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Working Paper No. 553

Insuring Against Private Capital Flows: Is It Worth the Premium? What Are the Alternatives?

by

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ABSTRACT

Following an analysis of the forces behind the "global capital flows paradox" observed in the era of advancing financial globalization, this paper sets out to investigate the opportunity costs of self-insurance through precautionary reserve holdings. We reject the idea of reserves as low-cost protection against the vagaries of global finance. We also deny that arrangements giving rise to their rapid accumulation might be sustainable in the first place. Alternative policy options open to developing countries are explored, designed to limit both the risks of financial globalization and the costs of insurance-type responses. We propose comprehensive capital account management as an alternative to full capital account liberalization. The aims of a permanent regulatory regime of capital controls, with respect to both the aggregate size and the composition of capital flows, are twofold: first, to maintain sufficient macro policy space; second, to assure a good micro fit of external expertise incorporated in foreign direct investment as part of a country's development strategy.

Keywords: International Monetary Order; Financial Globalization; Capital Flows; Financial Crises; Capital Controls; Foreign Reserves

JEL Classifications: E43, E58, F02, F32, F33, F55

1. INTRODUCTION

Capital account convertibility has been widely advertised as a market-oriented development strategy, with the International Monetary Fund (IMF) acting as a main protagonist in the ideological push for universal capital account convertibility. By permitting developing countries to draw on foreign saving (i.e., capital imports), the argument went, capital account convertibility would set free faster growth and catch-up. In actual fact, the era of advancing financial globalization has witnessed many developing countries running sizeable current account surpluses with massive *official* outflows into low-yielding U.S. dollar assets. From a mainstream theoretical viewpoint it is truly paradoxical that capital should flow from "South" to "North" rather than the opposite way—thereby even squeezing the developing world's savings available for domestic investment and development, it would seem.

Following an analysis of the forces behind the so-called "global capital flows paradox" (Summers 2006), this paper sets out to investigate the opportunity costs of rapid reserve accumulation in developing countries and then explore potential alternatives. Apparently, developing countries accumulate reserves as protection against the insecurities inherent in today's international monetary and financial order. While such a strategy of "self-insurance" was proposed by Martin Feldstein (1999) in the aftermath of the Asian crises, we agree with Rodrik (2006) that the insurance premium involved here may be higher than generally supposed. Related questions concern the effectiveness and sustainability of the supposed self-insurance scheme, as well as its overall economic wisdom compared to potential alternatives. It turns out that these questions pertain to another popular hypothesis put forward in this context, namely the "revived Bretton Woods regime" (BWII) hypothesis (Dooley, Folkerts-Landau, and Garber 2003). After highlighting some crucial shortcomings that question the supposed sustainability of BWII, we deny the ultimate wisdom of capital account convertibility in developing countries and propose an alternative strategy of comprehensive capital account management.

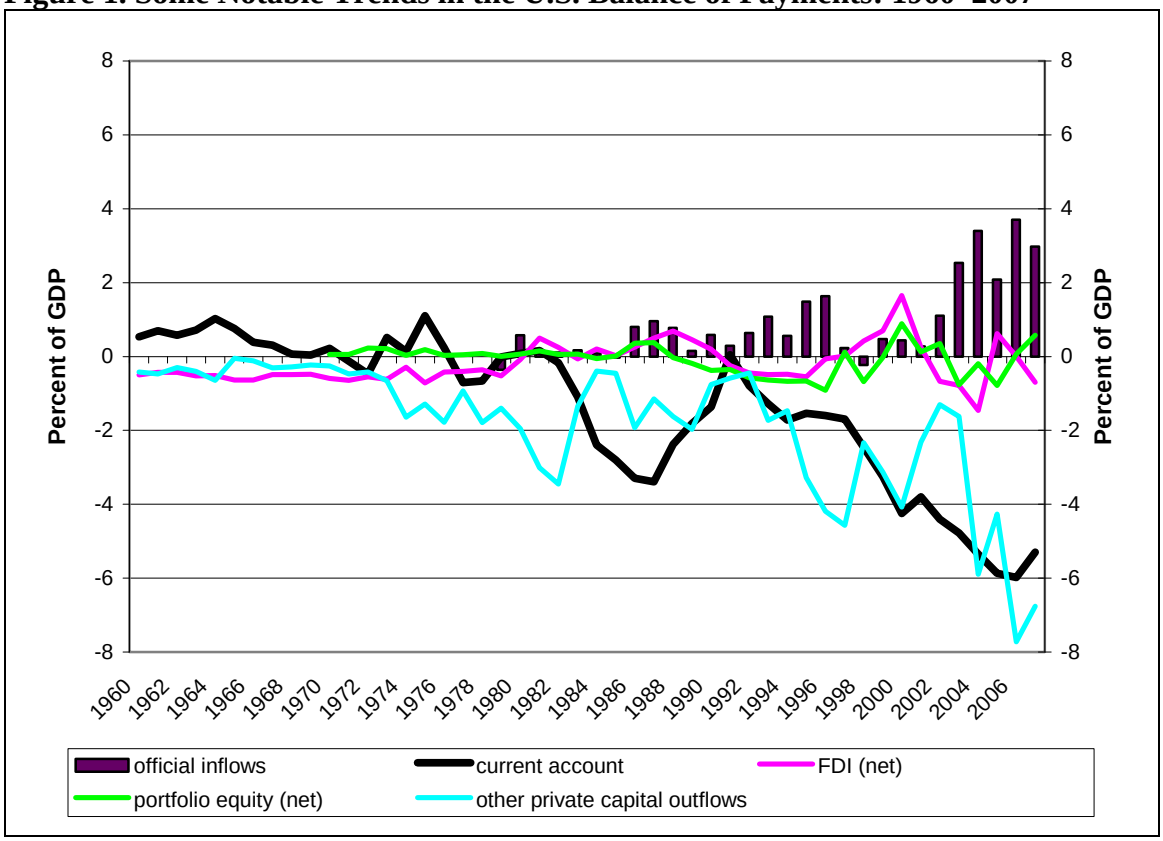
The paper begins with an analysis of the postwar international U.S. dollar standard together with a historical review of the evolution of the U.S. balance of

payments in view of the U.S.'s special status as the n^{th} country in the Bretton Woods regime. After offering some reservations concerning the supposed sustainability of the BWII regime in section 3, the analysis in section 4 turns toward assessing the true opportunity cost of self-insurance through U.S. dollar reserve holdings. This is followed in section 5 by a reconsidering of the overall wisdom of financial globalization as contributing toward development. We explore some alternative policy options of developing countries designed to contain the risks of financial globalization and avoid the costs of insurance-type responses. Section 6 concludes.

2. BRETTON WOODS, THE U.S. DOLLAR, AND THE N^{TH} COUNTRY ROLE

In any pegged exchange-rate regime of *n* currencies, there are only *n*-1 exchange rates to peg, leaving one degree of freedom concerning the regime's overall monetary stance. Typically, it may fall on one county, the n^{th} country, to act both as currency anchor, as well as engine (or last resort) of economic expansion. For, to the extent that the *n*-1 members' demand for international liquidity is not provided for through some common institution or mechanism that either pools and clears member currencies and/or creates liquidity on its own (a role assigned to the International Monetary Fund in the Bretton Woods regime of 1944), their demand can ultimately only be met by the n^{th} country itself through running a balance of payments deficit. The key currency issuer's flexible policy reaction is thus vital to the global economy. In particular, any aggregate increase in the propensity to hoard the reserve currency (or, rise in international liquidity preference) will otherwise put upward pressure on its exchange rate and create deflationary pressures on the system as a whole.

Figure 1. Some Notable Trends in the U.S. Balance of Payments: 1960–2007



Source: Bureau of Economic Analysis (BEA), International Monetary Fund (IMF), and the U.S. Department of the Treasury

Throughout the postwar period, contradicting fears of a built-in contractionary bias widely held at the time of the Bretton Woods negotiations in 1944, the United States has proven itself sufficiently flexibly and creative in making U.S. dollar reserves available to the rest of the world. Figure 1 shows the evolution of the U.S. current account balance, (net) foreign direct investment (FDI) and (net) portfolio equity flows, U.S. private capital outflows (other than FDI and portfolio equity), and official inflows since 1960 (or later depending on data availability; all expressed as percent of U.S. GDP). Ignoring U.S. official reserve outflows, balance of payments accounting implies that deficits on current account and private capital outflows require corresponding foreign (private and/or official) flows into U.S. assets.

It is noteworthy that the United States had a current account *surplus* position until 1970. In the early postwar years, generous official aid (the "Marshall Plan," in particular) provided foreign countries with the needed U.S. dollars. Then, during the 1950s and 60s,

U.S. foreign direct investment provided the key source of U.S. dollar reserves. Rapid catching-up growth in Western Europe and Japan was made possible in a low inflation, low interest rate environment, with the United States providing restraint. This global constellation came under rising stress over the course of the 1960s for two reasons. First, progressive easing of capital controls and the emergence and growth of Eurocurrency markets in London allowed a rising role for private short-term funds attracted by interest rate differentials (which were adverse to the United States). Second, the Vietnam War pushed the U.S.'s resource needs beyond the country's own means so that the current account deteriorated and turned into deficit in 1971.

In the end, the Bretton Woods regime of pegged exchange rates failed for reasons of dollar abundance rather than scarcity as Europe's refusal to either accept currency revaluation or accumulate more dollars put mounting pressure on the dollar's supposed gold backing. U.S. President Nixon responded on August 15, 1971 by officially cutting the U.S. dollar free from gold. The era of floating dollar exchange rates vis-à-vis the currencies of industrialized trading partners started, giving way to the economic and financial instabilities of the 1970s.

In fact, during the 1970s economic and political vulnerability seemed to undermine U.S. leadership and dollar hegemony. The deutschmark and the yen emerged as competing reserve currencies. There were even initiatives for international policy coordination featuring Europe as a new global "locomotive" for recovery from the oil-price shock. Arguably, the perceived failure of the agreed macro stimulus program of the late 1970s not only inspired a lasting paradigm shift in German economic policymaking in 1982 (forcing the French "franc fort" policy shortly later), but thereby also bequeathed a peculiar "supply-side-only" policy wisdom to the Maastricht regime of Europe's monetary union (EMU), (mis-)guiding Euroland's policymakers until today. The impact on the developing world was profound, too. Essentially, the first wave of financial globalization featuring increased bank lending ("petrodollar recycling") to Latin American and other developing countries, although welcomed at the time to support global growth, set the stage for the developing-country debt crises of the 1980s.

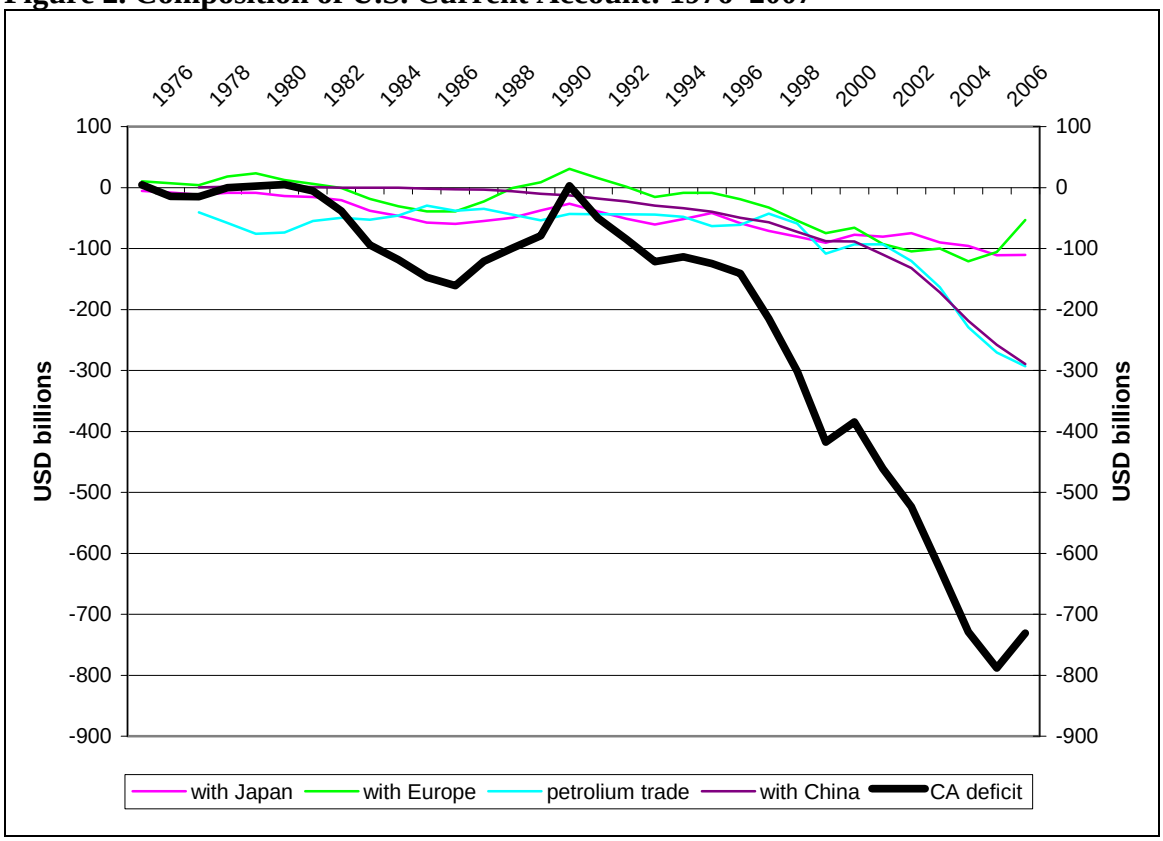
The developing-country debt crises were triggered by short-term U.S. interest rates reaching exorbitant levels in the early 1980s. The "Volcker shock" also gave rise to

a global recession from which the U.S. miraculously emerged with its global leadership role reestablished and its currency surging on the exchanges despite the U.S.'s "twin deficits" (on both its current account and government budget). As private (non-FDI, nonequity) capital outflows from the United States slowed sharply in 1982 and the United States started to attract net FDI inflows throughout the 1980s, a surging U.S. current account deficit became the key source of foreign acquisitions of U.S. assets.

In fact, since the early 1980s, U.S. global leadership included acting as the lead driver of global demand growth most of the time, resulting in (almost) continuous current account deficits ever since. While the United States attracted large private capital inflows in the late 1990s (including net FDI and net equity inflows), since 2002 foreign official inflows have come to play a rather prominent role, exceeding previous episodes of dollar weakness in the late 1980s and mid 1990s, a feature that has inspired BWII and also relates to the "global capital flows paradox" to be discussed below in sections 3 and 4, respectively.

Decomposing the U.S. current account deficit into its key sources or counterparts, figure 2 reveals that the U.S. current account deficit of the first half of the 1980s mainly mirrored the lagging of Japan and Europe behind the U.S. locomotive (propelled by the Reagan fiscal expansion). The situation changed in the second half of the 1980s, as the U.S. dollar depreciated (following the Plaza Accord), oil prices slumped, and both Japan and Europe experienced a belated economic boom (lasting until 1990 in Japan's case and 1991 in Germany's), whereas the United States experienced a mild recession in 1991. Accordingly, the U.S. current account deficit shrunk after 1986 and even briefly disappeared by 1991 (also reflecting foreign transfer payments in recognition of U.S. military action in Iraq).

Figure 2. Composition of U.S. Current Account: 1976–2007



Source: Bureau of Economic Analysis (BEA)

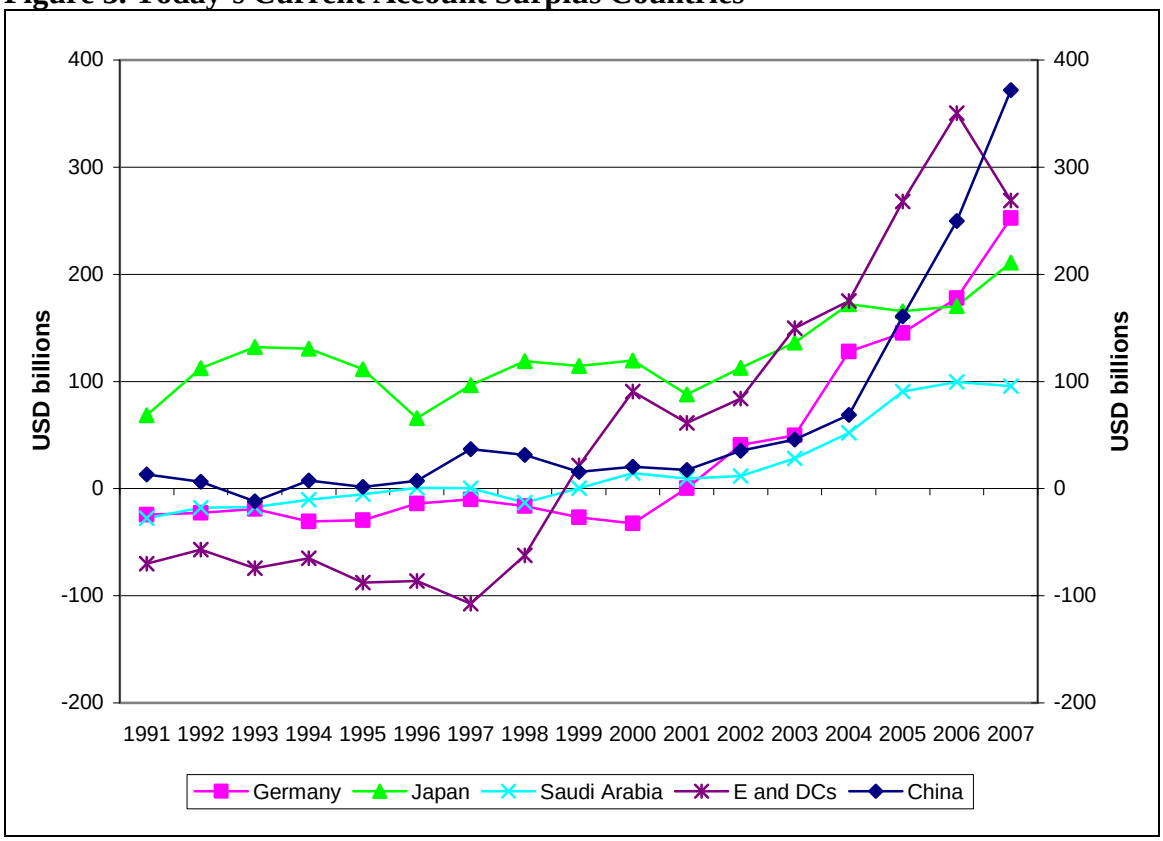
This was a brief reversal of roles though. Since 1992 the bilateral positions with Japan and Europe have steadily deteriorated once again as both Japan and Germany got stuck in protracted domestic demand stagnation and German ("supply-side-only") policy "wisdom" was exported to Europe via the Maastricht Treaty of 1991. Apart from representing a *recurrent* element in the U.S. current account imbalance, stagnation in Europe and Japan may actually be singled out as the dominant factor for the 1990s.[1] In recent years, at least the imbalance with Europe has declined markedly from its peak in 2005, owing to both a belated pickup in European growth in 2006, as well as exchange-rate developments since 2002. By contrast, the bilateral imbalance with China, which has been the primary focus of debate in the United States in recent years, has grown significantly since 2002 (although to some extent replacing deficits with other East Asian

[1] In its *World Economic Outlook* of September 2002, the International Monetary Fund still observed that "external imbalances across the main industrial country regions widened steadily during the 1990s [with these imbalances being] dominated by the euro area and Japan, respectively" (IMF 2002: 65–7).

countries). And as fast industrialization and catch-up in China is widely held to be a key driving force behind the oil price (and the more general commodity price) boom of recent years, the "China factor" may also be related to the rise in the U.S.'s petroleum trade deficit, reaching some $300 billion in 2007. A look at the composition of the U.S. current account imbalance thus reveals that the build-up of the U.S.'s external deficit since 1991 is owed to a whole variety of factors, including: protracted domestic demand stagnation in some key industrialized countries, the emergence of China on the global scene, and the oil price.

While the U.S. current account deficit has been at the center of concern about "global imbalances," figure 3 focuses on the other side of the imbalance, namely, today's largest current account surplus countries (or groups of countries). The list includes Germany and Japan, with current account improvements of around $285 billion and $90 billion since 2000, respectively, and China with a current account improvement of some $350 billion since 2003. Note that China only emerged as a globally significant factor at that time. Saudi Arabia's sharply improved current account position (by some $80 billion since 2000) is representative for oil exporters at large.

Figure 3. Today's Current Account Surplus Countries



Source: IMF
Note: IMF classification of emerging and developing countries, plus NICs, but excluding China and Saudi Arabia.

In addition, figure 3 also reveals another conspicuous fact and contributing factor to the build-up of global imbalances. In the late 1990s, the aggregate current account position of "emerging and developing countries" as a whole (including the "newly industrialized countries," but excluding China and Saudi Arabia, which are shown separately) turned from deficit into surplus.[2] In other words, in the aftermath of the Asian crises, capital flows changed direction, and, ever since, they have been flowing from poor to rich countries, primarily the United States. Apparently triggered by the Asian crises, a conspicuous course change in behavior has turned the developing world as a whole into a net capital exporter and hoarder of surging reserve holdings in the form of U.S. Treasury

[2] While not shown separately in figure 2, Henning (2000) estimates that almost $100 billion of the rise in the U.S. deficit at that time was a consequence of allowing Asian and other crises economies to see their current account positions turn into surplus in the aftermath of the crises.

securities—a phenomenon that was dubbed the "global capital flows paradox" by former U.S. Treasury Secretary Larry Summers (2006).

In summary, in view of the U.S.'s n^{th} country status, the U.S. current account deficit has largely been a reflection and by-product of the U.S.'s flexible response to deficient demand elsewhere in the world economy. Essentially, in freely playing its n^{th} country role, the issuer of the world's key reserve currency stimulated domestic demand growth whenever deflationary pressures arrived at its shores. Owing to the fact that this global arrangement worked rather well, at least until recently, an oil price boom has further magnified the U.S. current account deficit. The next section will scrutinize the supposed sustainability of the U.S.'s external deficit, as suggested by Dooley, Folkerts-Landau, and Garber 2003 in the "revived Bretton Woods system" hypothesis (or BWII).

3. BWII RECONSIDERED

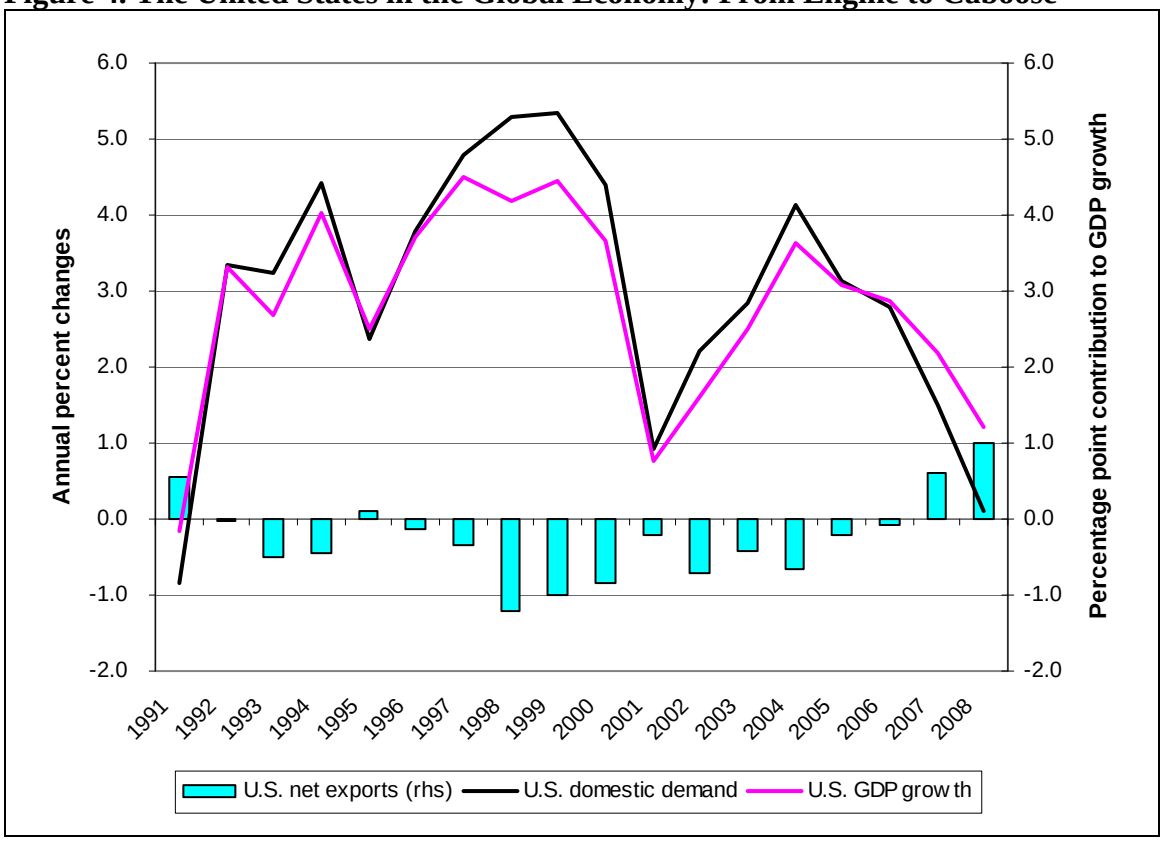
According to the BWII, the "imbalances" in global current account positions that have featured prominently as crucial risks to global stability in policy debates in recent years were actually an indication of a *sustainable* symbiosis of interests among deficit (U.S.) and surplus (developing world) countries. In this view, the developing world's interest is to sell its products into the large U.S. market as a way of stimulating employment growth and development. The U.S. economy, on the other hand, is flexible enough to tolerate the resulting quasipermanent drag on U.S. income growth given its comparative advantage in creating safe financial assets, which provide the collateral for the FDI stock needed in the developing world to complement its vast cheap labor resources in export production.

Important elements of agreement between BWII and the analysis of the U.S.'s n^{th} country status presented in the previous section cannot be denied. In fact, we argue that the breakdown of the Bretton Woods system of pegged-but-adjustable exchange rates in the early 1970s did not fundamentally change the hegemonic position of the U.S. dollar at all. If anything, floating exchange rates, together with financial globalization, have further magnified the influence of, and benefits thereby bestowed upon, the system's lead country in playing its n^{th} country role. This section highlights certain disagreements with

BWII that also raise doubts about the regime's supposed sustainability despite the subprime crisis, as recently reconfirmed by Dooley, Folkerts-Landau, and Garber (2008).

To begin with, it is curious that BWII completely neglects factors other than the supposed neomercantilist development strategy of prominent emerging-market economies, with China in particular, thereby assigned center stage in the BWII interpretation of the build-up of global imbalances (Bibow 2007). This conflicts with the fact that China has only become a globally significant factor in recent years. Instead, it was the sum of factors discussed in the previous section that has led the United States onto the increasingly unbalanced path that culminated in the subprime crisis. And, next, it seems unlikely to us that the United States will get back on its feet any time soon and continue playing the role reserved for it in BWII as if nothing has ever happened. By implication, with the United States as caboose rather than engine of the global economy, continued global growth will require a change in behavior on the part of a number of players, including the stagnant industrialized countries and commodity-rich countries. Figure 4 highlights the reversal in the contributions of net exports to U.S. GDP growth since 2006.

Figure 4. The United States in the Global Economy: From Engine to Caboose



Source: OECD *Economic Outlook*, No. 83 (June 2008)

While the first two criticisms are empirical, the next concerns theory, namely the supposed ways in which the "massive excess supply of labor in Asia" (Dooley, Folkerts-Landau, and Garber 2008) could produce the excess domestic demand growth in the United States that was required to keep the global economic cylinders humming. Starting from a theoretical position that appears to be similar to what also inspired Bernanke's (2005, 2007) "saving glut hypothesis," Dooley, Folkerts-Landau, and Garber (2008: fn 3) assert that "the advent of the [BWII] system persistently lowered the long term rate of interest at every stage of the business cycle because of the large scale supply of net savings that emerging market countries were pushing into the industrial countries," developments which they attribute to the "historically unusual decision of many EM governments to place a substantial share of national savings in international financial assets."

In their view, domestic institutional deficiencies in developing countries rationalize the observed two-way capital flows with net flows from poor to rich. Official

outflows into reserves "collateralize" private inflows (i.e., assure foreign investors of a safe exit option), while net capital outflows from poor countries represent no real loss of domestic savings, as these would be wasted anyway. They would be wasted because deficiencies in domestic financial institutions prevent domestic savings from being intermediated efficiently into capital formation. In this view, capital controls on outflows would appear to be positively harmful as "capital flight from distorted emerging market financial markets can promote growth if that capital is returned by investors attracted by high return projects" (Dooley, Folkerts-Landau, and Garber 2008).

I have argued elsewhere that this explanation for Greenspan's famous "bond market conundrum" is based on *flawed* loanable funds theory [see Bibow (2001, 2008, and 2009)].[3] An alternative liquidity preference theoretical explanation starts from the observation that the expansion in the United States was made possible in the first place not by "excess saving" on the part of anyone, but by nothing else but *dollar liquidity*. Dollar liquidity—based on U.S. credit creation!—spilled over to much of the rest of the world through U.S. spending growth in excess of U.S. income growth and soaring global imbalances. The alternative liquidity preference theoretical explanation attributes the phenomenon to a *global dollar glut* arising in an environment of deficient demand in product markets with the United States playing its n^{th} country role. Importantly, in this view, developments in product and labor markets triggered the policy and market responses that delivered low interest rates ruling in financial markets. Imagined "excess saving" in Asia did neither *directly* lower U.S. interest rates nor provide "finance" for the U.S. boom in domestic demand (other than in *ex post* balance of payments accounting).

The *global dollar glut* occured at low interest rates since both key ingredients were in place; first, low U.S. policy rates and, second, benign interest rate expectations

[3] Loanable funds theory continues to enjoy immense popularity today, and not only among mainstream economists. Calling upon Greenspan as support for her interpretation of international capital flows in and out of the U.S., D'Arista (2007–2008: 14) asserts that in both 2004 and 2005 "the excessive inflow of foreign savings returned into the global economy as U.S. residents recycled the surplus capital they could not use profitably at home." The point is that those foreign savers, who only have any saving to allocate if they happen to earn the income out of which to save in the first place, simply cannot create U.S. dollars, but only use dollars either acquired through net exports (i.e., the source of the income creation) or capital inflows. Any increased aggregate desire on the part of foreign residents to hold U.S. dollars will tend to put upward pressure on the dollar's exchange rate, as was the case from 1995 to early 2002 (the period to which Greenspan's observations actually referred). Developments since then were rather different though.

held by financial market players. Both policy rates and interest rate expectations remained low despite rapid demand growth because of vast new global supply-side opportunities and generally weak pressures in labor markets. Even as inflationary pressures finally emerged in 2007 (reflecting global commodity resource constraints), bond yield stayed low as markets apparently judged that the global boom and the monetary tightening cycle were already at or past their peak, so that inflationary pressures would soon abate again.[4]

Note that the link is running from global demand conditions in product (and labor) markets—rather than any imaginary "saving glut" in capital markets—to U.S. interest rates featuring the U.S.'s n^{th} country role and the Fed's mandate to maintain high employment and price stability in the U.S. The link was most clearly visible in the context of the "2001 global slowdown," with rising unemployment and deflation threats in the United States. There can be little doubt that the global boom was sponsored by highly expansionary U.S. fiscal and monetary policies (see Godley et al. 2007). The U.S. fiscal stance was eased by an unprecedented six percent of GDP between 2000 and 2003, while the U.S. Federal Reserve cut 550 basis points off its Fed Funds target between January 2001 and the end of 2002. The U.S. expansion was transmitted throughout the "dollar zone" through the developing world's policy of maintaining a competitive exchange rate vis-à-vis the U.S. dollar.

And yet, while expansionary fiscal policy played an important role in the U.S. recovery since 2001 (as had been previously the case in the early 1980s and early 1990s, too), public debt as a percent of GDP has been rather trendless over the period as a whole. In other words, while fiscal policy was successfully used in an anticyclical fashion to stabilize the U.S. economy, the excess of U.S. domestic demand growth over GDP growth and rising U.S. external deficit was *not* driven by public, but private, spending. The U.S. expansion was essentially a consumer boom—based on rising consumer debt

[4] This market consensus got challenged in the spring of 2008 under the leadership of the European Central Bank (ECB), raising the specter of "preemptive" interest hikes at envisioned threats of second-round effects (in the context of a weakening growth momentum underway in Euroland and the world economy) and causing manifold irritations in financial markets. The ECB followed through with hiking interest rates in July, only to make a fool of itself as Euroland's predictable inability to "decouple" became all too apparent at just that time.

(mortgage debt in particular). BWII totally misses this point and its relevance concerning the supposed sustainability of the regime.

Behind the macro policy mix that produced this outcome is an ideology that generally abhors public spending, budget deficits, and public debt. Therefore, if the United States is to play its n^{th} country role, it is left to the Federal Reserve and monetary policy to make this possible. In general, this requires interest rates that are low enough, and asset prices that are high enough, to bring forth the private spending sufficient to maintain high employment and price stability in the U.S. Over time, as the rest of the world became overly reliant on the U.S. growth engine (see section 2), the Federal Reserve had to kick the accelerator especially hard in the aftermath of the dot.com bubble burst. Essentially, with the corporate sector in balance-sheet-repair mode, U.S. consumers alone had to be sufficiently enticed to do the excess spending required to get the global economy back on track—as they duly did.

Rather unsurprisingly, the largest impact on the U.S. economy itself came through the housing sector, the one large domestic sector in which offshoring is not an issue (while immigrant labor surely is). As to industry, automobile demand, based on either auto loans or home equity loans, was the key driver. As to services, Wall Street truly thrived on the surge in U.S. spending, both in product markets as well as asset markets, including international capital flows. Today, following years of exuberance, overhang characterizes construction and auto industries, property markets and Wall Street alike. The subprime crisis is really only the tip of the iceberg in all this.

While it is certainly appropriate today to investigate the fraud elements involved in the property and credit booms, to think more carefully about properly designing anticyclical financial regulations and to review blindly adored financial innovations in a more sober light, it seems somewhat misplaced to put all the blame at the Federal Reserve's doorstep regarding its "easy money" monetary policies.[5] For the Federal

[5] A debate has been rekindled on the role of asset prices in monetary policy. German/European central bankers seem to feel vindicated in their view that it is not good enough to wait until it is time to mop up the mess after the bubble burst (the Greenspan doctrine). Not only does any Schadenfreude seem hypocritical given that, despite its "stability-oriented" central bankers, Europe has seen its own fair share of bubbles. The point is that if the Federal Reserve had ever followed Bundesbank wisdom, the global economy would have remained stuck in permanent stagnation ever since the early 1980s (as Germany did except for brief interruptions sponsored by export booms and the accidental unification boom).

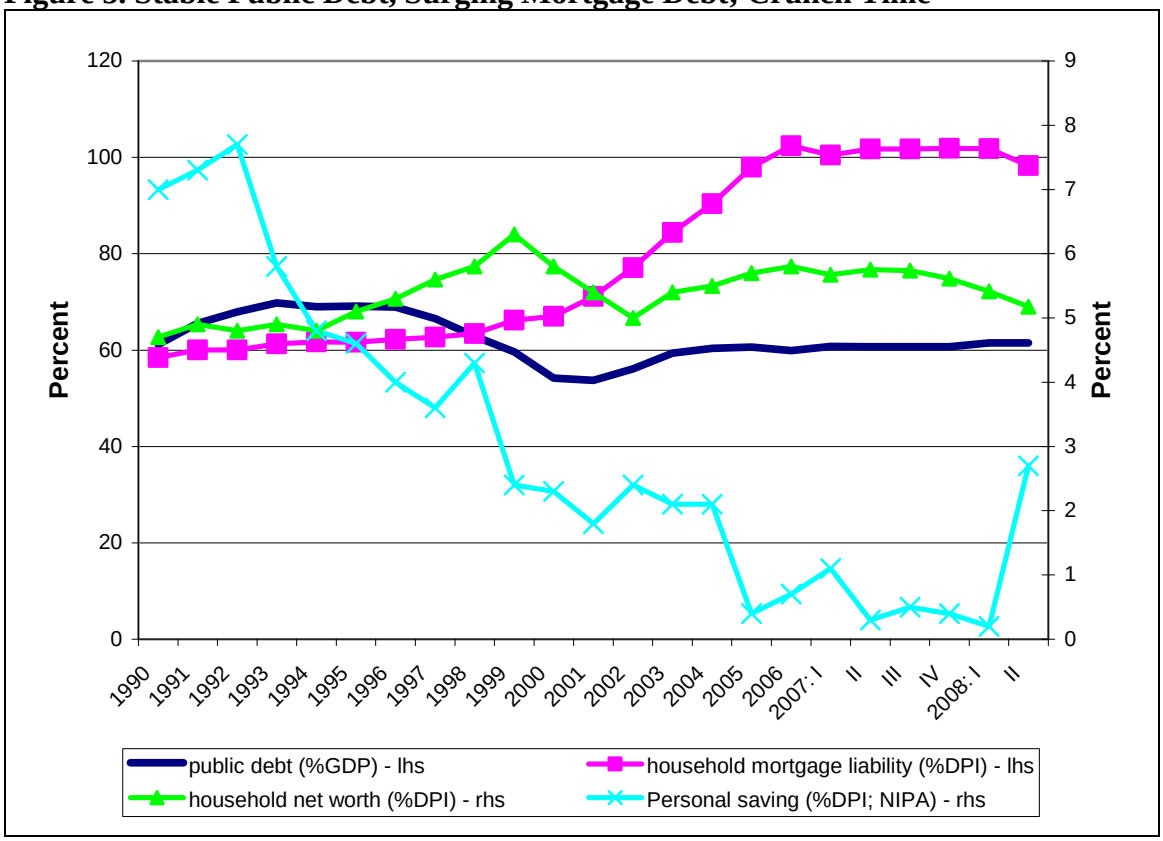
Reserve was following its U.S. mandate as—globally—the United States played its n^{th} country role. While internally the United States went through a "Minskian boom-bust cycle," ironically, externally the United States became portrayed as the villain behind soaring global imbalances. *Yet, a world economy less reliant on U.S. domestic demand growth would have seen very different monetary policies from the Federal Reserve, too.* In a financially globalized world scrambling for safety in exporting and running up U.S. dollar holdings, while hamstrung by an ideology that frowns upon fiscal policy and public debt, the U.S. consumer—enabled by *private* debts!—became the world's spending power of last resort.

There are a number of important upshots concerning the global economic situation today and the next five years. First, the focus on China's (and other developing countries') accumulation of a rising share of the outstanding stock of U.S. public debt (i.e., those *safe* assets the U.S. has a comparative advantage in providing according to BWII) overlooks the fact that the consumer boom was actually built upon the liberal creation of huge amounts of rather *unsafe* assets, as the ongoing subprime crisis has brought to light. After many years of earning handsome margins and fees on its credit creation and intermediation services, Wall Street is now caught up with its debtors' fate as the exuberant leveraging drive of yesterday has turned into deleveraging—the full economic repercussions of which have yet to work their way through the system.

Second, as the U.S. consumer has got overburdened in shouldering the U.S.'s n^{th} country role (over the past five years in particular), the old (BWII) regime seems unlikely to get back on track any time soon—contradicting the forecast made by Dooley, Folkerts-Landau, and Garber (2008) that the future will be more of the same in following the system's dynamics to its terminus. Instead, the possibility of a U.S. consumer retrenchment poses a serious threat to global stability. In addition to the sharp rise in mortgage indebtedness, figure 5 shows that since the final quarter of 2007 U.S. households' net worth is declining, reflecting the impact of falling property and equity prices on leveraged household balance sheets, with household leverage (not shown) itself at a record high.[6]

[6] The background and inspiration to my analysis is Wynne Godley's work on the unsustainability of internal processes in the U.S. economy in the 1990s [cf. Godley (1999), for instance], regular updates of

Figure 5. Stable Public Debt, Surging Mortgage Debt; Crunch Time



Source: BEA, Federal Reserve, and IMF

No doubt the Federal Reserve's actions to provide emergency liquidity have gone a long way in preventing the unfolding credit crunch from slipping into a full financial meltdown. But the underlying solvency issue requires bold fiscal actions, too. In addition to essentially transforming old (underwater) private debts into public debts (i.e., large-scale bailouts of consumers and/or their creditors), the only effective strategy that could get the U.S. economy and the BWII regime back on track is a *large and sustained* fiscal expansion (probably with a medium-run budget deficit of some 5 percent of GDP and

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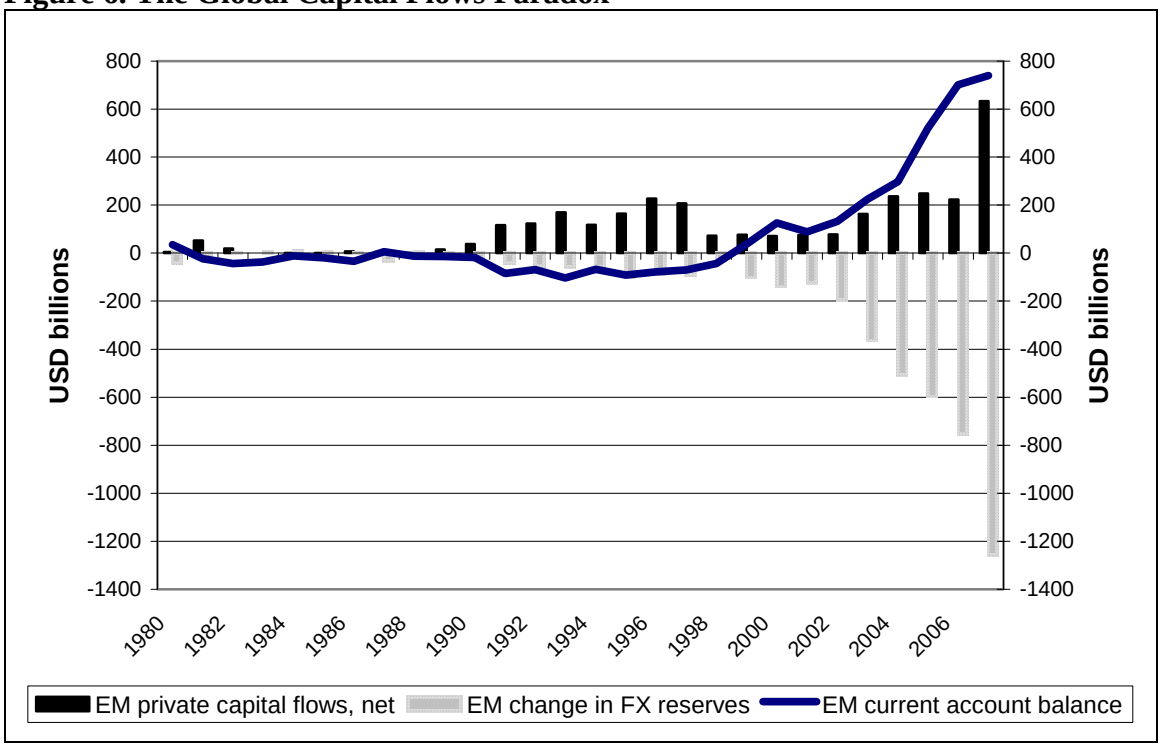
which appear as the Levy Economics Institute's "Strategic Analysis." I first presented my analysis of global imbalances as the external counterpart to unsustainable U.S. internal trends in early 2006 [later published as Bibow (2007); see also chapter 1 of UNCTAD (2006), which I coauthored]. Roubini and Setser (2005) denied the sustainability of BWII, though largely for risks related to the U.S.'s external indebtedness. Roubini is widely credited today for predicting the meltdown in 2006 (see The New York Times of August 17, 2008). Palley (2007–2008), too, denied the supposed sustainability of BWII, emphasizing the role of the U.S. housing price bubble. His figure 1 (Palley 2007–2008: 44) showing East Asian economies financing U.S. banks that in turn lend to U.S. consumers smacks of loanable funds theory though, which runs totally counter to the analysis proposed here.

even larger than that in the short run). Interestingly, while the external financing costs for U.S. external debts would be as before, at least for as long as foreigners continue to buy and hold safe U.S. public debt, the U.S. internal distributional consequences of a "revived Bretton Woods system" *actually* based on the public debt which then ends up in the official portfolios of the developing world—call it "BWIII"—would be rather different compared to the derailed (pre-subprime) BWII [see Bibow (2009)]. The fact that Wall Street profited so handsomely from the U.S. consumer boom and the process of U.S. dollar-based financial globalization providing its global outlet directs our attention to the other side of the coin: the developing world's true opportunity cost of self-insurance in a financially globalized world centered around the U.S. dollar.

4. TRUE OPPORTUNITY COST OF SELF- INSURANCE

The phenomenon of the developing world at large turning into a net capital exporter, with surging reserve holdings in the form of U.S. Treasury securities, was dubbed the "global capital flows paradox" (Summers 2006). Apart from again highlighting the conspicuous turning point in the aggregate current account balance of the developing world in 1998–9, figure 6 also shows that surging reserve accumulations have been sourced from both current account surpluses, as well as net *private* capital inflows. Does the developing world really have much of an interest in a quasipermanent arrangement along BWII (or, rather, BWIII) lines featuring uphill net capital flows and—apparently—bloated reserve holdings?

Figure 6. The Global Capital Flows Paradox



Source: IMF World Economic Outlook Database
Notes: Em Series include the IMF *World Economic Outlook* (WEO) groups "other emerging market and developing countries" and "newly industrialized Asian economies."
For the "change in FX reserves" series, a minus sign indicates an increase.

Recall that according to Dooley, Folkerts-Landau, and Garber (2008) the observed net capital outflows from the developing world represent no real loss to them since those savings would go to waste if they stayed at home anyway. As to the holding of foreign exchange reserves as self-insurance, the view seems to prevail that the costs involved are rather low or that self-insurance may even represent a free lunch (Ginsberg et al. 2005). Furthermore, some observers emphasize that the benefits of current arrangements clearly outweigh any costs, with Kregel (2008) also suggesting an interesting parallel between the BWII regime and Keynes's clearing union plan for Bretton Woods. Kregel highlights the *quasiautomatic* credit mechanism involved in extending finance to the deficit country, thereby preventing any deflationary response while, at the same time, meeting any increased demand for international liquidity, too (serving self-insurance purposes). [Compared to BWI], Kregel argues, the "current international system, driven by private international capital flows, seems closer to that proposed in Keynes's clearing union with these developing surplus countries

automatically providing financing required by deficit countries to sustain growth and employment" (Kregel 2008: 8).

To begin with, I agree that BWII may provide a safer and more effective development strategy than the alternative of reliance on capital imports (as a supposed supplement of domestic saving). Experience has shown that tolerating exchange rate appreciation and current account deficits may do little to lastingly boost capital accumulation and development, but foster asset price bubbles and consumption booms instead, followed by financial crisis and severe economic dislocations. After all, recurrent financial and economic crises in the developing world in the age of financial globalization, together with the proven insufficiency of multilateral insurance through official international liquidity provision by the IMF in the context of the Asian crises, appear to have motivated the conspicuous course change on the part of the developing world at issue here. Furthermore, in view of the investment and growth performance seen in the developing world since 2002, it is not obvious that any growth opportunities might have been foregone by *not* relying on (net) capital imports, but even exporting capital instead (UNCTAD 2008). Granted all that, the issue remains whether the developing world's revealed preference for taking out self-insurance really comes at a low costs or represents a (near) free lunch?

Unfortunately, assessing the costs of self-insurance is not a straightforward matter. Probably the most commonly used approach is simply to quantify any monetary loss arising from the yield spread between U.S. Treasuries and the respective domestic financial instruments, either assets sold or liabilities issued by the monetary authorities in sterilizing the reserve accumulation. In general, measured in this way, the cost of reserve holdings appears to be fairly low; in cases of developing countries with low domestic interest rates (implying a positive carry), reserve accumulation may even seem profitable (Ginsberg et al. 2005). The point is that this approach only narrowly measures the "fiscal cost" of sterilized interventions, but does not provide a measure of the "(self-) insurance premium" at issue here from a *national* viewpoint.

Rodrik (2006: 7) proposed an alternative measure as "the appropriate way of thinking about the social costs of reserves" that focuses on the "spread between the private sector's cost of short-term borrowing abroad and the yield that the central bank

earns on its liquid foreign assets." Based on an assumed 500-basis-points spread, his estimates show social costs of reserve holdings in the order of 1 percent of developing countries GDP. The insurance costs on "excess" reserves (i.e., reserves in excess of the 3-months-imports rule considered safe for current account transactions prior to financial globalization[7]) thus measured offer "a more realistic estimate of the costs imposed by financial globalization per se," in Rodrik's view (2006: 8)

Rodrik's measure shows that what is involved here is really a kind of "intermediation loss" (more precisely, a loss from the perspective of the developing country, but a profit from the perspective of the provider of international liquidity services). Ironically, while the foreign borrowing (of reserves, in effect) does not provide any real resource transfer to poor countries, this intermediation loss incurred thereby surely does (albeit from poor to rich).[8] Rodrik's exclusive focus on short-term debt is inspired by the idea that increasing reserves or reducing short-term foreign debts are alternative ways to increase liquidity and that, in practice, short-term debt seems to represent the most relevant opportunity cost. It appears to me though that any short-term foreign borrowing undertaken to acquire reserves altogether fails to increase *net* liquidity (and protection) anyway, while involving an intermediation loss that is hard to rationalize in the first place. It may of course be that the foreign borrowing is undertaken by *private* domestic entities for motives independent of the resulting *official* sector's accumulation of liquid foreign assets.

Perhaps it may be better then to broaden the perspective and instead start from the returns in general that foreign investors can earn on investments in a developing country. The key question then is what benefits arise for the developing host country in *allowing* foreign investors to earn these apparently attractive returns. Any benefits arising in this way will likely depend on the type of investment and the financing involved. Based on a cost-benefit analysis, policy should be geared towards *national* development goals. Capital inflows may seem rational from a private microeconomic perspective, but be costly from a national one. For instance, it may not be in a country's best interest to

[7] Other common measures feature the ratio of M2 over reserves and the ratio of short-term external debt over reserves, also known as the "Guidotti rule."
[8] See Kregel (2004) and Ocampo (2007–2008) on "reverse aid."

tolerate that private domestic entities find it beneficial to incur short-term foreign debts for which the public sector, in effect, pays an insurance premium to foreign investors—involving an element of domestic subsidy apart from rewarding foreigners for no good reason. The point is that it may be possible to achieve the same domestic outcome in alternative ways, but without *wasteful* self-insurance (through borrowed reserves that incur an intermediation loss).

Another approach to assessing the costs of reserve holdings is provided by Hauner (2005), who proposed a more comprehensive analysis of the fiscal opportunity costs, that also considers the social return on public investment as a relevant alternative. Notice, however, that if rising foreign reserves provided the rationale to increase public investment there would be a direct impact on the income generation process. Actually succeeding in reducing reserves, or decelerating their accumulation, then depends on how much of the income generation takes place outside the country at hand (through increased imports). But instead of just considering any public investment foregone by holding reserves, one may again broaden the perspective and include other alternatives. Surely tax cuts provide another option if the plan were to relax the fiscal stance in view of rising reserves, with additional private investment or consumption as the relevant opportunity cost to account for in this case. Again, a direct impact on the income generation process is involved. When deciding on the best option available in any particular situation, the key issue is what is in best accordance with a country's development strategy and current macroeconomic policy stance.

In attempting to further disentangle the matter, recall here that the developing world's soaring *low-yielding* foreign reserves are being sourced from both current account surpluses, as well as private capital inflows. Arguably, while the latter is perhaps more directly related to the self-insurance motive, the former source may also be more closely motivated by mercantilistic motives. Moreover, while the latter source is in the first instance in the nature of international financial intermediation (though generating an income flow from poor to rich, as argued above), the former is *by itself* in the nature of an intertemporal transfer of resources, though strangely, it seems, also from poor to rich. Essentially, with the developing world running current account surpluses and exporting

capital, consumption and/or domestic investment opportunities are foregone in the present, presumably in exchange for an *enlarged* potential for future consumption.

The trouble is to see how the enlarged future consumption is supposed to be made possible from investing in low-yielding foreign assets denominated in a depreciating foreign currency. Also, it is not clear why a poor country should forego present consumption in the first place when, supposedly, the social rate of time preference is fairly high, especially under conditions of widespread poverty, but certainly higher than in the rich, developed destination countries of capital flows. In other words, even if investment and growth performance has been benign despite being based on domestic saving only, there is no denying that the current account surpluses of the developing world involve a tradeoff between present and future consumption.

Note here that my focus is on too low present consumption, unrewarded by enlarged future consumption, which contrasts with the orthodox focus on investment, depicting capital imports as supplementing domestic saving as a source of capital accumulation. In the orthodox view there is no way around concluding that the international capital flows paradox poses an additional constraint on capital accumulation in poor countries. The point is that evidence of strong investment and growth in recent years poses quite a challenge to orthodoxy. Perhaps, then, one has to conclude that it is simply wrong to presume a "chronic 'savings gap'" (UNCTAD 2008) as posing an effective constraint on capital accumulation and development.[9]

Be that as it may, it appears to me that in certain countries there may, if anything, even be at risk of over-investment (complementing the hypothesized underconsumption) driven by exports in an undervaluation context. The risk is that over time economic structures may get distorted, ending in crisis once the unsustainable cumulative processes stemming from these distortions unravel.

Either explicitly or implicitly, proponents of BWII seem to presume the following conditions. First, international arrangements and economic structures are sustainable so that the development process will not get derailed in a crisis before any enlarged future consumption potential can be reaped, leaving part of the accumulated capital stock

[9] This denial of a key orthodox presumption is, however, not the same as confirming the Dooley, Folkerts-Landau, and Garber (2008) position, which I argued above is itself based on flawed theory.

obsolete, too. Second, capital accumulation and productivity increases boost future consumption potential sufficiently to overall justify foregone present consumption and self-insurance costs incurred. Third, capital accumulation and productivity increases achieved in this way are not otherwise obtainable. The jury is still out on whether the post-Asian crises development strategy of persistent current account surpluses is anymore sustainable than the prior strategy of tolerating current account deficits.

Differentiating the two sources of foreign reserve holdings served analytical purposes and shed some interesting light on the matter. Arguably, however, both sources are ultimately driven by the same underlying safety concerns—the risks of financial and economic instability that financial globalization has exposed the developing world to. I am therefore doubtful whether quantitative analyses along the lines of Aizenman and Lee (2007) are really meaningful. The real question is whether coping with heightened risk exposures owing to financial globalization along the lines of BWII ultimately justifies the costs of self-insurance borne by the developing world. While it may be impossible to precisely quantify the costs of self-insurance,[10] seen by daylight, capital account convertibility appears to be a nifty mechanism for rent extraction working through the defensive behavior of developing countries under the existing international monetary nonorder. Is capital account convertibility really a necessary condition for reaping any potential benefits of globalization? It is time to consider alternatives.

5. IS IT WORTH THE PREMIUM? WHAT ARE THE ALTERNATIVES TO UNLEASHED FINANCIAL GLOBALIZATION?

The above analysis has left us with some serious doubts about the supposed wisdom of full capital account convertibility in developing countries. Contrary to orthodox

[10] If anything, Rodrik's (2006) estimate of 1 percent of the developing world's GDP would seem to be on the low side, especially considering the foregone present consumption in poor countries. Will the present current-account-surplus-running periphery, once matured, be able to pass on their (excess?) international reserves to a new periphery? The role of today's international monetary (non-)order may also be seen by considering that proper "retirement/repayment" of reserve assets (i.e., debts) would require current account surpluses by today's reserve currency issuers at some point in the future. The U.S.'s positive investment income balance and stable net international investment position as a percent of GDP, despite huge current account deficits, are relevant facts about the other side of the coin used as international currency.

expectations, capital accumulation in the developing world at large has *not* been augmented by foreign saving since the Asian crises; apparently capital imports are too unsafe to rely upon. Apparently many developing countries have come to consider a competitive exchange rate as key to sustained growth. The sizeable (self-)insurance premium incurred through bloated foreign reserve holdings, sourced from both current account surpluses and private capital inflows, reveals financial globalization as a nifty device for rent extraction.

Ultimately, the problem with full capital account convertibility is that it restricts developing countries' policy space to such a degree that it appears prudent to them to pay an onerous insurance premium to recapture at least some of the lost ground. Referring to the gold-standard era with free capital mobility, Keynes identified the *macroeconomic* wisdom of a mercantilistic development strategy under such conditions. In chapter 23 of *The General Theory* (titled "Notes on Mercantilism") he observed that

> "[a]t a time when the authorities had no direct control over the domestic rate of interest or the other inducements to home investment, measures to increase the favorable balance of trade were the only *direct* means at their disposal for increasing foreign investment; and, at the same time, the effect of a favorable balance of trade on the influx of the precious metals was their only *indirect* means of reducing the domestic rate of interest and so increasing the inducement to home investment" (Keynes 1936: Vol. 7, p. 336).

Compared to the gold-standard era, the U.S. dollar standard (described in section 2, above) can more easily avoid any deflationary bias arising from mercantilistic development strategies as long as the n^{th} country willingly accommodates such endeavors by tolerating current account deficits and creating international liquidity along the way. As regards self-insurance strategies, too, the tendency for key currency appreciation resulting of any increased international liquidity preference can be similarly met by easing monetary conditions at the center. As private capital flows from the center towards the developing periphery further magnify the global dollar glut, spreading the monetary conditions set at the center throughout the dollar zone, individual peripheral countries may fine-tune their local conditions through steering the degree of sterilization of reserve

inflows and adjusting fiscal stance. But what benefits does financial globalization, including full capital account convertibility, really have to offer to developing countries?

Arguably, access to export markets and technology transfer are the two key external contributors to development. And these two factors may well require foreign direct investment (FDI) to work best. But granting FDI an important role in development is not the same thing as accepting full capital account convertibility, particularly if capital account convertibility either results in an uncompetitive exchange rate followed by financial crisis or turns developing countries into net capital exporters whilst foreign portfolio investors and bankers are invited to share the rewards of the developing world's catching-up process—and without even properly financing it! The former outcome typically involves massive macroeconomic damages at some point, the latter substantial insurance costs—with as-yet unproven long-term success in avoidance of macroeconomic disruptions. Neither outcome can be said to unambiguously enhance macroeconomic efficiency and both also come along with significant microeconomic distortions.[11]

Rather than taking out costly self-insurance against unleashed external "market wisdom," policymakers should deliberately manage their country's exposure to global finance with a view of fostering the national interest.[12] Active and comprehensive management of the capital account through a permanent regulatory regime incorporating room for countercyclical adjustment and with policy controls that target both the aggregate and the composition of capital inflows and outflows may be a superior strategy. Controlling aggregate capital flows serves the macroeconomic end of maintaining policy space so as to best align macroeconomic policy stance with local requirements (i.e., to decouple, if needed, from external macroeconomic conditions). Being selective regarding the composition of capital flows serves both macroeconomic and microeconomic ends.

[11] Another approach to rationalize capital account convertibility is to blame capital controls for causing distortions with a microeconomic price tag [for a critique, see Comert, Jayadeve, and Epstein (2008)]. My point is that microeconomic inefficiencies do arise in situations of exchange rate overvaluation and asset price bubbles, which have been frequently experienced with open capital accounts even prior to any macro collateral damage as a crisis hits. Furthermore, I ventured above that the mercantilist strategy of exchange rate undervaluation may be afflicted by similar shortcomings and prove suboptimal in the long term, too.

[12] See Kregel (2004), who argues that open capital accounts and reliance on external private financing of development tends to easily evolve into Ponzi-like financing schemes bound to end in crisis anyway.

In particular, from a macroeconomic perspective, types of inflows should be barred that tend to undermine national policy space and enhance the risk of financial fragility (through currency or maturity mismatches, etc.) In general, inflows should be restricted to FDI only and maturities of inflows should be in line with the (long-term) projects they promote. This aim can be made compatible with liquidity needs of foreign investors through the use of depository receipts. By contrast, there is no role for portfolio investments and bank lending (beyond trade finance), types of financing which tend to be volatile and procyclical. From a microeconomic perspective, the focus should be on matching external business expertise with any particular national development strategy.

This general approach also applies to capital outflows. With a reduced need for self-insurance through precautionary reserves, management of capital outflows should follow the following ranking: Priority should be given to the strategic use by national corporations though FDI outflows; yield-focused portfolio investments through Sovereign Wealth Funds come next; and adjustable allowances for private investors and travelers may provide another element of flexibility in the overall management of the capital account.

Confronted with evidence showing that "developing countries that have relied less on foreign finance have grown faster in the long run" (Prasad, Rajan, and Subramanian 2007), mainstream debate has redirected its search for justifications of financial globalization through turning toward suspected "indirect or 'collateral' benefits that accrue to a country's governance and institutions when it opens up to cross-border capital flows" (Prasad and Rajan 2008: 2). The core idea here is that capital account liberalization, through exposing the domestic financial sector to international competition, can act as a catalyst for domestic financial development. Other "collateral benefits" are supposed to arise through the spurring of improvements in domestic corporate governance, as well as alleged disciplining effects on governments and macroeconomic policy in general. These indirect benefits are believed to apply to capital flows in general, including portfolio investments and bank lending, which are supposed to improve the efficiency of liberalized domestic equity and debt markets and bank lending, respectively.

To begin with, it will be readily acknowledged that in cases of thoroughly corrupt and/or incompetent governments, any hopes for implementing a sound development strategy may be unfounded. It does not follow that governments in general are to be "disarmed" through unleashed market discipline imposed by external powers with a proven record of volatile and procyclical conduct causing both microeconomic distortions and macroeconomic instabilities. Such self-serving attitudes may be the convenient "consensus" in certain quarters representing certain vested interests, but among enlightened observers and policymakers alike, the invisible hand of financial market forces is known to be fallible and in need of regulation and guidance.

One key issue is the sheer size of institutional investors based in the developed world *relative* to the breadth and depth of financial systems in the developing world. It is easy to claim that giving the former a free hand to play in the latter will freely extend the former's wisdom to the development of the latter. It is of some interest to see that as soon as developing-country-based sovereign wealth funds of any noticeable size show any interest in playing on the home turf of global financial market wisdom, all sorts of concerns are quickly launched to stop them by developed-country government control.

Another key issue is that any of those supposed microeconomic efficiency gains can also be reaped under a regime of restrictive capital account liberalization focusing on selective FDI only when joined by targeted financial services trade, namely through importing the services of foreign experts and advisors. The importation of technology, managerial skills, and expertise may be necessary, but the liquidity of financial markets and financing of development can be organized and produced domestically on the basis of domestic claims rather than low-yielding international reserves. Domestic organization of finance avoids both the pitfalls of an open capital account, as well as the self-insurance premium otherwise incurred.

The point is that, with net capital outflows, free access to foreign finance does *not* provide any actual finance for development anyway. The arriving private capital inflows may give foreigners claims to domestic assets offering high yields owing to the country's catching up process, but what those foreigners provide to the developing country in terms of foreign finance is more or less automatically parked in low-yielding international reserves—not actually providing any finance for development at all. In fact, it seems

ironic that the authorities' main challenge ends up being one of mopping up *excess* liquidity creation based on bloated international reserves.

The irony involved here was rather nicely revealed in the advice given by Pimco's Bill ("Bond King") Gross, who proclaimed that "You want to invest where the growth is. The growth is in Asia and the growth is outside the United States. .. To be invested in U.S. fixed income is to be at a disadvantage twice" (quoted by Bloomberg, May 21, 2008). While making perfect sense from a foreign portfolio investor's perspective, do not overlook that given the unnecessarily increased exposure to financial fragility undertaken by the developing country in the process, the very assets that Bill Gross advises *not* to hold *actually end up in the portfolios of developing countries' official sectors*.

There is no good sense for developing countries in granting foreign pension funds, hedge funds, or other foreign portfolio investors or bankers free access to participating in the rewards of developing countries' catching-up process. Aggregate liquidity creation can be equally well-based on domestic claims, paired with importing any foreign expertise needed for making efficient micro picks of projects and firms. While public-debt-financed infrastructure investment plays a natural role in this, the point is that finance for private business also may be organized by service import rather than private capital flows. This alternative policy may include granting foreign banks and other financial institutions licenses to do business in domestic markets, as long as they operate under the same regulatory regime as their domestic competitors. And imports of expert services of any kind would surely come "at a fee," too.[13] But developing countries would no longer hand over part of the fruits of their catching up to foreign rentiers.

To be sure, any proposal for comprehensive capital account management, rather than openness, will be countered by alleging the ineffectiveness of capital controls. Again, this argument may well be true in cases of thoroughly corrupt and/or incompetent governments. But it does not follow that abolishing government and making room for the law of the jungle will guaranty best outcomes in the best of all worlds. In general, capital controls can be made effective, much to the nuisance of certain interests [see Epstein,

[13] As a complementary piece of advice, consider the strategy of using low-yielding international reserves to provide student grants for studying at top foreign universities and business schools linked with contracts for the students to return to their home country and apply their expertise to the benefit of their sponsor's development.

Grabel, and Jomo (2004) and Ma and McCauley (2007), for instance]. The flexible application of both quantitative and qualitative instruments can enliven the strategy outlined here and create the national policy space needed for an export-oriented development strategy that forecloses the rent extraction through self-insurance characterizing the currently propagated form of financial globalization. Comprehensive foreign exchange controls are at the heart of the matter; much depends on the licensing process and law enforcement.

Finally, let me add that I believe the general thrust of the strategy outlined here to be in the spirit of Keynes's vision for the postwar world. His aim was to both disable countries to pursue mercantilist strategies (as under BWII) and enable them to systematically pursue domestic demand-led growth through deliberate management of their economies instead. Capital controls were an important element in creating sufficient national policy space. His foreseen international monetary order featured symmetry in adjustment pressures through quasiautomatic exchange rate adjustments targeting balanced current account positions, with access to official international liquidity to bridge *temporary* imbalances. International bank money of elastic supply was to provide *costless* collective insurance [cf. Bibow (2009)]. Arguably, Keynes's vision provides a better benchmark to assess the developing world's opportunity costs of insuring against risks that do not seem to come along with any rewards that would justify the risk-taking in the first place.

Is it at least worth paying the insurance premium *under current conditions* then? The impressive performance in the developing world and avoidance of any "emerging market crisis" in recent years might suggest that it is indeed worthwhile. However, in view of the analysis of the international monetary (non-)order (presented in section 2) it is not all that surprising that the "missing crisis" is, this time round, occurring at the core of the international financial system instead. And in contrast to proponents of BWII (analyzed in section 3), we have strong doubts that the old regime can be fixed quickly and the developing world's impressive record of late be sustained along those lines.

To prolong that record, developing countries had to decouple from the sputtering U.S. engine. And at least at the early stage of the U.S. domestic demand slowdown, many of them were quite successful at that, more successful than Japan and Euroland. But

drawing on their self-insurance has changed the nature of the regime, as one source of U.S. dollar reserves is cooling off with the shrinking of the U.S. current account deficit. The other source may have largely dried up in the course of 2008, too, owing to "repatriations" of portfolio investments and disengagements of western banks in emerging markets in the context of worsening banking problems at the core of the global financial system and the general rise in risk aversion favoring U.S. Treasuries. Trends in real exchange rate that had been in place since 2002 sharply reversed in this context, with the dollar and the yen (as key carry-trade funding currencies) rising sharply against all others. Generally speaking, downward pressures on emerging-market currencies proved stronger for countries running current account deficits compared to those with a surplus position.[14] Reliance on export-driven growth does not seem an option for developing countries as long as the United States contracts. Switching strategy and boosting domestic demand will tend to turn current account balances around. We may still be debating the sustainability of BWII when the nature of the regime has already changed quite fundamentally.

6. SOME CONCLUDING OBSERVATIONS

This paper argues that the breakdown of the Bretton Woods system of pegged-but-adjustable exchange rates in the early 1970s has not fundamentally changed the hegemonic position of the U.S. dollar and the U.S.'s n^{th} country role in the global economy. Floating exchange rates together with financial globalization have, if anything, further magnified both the influence of and benefits thereby bestowed upon the issuer of the system's key currency. Since the early 1980s, U.S. global leadership included acting as lead driver of global demand growth most of the time, resulting in almost continuous current account deficits ever since. While the build-up of the U.S. current account deficit is owed to a number of factors, this paper focuses on the conspicuous turnaround in the developing world's current account position following the Asian crises of the late 1990s.

[14] Developing countries running large current account deficits (as a percent of their GDP) are concentrated among prospective Euroland members owing to huge private capital flows. Even with IMF and EU support, it remains to be seen whether the imbalances created thereby will be worked off in a nondisruptive fashion.

The investment and growth performance of developing countries running current account surpluses since then has undeniably undermined the mainstream "chronic saving gap" presumption. But there is also the issue of opportunity costs of self-insurance through bloated precautionary reserve holdings sourced from both current account surpluses and private capital inflows—another paradoxical feature of the global capital flows paradox. The analysis here not only suggests that the opportunity costs of self-insurance may be non-negligible, it also fundamentally challenges the wisdom of insuring the exposure to risks that offer no rewards to developing countries in the first place. Essentially, financial globalization appears like a nifty device for rent extraction working through the defensive behavior of developing countries.

The IMF acted as the main protagonist of universal capital account convertibility. And the Fund's emergency lending and influence soared in the 1990s as emerging markets, heeding orthodox advice for financial liberalization, frequently got hit by financial crises. The IMF then faced its own crisis as the Fund's loan portfolio and income plunged when its supposed customers substituted self-insurance for the IMF's services. The Fund has not changed course on capital account liberalization, peddling its advice on "managing large capital inflows" instead.[15] And as some fresh rescue requests arrived at the IMF's doorstep in the fall of 2008 from countries that were running large current account deficits, this would seem to underline that running a current account surplus offers some safety. Self-insurance is not a free lunch though.

Essentially, private global finance has largely taken over the business of the official international monetary support line. The insurance premium thereby extracted from developing countries for reclaiming part of the policy space lost through financial globalization is significant. Some rationalize the outcome by claiming that the welfare gains of self-insurance outweigh any welfare costs (Aizenman and Lee 2007). Cost-benefit analyses of self-insurance are beside the point though when the risk exposure insured against offers no real rewards otherwise unavailable in the first place.

[15] In its October 2007 *World Economic Outlook*, the IMF acknowledges the policy challenges posed by capital inflows referring to "their potential to generate overheating, loss of competitiveness, and increased vulnerability to crisis" (IMF 2007: ch. 3, p. 1). Fiscal restraint (i.e., small government) emerges as the best policy response available in the Fund's view. It is not clear though that curtailing public investment in order to let hot money play its games necessarily offers a favorable trade-off to developing countries.

There is another more preferable route out. Instead of full capital account convertibility, we propose comprehensive capital account management, both with respect to the aggregate and the composition of capital flows. The aims of a permanent regulatory regime of capital controls are twofold: first, to maintain sufficient macro policy space and prevent destabilizing hot money; and second, to assure a good micro fit of external expertise incorporated in FDI with a country's development strategy. This approach would not only avoid the self-insurance premium currently extracted from developing countries for insuring exposures that offer no real rewards in the first place. It should also help them get off a development strategy that might prove less sustainable than suggested by proponents of BWII—a process that seems already well under way. In fact, the financial crisis currently unfolding at the center of the international financial system—much in contrast to the former history of emerging market crises—raises further doubts about the true value of the "insurance scheme" apparently underlying the "global capital flows paradox."

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