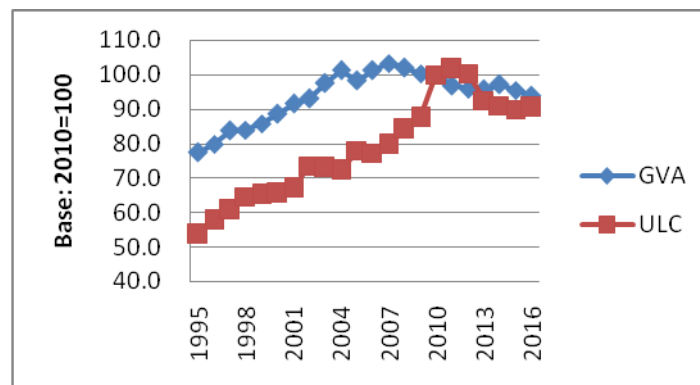
Figure 5.16: GVA and ULC of Greece (OECD,2017)
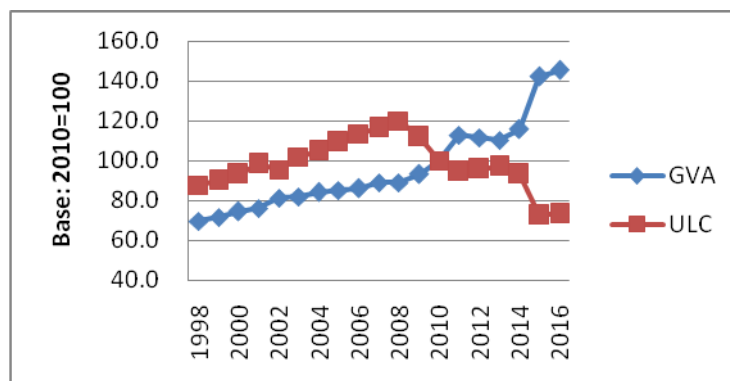
Figure 5.17: GVA and ULC of Ireland (OECD,2017)

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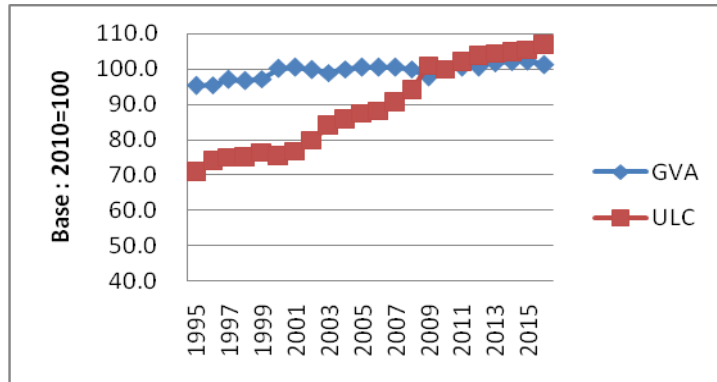
Figure 5.18: GVA and ULC of Italy
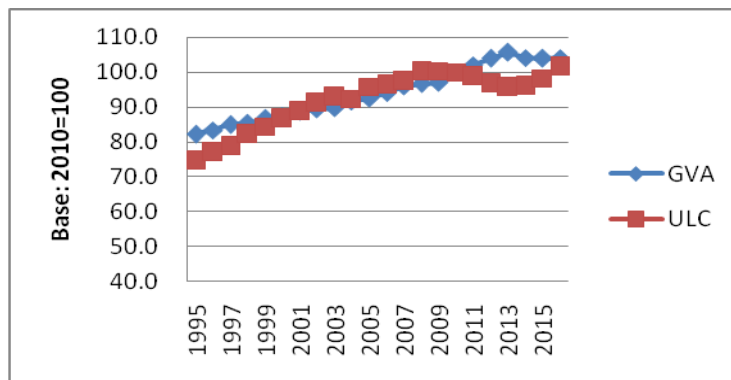
Figure 5.19: GVA and ULC of Portugal
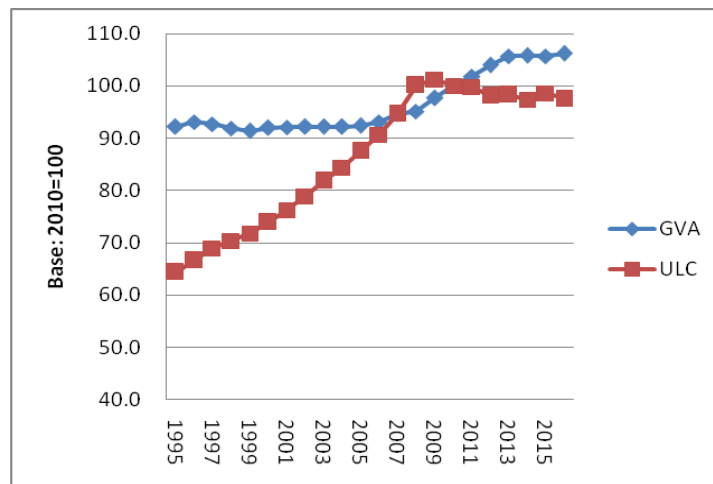
Figure 5.20: GVA and ULC of Spain

In the aftermath of World War II, when the reconstruction programmes were initiated in different countries under the Marshall Plan, the governments in Europe were looking to the possibilities of Keynesian intervention in the economy. The period was witness to increases in wages in tandem with improvements in labour productivity, which enabled large expansion of the domestic markets both in Europe and United States, through a rise in mass consumption. In due course, there was growth of exports and imports between both sides of the Atlantic, and this period of capitalism which registered high rates of economic growth with far more tolerable levels of unemployment is referred to as the Golden Age of Capitalism. Coming as it did in backdrop of the beggar-thy-neighbour policies being pursued in the interwar years, it was a great change.[13]

Source: Data from International Financial Statistics Yearbook 2017
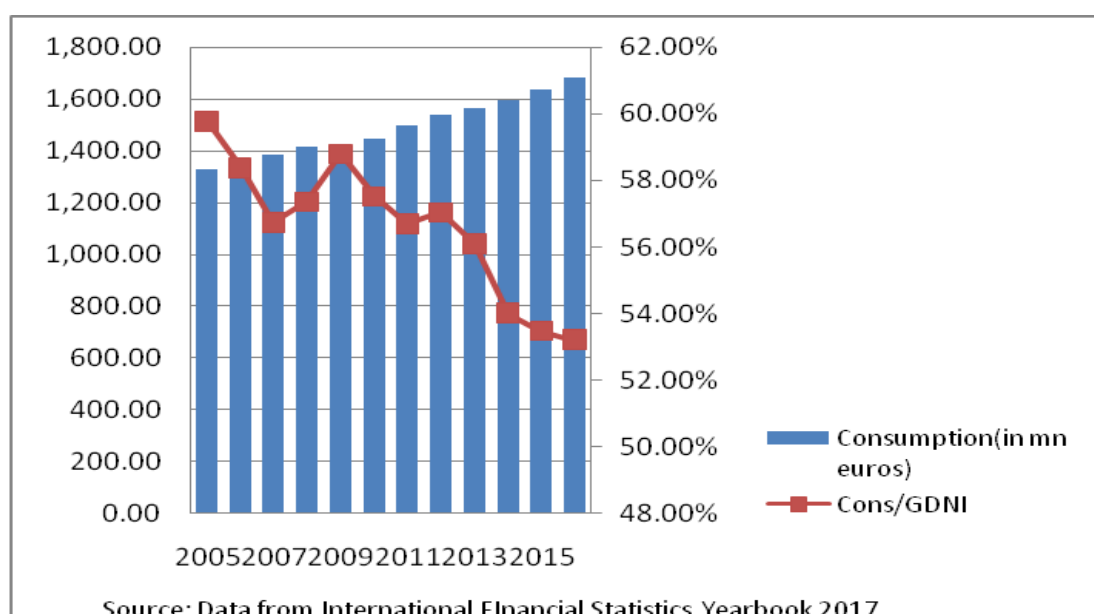
Figure 5.21: Consumption in Germany (bn euros)

As compared with this, in the last decade we find that a set of economies have been resorting to a consumption squeeze in order to generate a current account surplus in a form of neomercantilism. The data relating the consumption as a well as consumption to GDP ratio of Germany as well as Greece are provided in Figure 5.21 and Figure 5.22. In the case of Greece, which is now subject to deflation and a consumption squeeze, it should be noted that its 2015 absolute consumption as a proportion to the pre-crisis highest income is far lower at 52%.

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[13]For a collection of articles on the Golden Age of Capitalism, see (Marglin & Schor, 1990)

This contrasts with that of China, which has been witness to an increase in total consumption from 35.7% to 38% of GDP between 2010 and 2015 (Figure 5.23). This should also be seen in the context of the expansionary policies pursued by China in the aftermath of the global financial crisis.
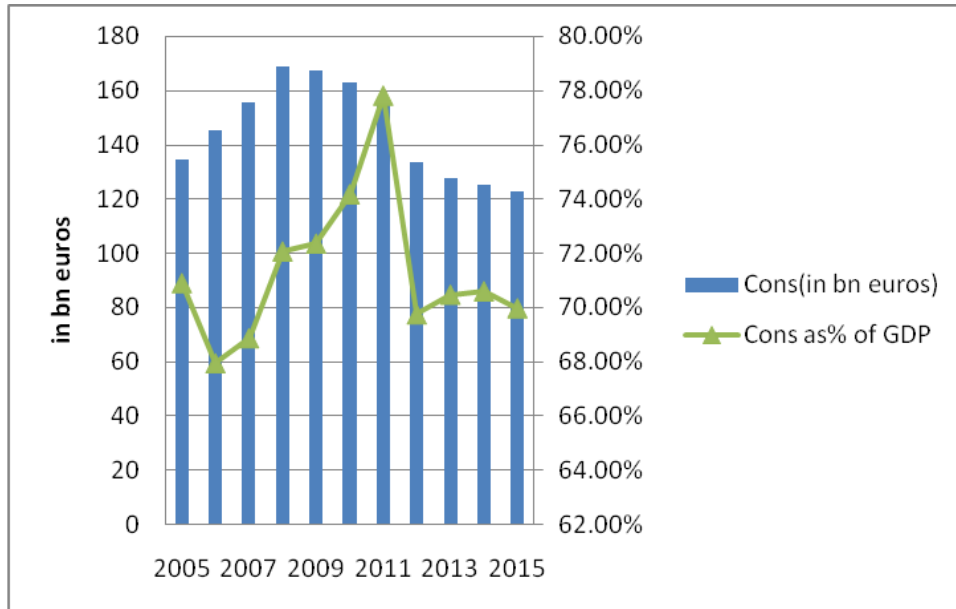
Source: International Financial Statistics Yearbook.. IMF(2017)

Figure 5.22: Consumption in Greece
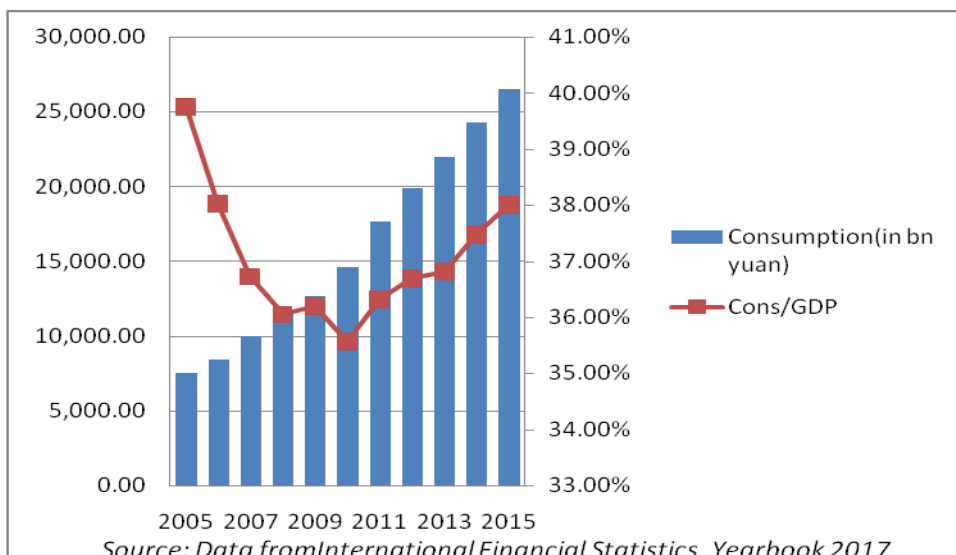
Source: Data from International Financial Statistics Yearbook 2017

Figure 5.23: Consumption in China (bn yuan)

III

German current account surplus and the Hartz Reform

The eurozone has been witness to a slide in the share of labour income in the total output since the inception of the euro. And, in fact, even as the eurozone was subject to a deflationary spiral, rather than resorting to countercyclical fiscal policies aimed at expanding the level of aggregate demand, countries have been pursuing policies of austerity, despite knowing only so well from Europe's own history the consequences. The period since the 1990s has been witness to a reduction in the share of labour income in the total output of different economies.

This is of importance given that the leader country in the region, Germany has been pursuing labour policies of this genre with a sort of vengeance, ever since 2002, when the level of unemployment in Germany was at its highest at 13.5%. A brief historical excursus into this would be informative.[14]

In the context of a high unemployment rate of 13.5% which afflicted Germany in 2002, following reunification, Chancellor Schroeder appointed a commission to address the issue of huge unemployment. This was the beginning of a break which Germany made from its past, where the state had adopted a more patronizing role and claimed to be a benefactor of labour. Peter Hartz, Director, Human Resources and Personnel section of Volkswagen, who headed the team, suggested a solution which involved a total revamp of the social security system which was prevalent in Germany since the post-World War II period. The reforms proposed by Hartz were implemented between 2003 and 2005, and led to the emergence of a labour market that had less of patronage or support from the state authorities. Hartz suggested that the high incentives provided by the system were proving to be a disincentive for labour to enter the job market. Though highly unpopular with the masses, due to its onslaught on the historically bequeathed labour benefits, the reforms ushered in policies based on labour market flexibility which reduced the bargaining power of labour. The labour market interventions adopted as part of the post-war social welfare

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[14]This section which follows is a critical appraisal of the Hartz Reform, the details of which are from a study done by Centre for Public Impact. (Centre for Public Impact, 2016)

state in Europe, were subjected to a serious revisit, with principles based on labour market flexibility having an overwhelming influence. This helped Germany to exploit export markets abroad and thus the German welfare system was identified as being antithetical to the interests of growth, and as being so overgenerous that work opportunities were shifting out of Germany. Moreover, it was argued by the proponents of the Hartz Reform that the incentives in the system encouraged labour to seek unemployment benefits rather than seeking work.

The reform in four phases included (a) creation of new types of employment opportunities (Hartz I); (b) introduction of additional wage subsidies (Hartz II);(c) restructuring of the Federal Employment Agency (Hartz III); and (d) a significant reduction in the unemployment benefits for long term unemployed (Hartz IV). These new laws included the creation of Personal Service-Agentur (Personal Service Agencies) to act as an agency to place unemployed people with employers, with a grant targeting entrepreneurs(Ich-AG) setting up new businesses and reduction of benefits to up to 30% if a worker refuses to take up a reasonable offer of work. It also initiated steps towards merging social welfare benefits with unemployment benefits.

The reforms suggested by Hartz were implemented between 2003 and 2005, and unemployment was reduced to 5.5% by 2012. All this, due to the impact of the reduction in the relative unit labour costs on the competitiveness of German goods in the international market. Even after significant productivity improvements, the improvement in wages in Germany, as per the ILO report has been far too little too. Riding the tide of the relatively lower unit labour costs, in due course, the *Sickman of Europe* was able to emerge as the Economic Superstar[15].

The dwindling share of wages in the output of countries coupled with the competitive race to the bottom pursued by countries are highlighted in the Global Wages Report 2012/13 of the ILO. In fact, in the background of the crisis, the European Commission has recommended that its members should establish decent and sustainable wages, towards helping prevent in-work poverty.[16]

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[15]For further elaboration in this regard see (Dustmann, Fitzenberger, Schinberg, & Spitz-Oener, 2014)
[16](European Commission, 2012)

IV

Germany's current account surplus and GIIPS- an empirical investigation

We examine the case of Germany vis-à-vis the economies which were at the centre of the European Sovereign Debt Crisis, i.e., GIIPS. Since Germany is a major exporter in the international economy with a large current account surplus, we try to trace the links between the trade balance of Germany with the countries which were at the centre of the European sovereign debt crisis. Towards this end, we undertake an econometric investigation with the trade balance of Germany with the country concerned $(TRADBAL)_{GER,C}$ as the dependent variable, and relative unit labour costs of Germany(ULC_{GER}/ULC_C), relative output of the country to that of Germany$(GDPC/GDPG)$ and the rate of growth of the economy in constant rates(rog) as the independent variables. We hypothesise that the German trade balance with the country concerned $(TRAD\ BAL)_{GER,C}$ improves with a decrease in relative unit costs of Germany vis-a-vis the country. An econometric model based on panel data with the following specification is used:

$$(TRAD\ BAL\ )_{GER,C} = \beta_0 + \beta_1(ULC_{GER}/ULC_C) + \beta_2(GDPC/GDPG) + \beta_3\ rog$$

As *a priori* signs, we assume that the relative unit labourcost of Germany will have a negative sign. The relative size of the economy vis-à-vis Germany $(GDPC/GDPG)$ will have a positive or negative sign depending on whether the economy's demand for the German goods would be more with growth in output, or otherwise. Given that the share of manufacturing in Germany is higher compared to all other economies in the list, we assume that it should also have a positive sign, given the service intensity of the other economies. For the rate of growth of GDP in constant terms, we expect a positive sign. Specifically so, when the growth in the region of the GIIPS were also largely driven by the large scale capital inflows from the rest of the world, and growth in the region would have led to large imports from Germany.

Sources of data

The data for Germany, with respect to direction of trade has been accessed from the Direction of Trade Statistics of the International Monetary Fund. All data are in million dollars. The fact that the DOTS data are largely on the goods exported and imported and does not include services is a shortcoming. But, nonetheless, it has a major advantage in the sense that the current account surplus of Germany is largely the result of the goods balance which it has with the rest of the world. In fact, with respect to invisibles trade, Germany has had a deficit. Other than merchandise trade, it is on the investment income front, largely reported as primary income, that the economy has a surplus.   The data relating to the exports of Germany to the country concerned and the imports from the country is taken and the X-M with respect to that country is calculated. The data relating to rate of growth of GDP at constant prices is drawn from the WEO Database of IMF. It should be noted that after collating data of GDPs of countries, the relative GDP vis-à-vis Germany was calculated .Though all of these data are available for a longer time period, the one related to unit labour costs for one of the economies in our set from the OECD Statistics Database, i.e., Ireland, is available only from 1998. Hence we restricted the investigation relying on the data relating to all these variables for the time period 1998 to 2015, so as to keep the panel balanced.

Analysis of data and findings

A panel data analysis is undertaken with the data of the trade balance of Germany with the five other economies for the time period 1998 to 2015.The Hausmann test statistic strongly rejects the Random Effects Model, for the p value of the estimated chi square statistic is very low. So, in this case a Fixed Effects Model is preferred to Random Effects Model, and the Fixed Effects Model is selected for further investigation. The following table gives the results.

Fixed effects model: (5 cross sectional and 18 time periods(1998-2015)					
Dependent variable: Trade balance of Germany with the country(TRAD BAL)$_{GER\ C}$					
	Coefficient	*Std. Error*	*t-ratio*	*p-value*	
Const	−7133.30	5696.84	−1.252	0.2141	
ULC$_G$/ULC$_C$	−13677.6	3527.25	−3.878	0.0002	***
GDPC/GDPG	118223	12263.7	9.640	<0.0001	***
rateof growth	390.471	103.664	3.767	0.0003	***
Mean dependent var		6424.324	S.D. dependent var		8540.121
Sum squared resid		6.81e+08	S.E. of regression		2881.414
LSDV R-squared		0.895116	Within R-squared		0.682866
LSDV F(7, 82)		99.97426	P-value(F)		1.94e-37
Log-likelihood		−840.4587	Akaike criterion		1696.917
Schwarz criterion		1716.916	Hannan-Quinn		1704.982
Rho		0.577050	Durbin-Watson		0.797727

Joint test on named regressors -

Test statistic: F(3, 82) = 58.8553

with p-value = P(F(3, 82) > 58.8553) = 2.15421e-020

Test for differing group intercepts -

Null hypothesis: The groups have a common intercept

Test statistic: F(4, 82) = 78.7915

with p-value = P(F(4, 82) > 78.7915) = 2.71657e-027

In the fixed effects model, it is estimated that the trade balance of Germany with GIIPS economies increases by $136.77mn with every percentage decrease in the relative unit labour costs of Germany. For a relative increase in the national income of the country vis-à-vis Germany by a percentage point, the trade balance of Germany increases by $1182.23mn, and a unit increase in the rate of growth in constant prices increases the trade balance of Germany by $390.471mn, and all of these independent

variables are statistically significant at 1% level. The LSDV (R squared) is reported at 0.895116 and F(7,82) is 99.97426.

In fact, the econometric model further gives credence to our earlier argument that the decline in relative unit labour costs has a perceptible impact on the increase in the trade balance of Germany

V

Some Concluding Observations

A brief glimpse into monetary history would be in order, before one concludes this chapter about imbalances in the eurozone. Though the monetary trilemma was discussed much later in the field of macroeconomics, there are various studies which try to provide empirical evidence with respect to its validity right from the time of the Gold Standard. But, to argue that the Gold Standard was literally following the rules of the game, as in the Humean price-specie-flow mechanism, does not stand empirical scrutiny. In fact, even under the Gold Standard, there were countries which used to sterilize the impact of the inflow of gold, as there were deficit economies which kept their interest rates high so as not to allow the flight of gold from their own country. Therefore, the adjustments were not clearly as outlined in the Humean scheme.

Moreover, even during its heyday, the Gold Standard was not ubiquitous. There were a number of countries in the periphery with which the core had a significant volume of trade, which were on the silver standard. So they did have the option of external devaluation, and did not have to go for adjustment in price levels, through changes in wages. There was stiff resistance from labour to the downward flexibility of wages, since the mid-nineteenth century. Indeed, the Chartist movement in nineteenth century Europe, which ultimately resulted in the workers getting enfranchised, assured that their interests also had to be taken into consideration with respect to the grammar of adjustment in monetary circles.[17]

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[17](Eichengreen, 2008)for the details of monetary transition across centuries. Also informative in the comparative analysis with the euro area and its troubles is (O'Rourke & Taylor, 2013)

The Miners' Strike in Britain in the 1920s, which put up a stiff resistance, when Churchill decided to restore the pound to its pre-war exchange rate, is a very important instance. History bears testimony to the fact that, apart from other factors, the environment of deflation in inter-war England also played an important role in the transition of Britain from a creditor nation to a debtor nation.

It is indeed paradoxical that countries under the eurozone are now left with only one option, that of deflationary adjustment, given the weak institutional setup in Europe, which is tilted more towards rentier interests. How is this bird's eye view of the monetary history of any significance to the contemporary European scenario and to our study of the German trade surplus with the sovereign debt crisis affected countries in the eurozone?

In their study, (O'Rourke & Taylor, 2013)conclude, that with neither a common market, nor a robust fiscal transfer mechanism or a market assuring free mobility of labour, the adjustment process in the eurozone, which had monetary union well before it had a proper institutional setup, is all the more problematic. A serious nagging problem is also the lack of readiness of the Germans to direct the larger eurozone in the interests of the collective common good.

The monetary union based on the euro in the eurozone deprives economies of one important tool of adjustment, i.e., their exchange rate. In the current case, it is clear that Germany, the surplus economy in the block is not ready to play ball, by inflating its economy, which would have been the best option. In fact, the genesis of the problem lies in the fact that Germany has not been willing to pass on the benefits of enhanced productivity improvements in the form of higher wages. The unwillingness of the surplus economies to take on the adjustment role was a matter that bothered Keynes during the Bretton Woods Conference too.[18] Given that the option of adjustment of the exchange rate is not there, wherein the Greek drachma could have been devalued against the euro or dollar, the Greeks are left with the difficult option of deflating their price levels as the only resort. The ECB has been pushing policies based on austerity in Greece with an intent of ensuring that the interests of finance are served and the size of the public debt is reduced towards

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[18]For an extraordinarily great narrative of the events during the time (Steil, 2014)

preventing sovereign default. So time alone would tell what the consequences would be in the context of the debt-deflation which would occur.

This study has drawn attention to the changes in current account in the GIIPS group being driven by the net inflows on the financial account. Our empirical investigation based on panel data has validated the contention that the changes in the trade surplus of Germany with its eurozone partners in the centre of the sovereign debt crisis(GIIPS) is inextricably related to the decline in the relative unit labour costs of Germany vis-à-vis those economies. For the eurozone, as well as for the world economy, a superior method of adjustment would be to allow the German price levels to increase, than having the price levels of other economies adjust downwards. But, this is again the old issue which Keynes raised at the Bretton Woods Conference of the reluctance of surplus economies to adjust. Various studies have drawn attention to the high correlation between austerity policies and the rise of the political right.[19]Yet, Europe seems to be treading the deflationary route, the consequences of which only time would tell.

With advanced economies like Germany emerging as one of the biggest exporters by keeping their relative unit labour costs low, and, a set of advanced economies which has suffered in the recent crises readying to export its way out of deflation, where is the space left for the emerging and developing economies, as suggested by the exponents of Bretton Woods II?

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[19](Ponticelli & Voth, 2011)draw attention to the strong correlation between fiscal austerity and political chaos over the last century , the result is robust with respect to the interwar sample.

Conclusion

This study critically addresses the conceptualisation of the workings of the international monetary system and the implications thereof in the Bretton Woods II postulate advanced by Dooley, Folkerts-Landau and Garber through their various writings. The first chapter locates that postulate in the context of the changing composition of global imbalances. The Bretton Woods II model is based on the rationale that inasmuch as the emerging economies would be willing to purchase US Treasury securities in order to keep their real exchange rates depreciated, so as not to lose competitiveness in the global markets, the core country, i.e., the United States would be only ready and willing to sustain higher current account deficits. Given that the purchase of the US Treasuries facilitates the financing of the deficits of the United States, as well as assures the relative stability of the dollar, this system works favourably for the centre country too.

Many of the assumptions on which the Bretton Woods II model is based do not stand the up to empirical scrutiny. The argument that foreign exchange reserves serve as a collateral of sorts for the foreign direct investment undertaken in the emerging economies gives the impression that the exports of these economies have been made largely by foreign direct investment. This, at best, is true for China and the industrialising economies of east Asia. Moreover, the model is silent about the set of economies accumulating Treasuries using the net capital inflows on the financial account. The whole argument that the Bretton Woods II system is offering financial intermediation services of sorts for the developing economies seems to be ignorant of the fact that there has been a concomitant increase in the investment and saving ratios across emerging economies, largely in line with the Feldstein-Horioka thesis.[1] And most importantly, the argument that the emerging economies accumulate foreign exchange reserves with the explicit mercantilist intent of maintaining the competitiveness of their goods does not hold. Their cost advantage should be traced to large labour reserves more than anything else. And, reserve accumulation done through intervention in the markets by the developing country central bankers should be seen as part of a purely precautionary motive, insurance of sorts against volatile

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[1] This puzzle drew attention to the striking correlation between investment ratios and savings ratios in economies, implying that at best, the foreign savings was supplementing domestic savings.(Feldstein & Horioka, 1980)

fluctuations in the foreign exchange markets. Forced to do so also by virtue of the purely ad hoc nature of the international liquidity available through the credit lines extended by central banks like the Federal Reserve, indirectly rationalising the arrangement as "Bretton Woods II" is tantamount to sidestepping arguments with respect to the reform of the international monetary system towards redressing the adverse impacts on the developing countries.

The Bretton Woods II which has evolved *pari passu* with the world of free capital movements since the nineties gathered momentum in the course of the first decade of the current century. During this period, in response to the large increase in the demand for safe assets from the rest of the world, the financial system in the United States provided the same, apart from the Treasuries, through the creation of private labelled securities. These securities which received high ratings in the international financial markets found their values crashing with the sub-prime crisis, inflicting severe stress on different banks in the global economy, leading to the global financial crisis.

The faster pace of growth of the rest of the world, reflected in the increasing share of emerging market economies in the world GDP, is posing a modern Triffin dilemma of sorts(Gourinchas, 2016). The continually increasing demand for reserves that serve as a safe haven, not just from the EMDEs, but also a set of the advanced economies, would be too much for the US Treasury to issue, given the growth in the debt to GDP ratio which it would entail. Moreover, the trajectory chosen by the United States financial system to meet the demand through the issue of private labelled securities like ABS and MBSs is no more feasible, given the large decrease in the value of such assets which occurred in the course of the global crisis. But, questions still loom as to what should prevent the issue of the Treasury securities and fiscal expansion, given the extremely low rates of interest in the United States, and the deficiency of demand in the global economy. This should no more be construed as being raised by some post- Keynesian economists. Even Blanchard dwelt on it in an address to the American Economic Association(Blanchard, 2019). Not only does the crowding out argument not hold, particularly since the economy is in a downturn, with deflation, but all tools in the monetary policy toolkit have also got exhausted. Worse, policymakers dogmatically maintain that there is no possibility of output

expansion through the use of fiscal policy, despite arguments and evidence to the contrary.

The modern-day Triffin dilemma would, *ipso facto*, make its presence felt, once this sense of fiscal conservatism dominates. Only with demand being restored in the system would the productivity-enhancing technologies possibly be introduced. With output increasing in the system, the very premises of the argument which is structured on the rise in debt to GDP ratios would no more hold water.[2]

The realignments in the world economy have resulted in the share of the euro area declining to 15% of world GDP, and the Chinese share rising to 15%. Though the share of the US economy had declined from 30% (2000) to 25% in the recent past, it continues to be the leader country. Given the decline in the relative share of the euro area GDP, and the dominant preference for Treasury securities, as against private labelled securities, at least in the current dispensation, it would only be through expansionary government expenditure from the United States that the demand for safe assets could be met.

Based on this discussion, Chapter 1 draws attention to the fact that in the aftermath of the global crisis, not only have the current account surpluses of EMDEs (including that of China) been on the decline, but those of advanced economies like Germany have been increasing. The possibility of a set of emerging economies ending up in a middle income trap of sorts, with another set replacing them as the new periphery is conjectured.

The second chapter draws attention to the growing accumulation of foreign exchange reserves in the world economy. The basic premises of Bretton Woods II are structured in such a manner that net resources would keep flowing to the United States, in return for which, the developing economies would have access to markets. The data reveals that since the crisis, even as the share of the current account surpluses of the emerging economies has been on a decline, the difference between the rates of return on the external assets of the USA as against its liabilities has been on the increase. In other words, even as the access to markets has dwindled for the

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[2]As per the debt model of Domar, inasmuch as the rate of growth in the economy is higher than the rate of interest, the sustainability of debt would not be a problem. And, in the contemporary global economy, the demand for Treasuries is such that the yield on the same is so low.

EMDEs, the United States continues to enjoy the exorbitant privilege of being home to the reserve currency. It is of particular significance to note that other than some economies like China, contrary to what is argued by the proponents of Bretton Woods II, foreign exchange accumulation has occurred not as a result of surpluses on the current account, but on account of the net inflows in the financial account. As various studies have empirically testified, this entails a significant social cost.

The chapter further attempts a comparison of the growth of a set of emerging market and developing economies in the period 1998 to 2007 and the period 2008 to 2014. It brings to attention a set of economies (Hungary, Romania, and Poland) whose rates of growth have decreased with a drastic improvement in the current account. In other words, this set of economies had gone for a pattern of debt-driven growth with unusually high current account deficits, which has become untenable with the retreat of capital from the region of emerging Europe, of which are all three economies are a part. The *ad hoc* nature of the international monetary system in the world economy characterised by largely free mobility of capital has been pushing economies through a debt-driven boom with its associated boom-bust cycles.

The third chapter draws attention to the changing patterns of global liquidity trends in the international arena during the BW II era, which has been characterised by flows of private liquidity. It draws attention to the decline in cross-border capital flows, both in absolute terms as well as a share of the world GDP, since the crisis. Even as there has been no recovery on this front to the pre-crisis levels, there has been a steady upswing of the issuance of international debt securities by corporations across the world.

Given the two-way flow of gross capital, banks based in Europe relied on borrowings in the money markets in the United States towards financing their investment in asset-backed and mortgage-backed securities.[3] As the rollover of these short-term liabilities became impossible, and the money markets froze, many of the

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[3]The increased net lending abroad between mid-2007 and mid-2008 is mainly attributable to U.S. offices of European-owned banks lending to their affiliated offices in Europe. The current account deficit of the United States and net capital inflows into the United States apart, the claims of the banks based in US have been higher than the liabilities it owes to the economies since the mid nineties. In other words, as far as banking flows are concerned, USA has been a net lender (Bertaut & Pounder, 2009).

banks headquartered in Europe had to sell their assets to clean their balance sheets. Even while the foreign claims of German, French, Austrian and Swiss banks declined, those of Canada, Australia, Singapore, China and Japan have been on the increase. In fact, with the deleveraging of the European banks, which used to intermediate between US money markets and Asia, the latter set of banks have taken on this role. Not only has the dollar credit outside United States increased, that to the EMDEs has increased from 8.84% to 11.29% of the EMDE GDP between 2007 and 2017.

The expansionary monetary policies based on bond purchases pursued by the major central banks like Fed Reserve, ECB and Bank of Japan have resulted in the expansion of the central bank balance sheets, and, led to a reduction in the levels of interest rates in the global economy. The fallout this has been a steep increase in capital flows to EMDEs, both through banks as well as the issuance of international debt securities. These flows to the EMDEs, without any concomitant increase in investment ratios in these economies, make it self-evident that the flows are motivated by the search for profits out of from the interest rate differentials. The risks associated with the same became evident with the taper tantrum of 2013, when with the Fed announcement that bond purchases would be reduced, there were large capital outflows from the emerging economies, resulting in exchange rate depreciation coupled with the high level of volatility.

It is being projected that this post-GFC period has been used by the different emerging market economies towards mobilising funds in domestic currencies. Notwithstanding the increase in the share of recent gross issuances denominated in local currencies, the stock of the international debt securities denominated in domestic currencies is too low to pose any credible challenge to the 'original sin' hypothesis. Moreover, there is a growing difference between the international debt securities being mobilised on a nationality basis as against residence basis, which adds to the risks and vulnerabilities of economies not properly reflected in the balance of payments accounts. Within external debt, even as the ratio of publicly guaranteed debt to GDP has not recorded an increase for many EMDEs, private non-guaranteed debt to GDP has risen steeply. In the case of certain economies, this debt has been used to finance investment in third countries too

This chapter emphasises the fickle nature of global liquidity which exposes the EMDEs to severe risks and uncertainties, under the regime characterised as Bretton Woods II. Ever since the crisis, with the adoption of expansionary monetary policies, the surge in capital flows to the emerging market economies in search of yield have been adding to their vulnerabilities. Any reversal of that flow from the main centres would lead to major turmoil in the emerging markets.

The fourth chapter dwells at length on the economies of Hungary, Romania and Poland, as they traverse from a stage of financialisation-induced growth to deleveraging-induced deceleration. These economies had been integrated into the world of global finance like the others in eastern Europe and the Baltics to such an extent that a substantial portion of the liabilities of households and firms were denominated in foreign currency, and a large share of the assets of the banking system was held by foreigners. Hence, macroeconomic events like the global financial crisis, the European sovereign debt crisis as well as the Swiss franc appreciation proved far more damaging. Depreciation of local currencies had serious adverse effects on the balance sheets of the households, forcing central bankers in eastern Europe to initiate steps to convert foreign currency-denominated liabilities into domestic currency debt. This was, in fact, a big break from the past, which was followed by various steps including legislation affecting financial institutions in Romania that favoured the interests of the consumer, measures to increase the share of the state in the assets of the banking system in Poland, and the passing of the Fair Banking Law in Hungary. In a region that had central bankers pursuing strategies like issuance of sterilisation bonds to enhance the profits of foreign banks based in their territory, this sort of shift was indeed remarkable.

The changes in these eastern European economies might be seen as being purely temporary in nature, or too trivial to be significant. But, having discovered the futility of full-blown financialisation with literally no controls, eastern European economies have been making efforts to rein in finance. Coupled with other steps, the relative improvement in the returns of the productive sectors as compared with the profits of finance could continue into the medium term. The new dispensation has also involved concerted efforts such as the Vienna Initiative providing *de minimis* support for small and medium enterprises, and the strategy of enhancing technology exports

through the Responsible Development Plan in Poland. Given the similarity of the region with Asia in educational attainments, and the reality that many of the economies are already part of the global value chain centred around Germany, the chapter goes on to speculate on the possibility of emerging Europe graduating to be the new periphery in the Bretton Woods II era. Given that already the core country has a problem with China cornering a lion's share of the surplus, it is quite likely that a set of emerging economies would graduate to this role.

To date, the speculations were only in terms of which of the developing economies would dislodge the existing ones to serve as a new periphery in the Bretton Woods dispensation. However, under the changed dispensation, one cannot rule out even erstwhile advanced economies affected by the crisis in Europe stepping into this role. Capital flows from mainland Europe could push some of the advanced economies into a state of crisis, despite the initial impression that these economies were "catching up", and, that there were signs of convergence with the adoption of the common currency euro. The chapter explores the transformation of Germany into a major exporter in the world economy. This transformation implies that with the adoption of policies on labour market flexibility, even an advanced economy can graduate to become a major surplus economy, benefiting from the United States being the economy with the largest deficit. By keeping its price levels, or, wages from increasing at a faster pace, Germany, through its deflationary policies, has been able to earn a surplus, even in its trade and economic relations with the crisis-ridden economies of Greece, Ireland, Italy, Portugal and Spain.

Postscript

This study has been largely confined to the database of the world economy from the period from 1990 to 2015. Since then, there have been a number of changes. There has been a reduction in the volume of world trade, because of slower growth and the trade disputes which have gathered momentum at the global level, even after the current account surpluses of China have registered a sharp reduction since the crisis. Despite the arguments advanced by economists of various hues about the importance of fiscal expansion and the limits to monetary policy action in the world economy characterised by deflation, there has been a doctrinaire adherence of sorts to fiscal conservatism and reliance on easy money policies. While there has been a

distinct increase in international credit (global liquidity), as per BIS database, from 33% of world GDP (2015) to 38% (2018), there have been no favourable signs on the growth front. Reflective of the sense of uncertainty which prevails is the growth of foreign exchange reserves, accumulated by economies by incurring a heavy cost. Even as the stock of foreign exchange reserves grow in the EMDEs, they are increasingly not able to even meet the external debt liabilities of the country, given that the accumulation of reserves is driven in many economies by inflow of liabilities on the financial account.[4] It seems that beyond rationalising the contemporary global economy, the Bretton Woods II postulate, serves little other purpose from the point of view of developing economies.

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[4]In the recent Report on Economic Capital Framework of RBI, it is observed......... "the foreign exchange reserves (more than $400 billion) are significantly lower than the country's total external liabilities ($1 trillion) and even lower than total external debt ($500 billion). This position is in contrast to that in 2008 when India's foreign exchange reserves, at $310 billion, exceeded the then total external debt of about US$224 billion and provided a much larger coverage of total external liabilities that amounted to about $426 billion"(p.24) (Reserve Bank of India, 2019).

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