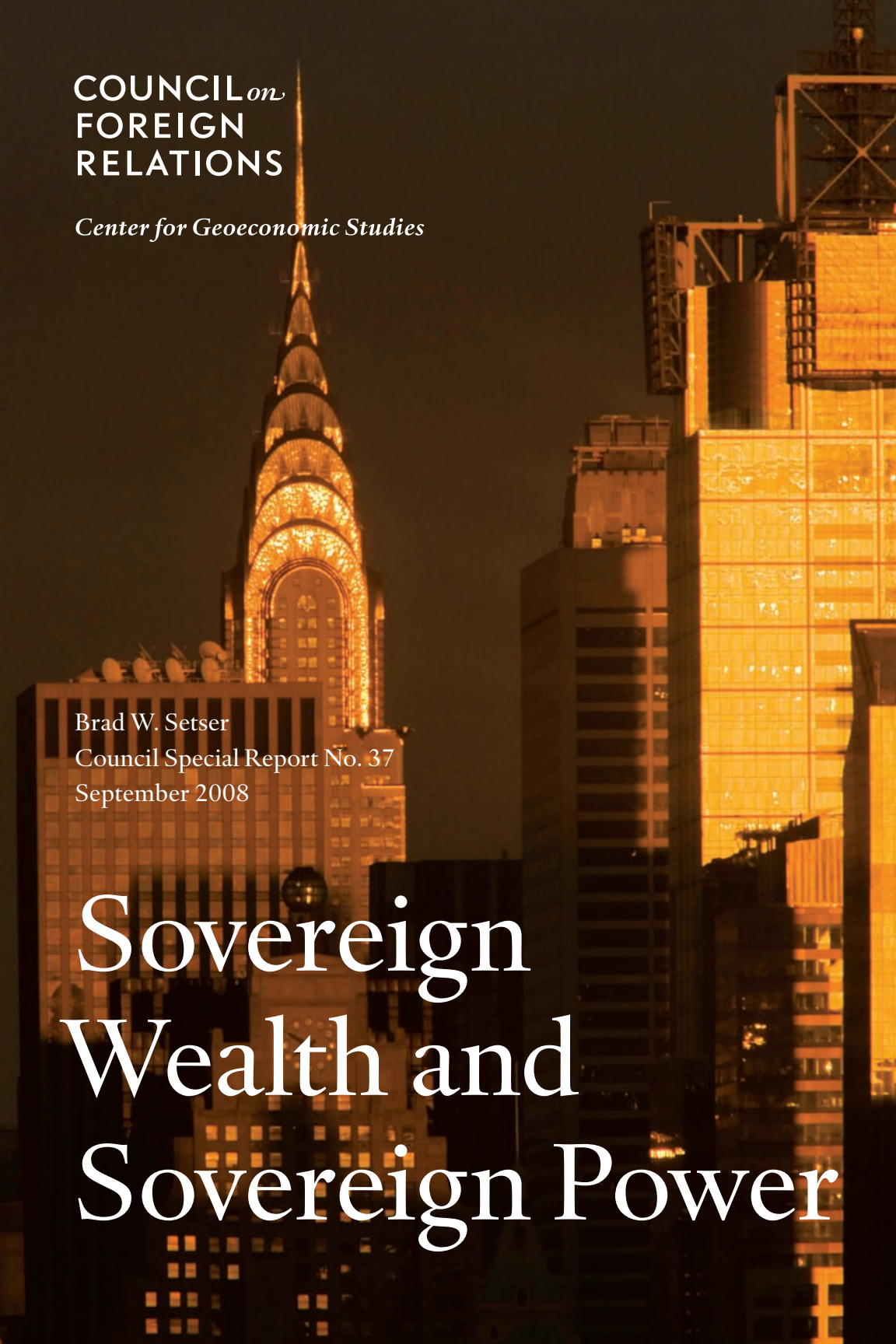

COUNCIL on FOREIGN RELATIONS

Center for Geoeconomic Studies

Brad W. Setser

Council Special Report No. 37
September 2008

Sovereign Wealth and Sovereign Power

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The Strategic Consequences of American Indebtedness

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Brad W. Setser
CSR No. 37, September 2008
The Bernard and Irene Schwartz Series on American Competitiveness

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Foreword

In 2000 the Council on Foreign Relations established the Maurice R. Greenberg Center for Geoeconomic Studies to examine issues at the intersection of global politics and economics. Few issues fit that description more closely than the subject of this Council Special Report. America's current account deficit is financed by foreign purchases of such assets as Treasury securities and stakes in U.S. firms. A good deal of these purchases today are made by the central banks and sovereign wealth funds of countries that do not share many American political values and foreign policy goals.

Some argue that this is no cause for concern. But Brad W. Setser makes a compelling case that the U.S. deficit matters for economic and strategic reasons alike. The United States may have more to lose than its creditors if they sell American assets or stop accumulating them at their current pace. This gives creditors potential leverage over U.S. policy. Setser also argues that indebtedness limits America's ability to influence other countries' policies, for example through sanctions and lending arrangements.

The problems associated with U.S. indebtedness cannot be addressed overnight. But the report proposes ways for the United States to guard against the effects of a disruption in foreign financing, such as consulting with allies who hold dollars and encouraging other creditor countries to spend and invest surpluses instead of accumulating reserves. It also suggests measures to reduce the need for financing in the first place, such as working to balance the U.S. budget and, most importantly, taking steps to reduce U.S. oil imports.

Sovereign Wealth and Sovereign Power raises the potential strategic implications of U.S. indebtedness, challenging the sanguine view that

global economic interdependence guarantees prudence. The report is a significant contribution to the debate on America's political and economic position in an age of globalization.

Richard N. Haass
President
Council on Foreign Relations
August 2008

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Finally, I would like to thank the Bernard and Irene Schwartz Foundation for its generous support of this project.

Brad W. Setser

Acronyms

CIC	China Investment Corporation
COFER	currency composition of official foreign exchange reserves
EU	European Union
GDP	gross domestic product
G7	Group of Seven
IMF	International Monetary Fund
NBER	National Bureau of Economic Research
PBoC	People's Bank of China
RMB	renminbi
SWF	sovereign wealth fund
TIC	Treasury International Capital

Council Special Report

Introduction

In the 1870s, the scope of Great Britain's financial empire exceeded the scope of its political empire. Dependence on British investors sometimes was a precursor, though, to informal—or even formal—political control. When Egypt's khedive needed to raise cash to cover his personal debt to private British banks, he sold his large personal stake in the Suez Canal to the British state. Egypt's ruler did little better managing Egypt's public debt: difficulties making payments led Britain and France to assume control over Egypt's treasury and, by 1882, to full British political control.[1]

In the 1950s, Egyptian president Gamal Abdel Nasser's decision to nationalize the Suez Canal led Britain—together with France and Israel—to occupy the Canal Zone. But Britain's financial position had deteriorated, and it now depended on external financing to sustain the pound's peg to the dollar. The United States—then Britain's most important creditor—indicated that its willingness both to provide direct financial support to Britain and to back an International Monetary Fund (IMF) loan hinged on Britain's willingness to respect a UN General Assembly resolution calling for Britain, France, and Israel to withdraw from the Suez. The U.S. ultimatum forced Britain to reconsider its position. British prime minister Anthony Eden explained: "We were therefore faced with the alternatives, a run on sterling and the loss of gold and dollar reserves till they fell well below the safety margin … or make the best we could of UN takeover and salvage what we could."[2] Britain's decision to withdraw from the Suez duly prompted the United States to back a larger than expected IMF loan.[3]

The lesson of Suez for the United States today is clear: political might is often linked to financial might, and a debtor's capacity to

project military power hinges on the support of its creditors. The United States is militarily far stronger than Britain was in the 1950s—and unlike Britain, it is not committed to maintaining the dollar's external value. However, in some ways the United States' current financial position is more precarious than Britain's position in the 1950s. While Britain ran a small current account surplus in 1956, the United States ran a $750 billion current account deficit in 2007—5.5 percent of gross domestic product (GDP). Britain's main source of financing was a close political ally. The United States' main sources of financing are not allies. Without financing from China, Russia, and the Gulf states, the dollar would fall sharply, U.S. interest rates would rise, and the U.S. government would find it far more difficult to sustain its global role at an acceptable domestic cost.

To date, the fears concerning reliance on foreign governments for financing have not been borne out. China and Russia bought the debt the United States issued to finance the war in Iraq even though they voted against the United States in the UN. A fall in private demand for repackaged mortgage-backed securities in August 2007 was offset by a rise in central bank demand for Treasury securities and the "agency" bonds issued by Fannie Mae and Freddie Mac. Because the United States' ability to borrow huge sums at favorable rates seems unlimited, many have come to see reliance on foreign finance not as a source of vulnerability but as a sign of strength. Others argue that the United States is simply too big an economy to fail. Foreigners cannot withhold credit from the United States because the resulting decline in the dollar and fall in U.S. consumption would undermine their own exports.

This report takes the opposite position. It argues that the United States' current reliance on other governments for financing represents an underappreciated strategic vulnerability. The willingness of foreign central banks—which remain a far more important source of financing for the United States than sovereign wealth funds (SWFs)—to build up dollar reserves has long provided a stable, but limited, source of external financing. But the United States increasingly relies on financing from central banks that already hold far more reserves than are needed to assure their own financial stability. It is true that foreign cen-

tral banks have an interest in keeping the dollar strong. But the United States might have more to lose from a disruption of this relationship: financial flows create mutual interdependence, but the interdependence is asymmetric. The longer the United States relies on central banks and sovereign funds to support large external deficits, the greater the risk that the United States' need for external credit will constrain its policy options.

The report is organized in three parts. The first highlights the growth of emerging market central bank reserves and sovereign funds, and the corresponding increase in their financing of the United States. The second reviews the debate over the political consequences of financial interdependence. The third looks at the ways reliance on financing from central banks and sovereign funds could constrain American policy. The conclusion recommends policies to help the United States manage the risks associated with its current need for external financing—and policies that would help reduce the United States' future need for financing from other governments.

Capital Flows without Precedent

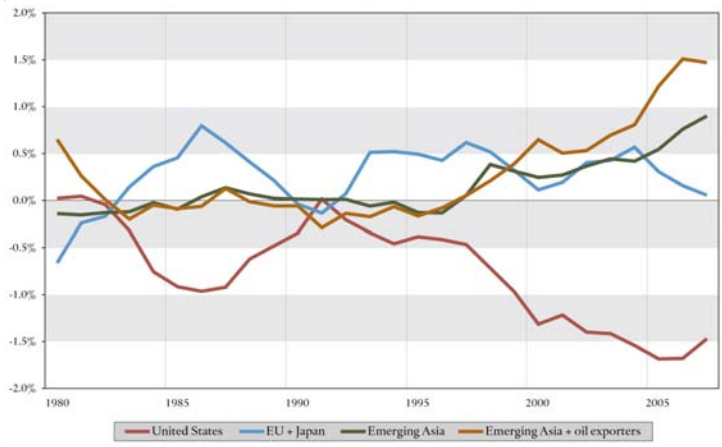
THE GLOBAL FLOW OF FUNDS

The United States has run a deficit in its balance of payments for the last twenty-five years. However, today's deficit is unique.

First, the current account deficit is larger than the deficits the United States has typically run in the past. The U.S. trade deficit fell a bit in 2007 as the U.S. economy slowed, but it remains about twice as large, relative to U.S. GDP, as in the 1980s. It could increase again in 2008, as higher oil prices overwhelm the improvement in the non-oil trade balance. It is also large relative to the deficits—current and historical—of other large industrial economies.[4]

Second, the surpluses that balance the U.S. deficit are no longer located in other rich countries. The European Union (EU) as a whole runs a deficit. Japan has a surplus, but it has not risen dramatically. The recent rise in the U.S. deficit has coincided with a large rise in the surplus of the world's emerging economies. China's 2007 current account surplus of $370 billion is the world's largest (see Figure 1).

Figure 1: Current Account Balance of Key Regions as a Percent of World GDP: 1980–1997



Source: IMF World Economic Outlook.

China's surplus is not expected to fall significantly in dollar terms in 2008, while the combined surplus of the oil-exporting economies is expected to soar.[5] Capital is now said to flow "uphill," from poor countries to rich countries, a metaphor that hints that this process is unnatural.[6] China's per capita GDP—even using purchasing power exchange rates rather than market rates—is only around 15 percent of the United States per capita GDP, so why would China ship capital to the United States? *The Economist* noted in March that "roughly 300 million people in China live on less than a dollar a day… [yet] China adds about $1.25 per Chinese citizen per day to its reserves."[7] Setting aside Norway, Qatar, Kuwait, and the United Arab Emirates, the oil-exporting countries are also generally poorer than the United States or Europe.[8]

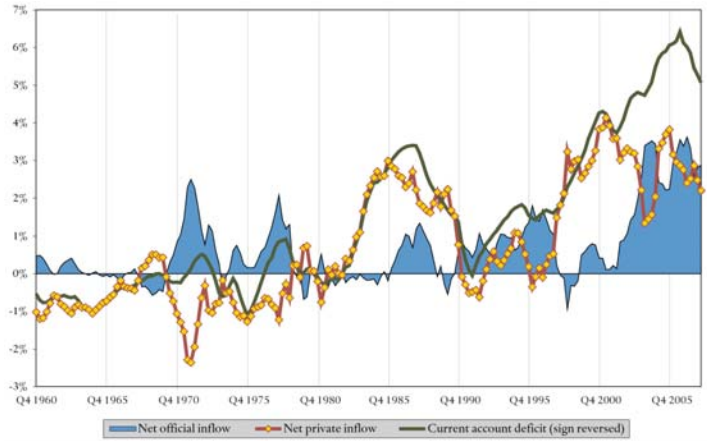
Third, the United States has attracted large net capital inflows even though the financial return on U.S. assets has lagged elsewhere. U.S. interest rates have been quite low. U.S. equity markets have not performed as well as equity markets abroad. The dollar has depreciated against most currencies. This unusual situation—large flows despite

low relative returns—has some advantages.[9] The United States still earns more on its holdings of foreign securities and direct investment abroad than foreigners earn on their holdings of U.S. securities and direct investment in the United States. Because the market value of U.S. equity investments abroad has increased faster than the market value of foreign equity investments in the United States, the resulting capital gains have helped to offset the rise in the United States' stock of external debt. But it would be unwise to assume that this situation will persist. The uphill flow of capital from high-return assets abroad to low-return assets in the United States seems as unnatural as the "uphill" flow from poor to rich.

The low returns on private investment in the United States during the most recent expansion of the U.S. current account deficit stand in marked contrast to the early 1980s and late 1990s—two other periods when the U.S. deficit expanded. Figure 2 shows that in the early 1980s and in the late 1990s, strong returns on U.S. assets pulled in private funds and net private demand for U.S. long-term financial assets rose sharply. By contrast, the current account deficit increased from 2002 to 2006 even as net private demand for U.S. assets shrank.[10] The fall in net demand reflected—as Figure 3 illustrates—a fall in gross private foreign demand for U.S. long-term debt and equities as well as an increase in U.S. demand for long-term foreign assets. Short-term inflows did rise—at least until the credit crisis—but they generally were offset by short-term outflows.

Figure 2: Net Private and Net Official Flows vs. U.S. Current Account Deficit

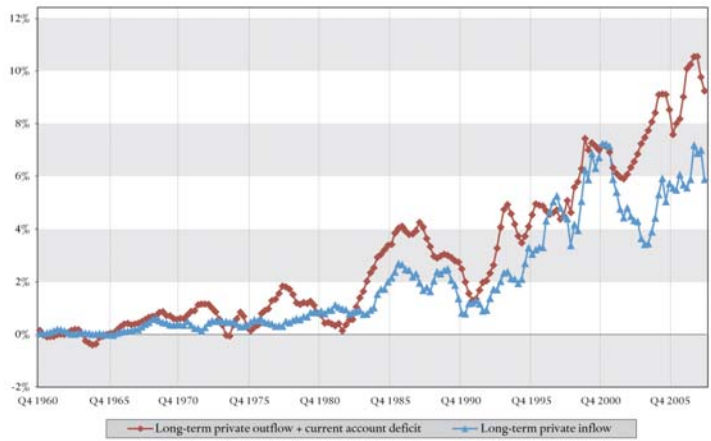
Rolling 4th Quarter Sums as a Percentage of U.S. GDP



Source: Bureau of Economic Analysis (BEA).

Figure 3: Net Private and Net Official Flows vs. U.S. Current Account Deficit

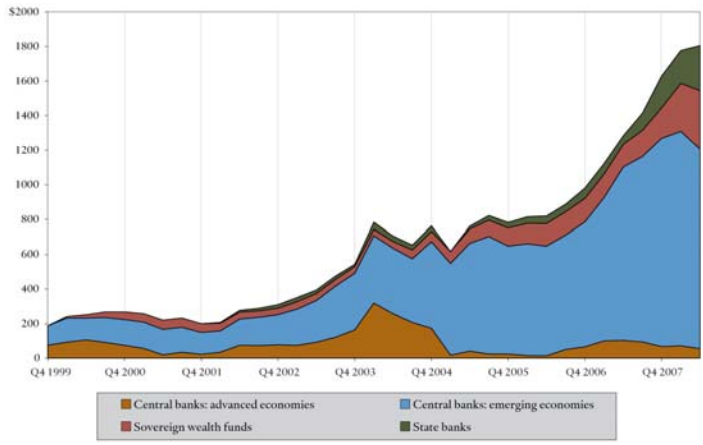
Rolling 4th Quarter Sums as a Percentage of U.S. GDP



Source: BEA.

Fourth, central banks and sovereign funds play a large and growing role in the financing of the United States' external deficit. Chinese observers talk of China's dual surplus—a surplus in the current and the financial account. Such a dual surplus also exists for the emerging world as a whole. According to the IMF, emerging economies and developing economies attracted $600 billion in net private capital inflows in 2007 even as they ran a $630 billion current account surplus. Central banks have taken on a balancing role: they are acquiring dollars as fast as exporters and investors looking for higher returns in the emerging world are selling them. The inevitable result is a truly extraordinary buildup of dollar assets in official hands. According to the IMF, emerging market central banks added $1.24 trillion to their foreign exchange reserves in 2007 and sovereign funds added another $150 billion or so.[11] The available data—summarized in Figure 4—suggests even more rapid growth in official assets in 2008. While more is going to sovereign funds, the vast majority remains with the world's central banks.

Figure 4: Estimated Official Asset Growth
Rolling 4th Quarter Sums, $billion

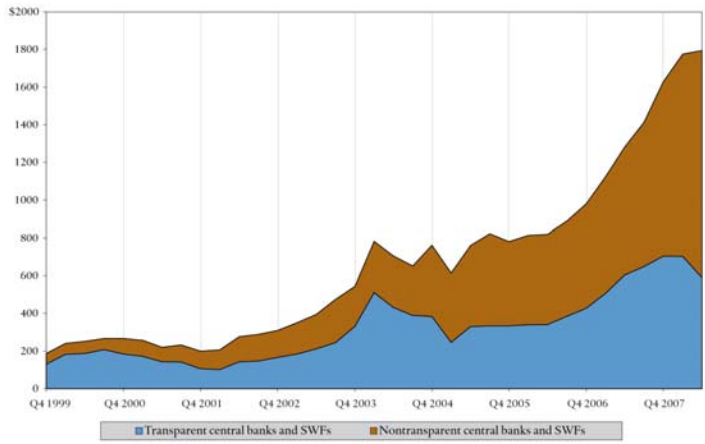


Source: IMF Currency Composition of Official Foreign Exchange Reserves (COFER), national data, and author's estimates.

Quantifying how much of this went into U.S. assets is difficult. As Figure 5 shows many major central banks and most sovereign funds do not report detailed data on the currency composition of their reserves to the IMF. The U.S. balance of payments data tend to understate official purchases of U.S. assets. Official purchases tend to be revised upward once data from the Treasury's annual survey of foreign portfolio investment in the United States become available. Even the revised data likely understate the role of sovereign investors, as they do not capture either the growth in offshore central bank dollar deposits or government funds that are managed by private investors.[12] However, given the scale of the increase in sovereign assets, central banks and sovereign funds likely added somewhere between $800 billion and $950 billion to their dollar portfolios in 2007 (as shown in Figure 6).

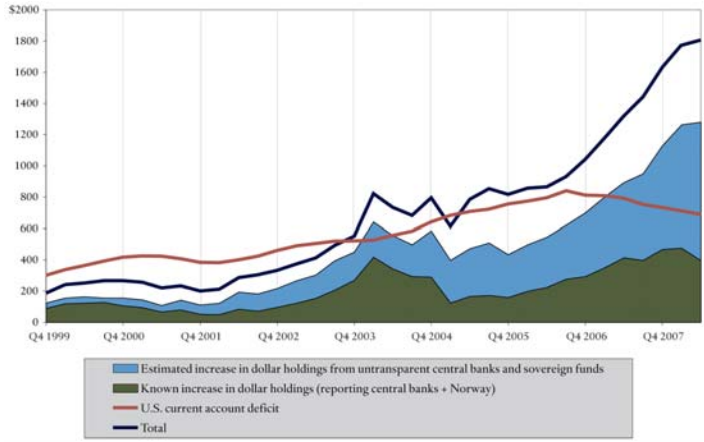
Figure 5: Transparent vs. Nontransparent Central Banks and Sovereign Funds

Rolling 4th Quarter Sums, $billion



Source: IMF and author's estimates.

Figure 6: Estimated Increase in Dollar Assets of Central Banks and Sovereign Funds Tops the U.S. Current Account Deficit
Rolling 4th Quarter Sums, $billion

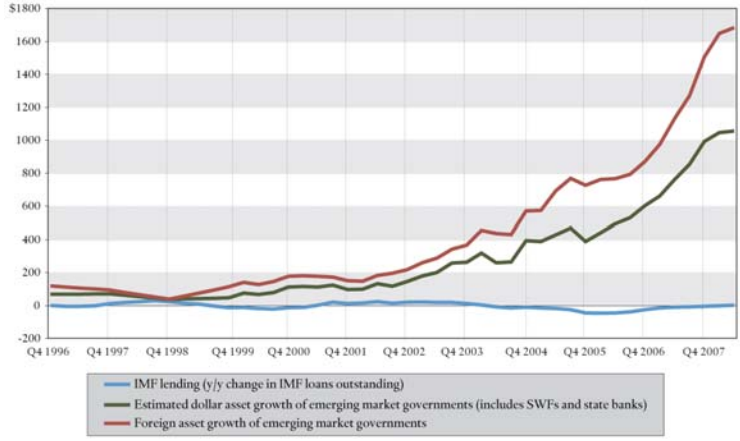


Source: Author's estimates, based on IMF and national data.

Much of that increase translated, directly and indirectly, into demand for U.S. financial assets—with the overwhelming majority flowing into U.S. Treasury and agency bonds, pushing down U.S. interest rates even as the U.S. external deficit expanded.[13]

As Figure 7 demonstrates, the financing that emerging economy governments have provided to the United States dwarfs the emergency financing that the IMF provided to the emerging world in the 1990s.

Figure 7: Outgunned: IMF Lending to Emerging Markets vs. Growth in Dollar Assets of Emerging Market Governments
Rolling 4th Quarter Sums, $billion



Source: IMF, national data, and author's estimates.

Indeed, in 2007 alone, the estimated increase in the dollar reserves of emerging economies was roughly thirty times larger than the financing that the IMF provided to the emerging world in 1997–98.[14] Table 1 illustrates this astonishing imbalance in a slightly different way: The $30 billion in new capital that U.S. banks and broker-dealers raised from sovereign funds in China, Singapore, and the Gulf states in December 2007 and January 2008 is equal to the largest loan the IMF extended to any emerging economy.

Table 1: Sovereign Wealth Funds' Investment in U.S. Financial Institutions vs. IMF Programs for Emerging Economies

	Agreed	Drawn
IMF lending		
Mexico	18.0	13.1
Thailand	3.9	3.7
Indonesia	11.3	5.0
Korea	20.8	19.4
Brazil 1998	18.4	13.4
Russia	15.1	5.1
Argentina	22.1	12.7
Brazil 2001	15.6	14.6
Brazil 2002	29.3	22.1
Uruguay	2.7	1.9
Turkey 1999–2001	20.7	16.2
Turkey 2002	17.6	14.8
SWF recapitalizations		
Merrill Lynch*	9.9	9.9
Citigroup†	17.4	17.4
Morgan Stanley‡	5.0	5.0
All U.S. financial institutions[15]	32.43	32.43

*Temasek Holdings, Korea Investment Corporation (KIC), Kuwait Investment Authority (KIA).

†Abu Dhabi Investment Authority, Government Investment Corporation, KIA.

‡China Investment Corporation (CIC).

Source: IMF and news reports.

Moreover, the IMF lent on terms—in the currencies of the IMF's major creditor countries, with "preferred" payment, and with strong conditionality—which almost guaranteed that the IMF would make money. By contrast, emerging market central banks are lending to the United States on terms that offer little financial protection. Sovereign funds hope for outsized returns on their equity investments that will make up for dollar depreciation. Yet so far their high-profile investments in the U.S. financial sector have produced large losses.

Despite the rapid growth of sovereign wealth funds' dollar investments and central bank dollar reserves, there is a debate about their significance in financing the U.S. current account deficit. A rise in official flows of capital into the United States could finance private capital outflows as easily as a larger current account deficit. If U.S. and European bonds are close substitutes, a rise in central bank demand for U.S. government bonds would lead private U.S. and foreign investors to switch away from Treasuries to purchases of European government bonds; the result would be a change in the composition of capital inflows into the United States rather than a change in the size of the deficit. This is why former Federal Reserve chairman Alan Greenspan has argued that a shift in central bank purchases of dollars to central bank purchases of euros would increase U.S. interest rates by less than fifty basis points.[16] His assumption is that if foreign central banks bought fewer dollar assets, foreign private investors would take up the slack, cushioning the blow to the United States.

Greenspan's views are influenced by the absence of a rise in Treasury yields when Japan's government ended its intervention in the foreign exchange market in 2003. But it is not clear that Japan is a reliable precedent. Japan actually kept buying Treasuries after it stopped intervening in the foreign exchange market, as it initially had built up large bank deposits. The end of Japanese buying of long-term U.S. debt didn't occur until the summer of 2004—and it was quickly followed by a surge in buying from emerging markets. Moreover, Japan's intervention in the market, large as it seemed at the time, is actually small relative to China's current intervention. At its peak, Japan added about $325 billion over four quarters. China now adds only a bit less—

somewhere between $200 billion and $250 billion—in a quarter, if funds held by the state banks and funds shifted to the CIC are counted. It is not just China either: if oil averages $120 a barrel in 2008, the total increase in the official assets of the oil-exporting economies could approach $900 billion. This year both the Russians and the Saudis will not be all that far behind Japan's peak purchases. Finally, the end of Japan's intervention also coincided with the beginning of the Federal Reserve's rate hikes, which helped generate private demand for dollars and reduced pressure on the yen. The scenario that generates the most concern though, is the opposite: private demand for U.S. debt falls, and rather than stepping in, central banks also pull back.

It is possible that the comforting dynamic Greenspan assumes would not merely fail to transpire, but that the opposite dynamic could take over. Arguments that a fall in central bank purchases of U.S. debt would have a limited market impact generally hinge on the assumption that if central banks shifted from buying dollars (and dollar-denominated bonds) to buying euros (and euro-denominated bonds), private investors would increase their purchases of dollars and dollar-denominated debt, preventing any large change in price. But private investors could also amplify rather than offset a change in central bank purchases, selling what China—or another large central bank—is selling, and buying what China is buying, rather than doing the opposite.

Foreign Demand for U.S. Debt: Strategic Asset or Achilles Heel?

In the 1970s, rising U.S. imports of OPEC oil—and the displacement of the Western oil majors by state-oil companies—gave rise to a literature that examined how economic interdependence could create asymmetries and vulnerabilities that states could try to exploit.[17] The past ten years have been marked by the rising role of states in financial markets—whether in the foreign currency market, the government bond market, or in the "market" for providing troubled banks and broker-dealers with fresh capital. Yet rising U.S. imports of capital—and the displacement of private funds by state investors—has not produced a comparable literature examining whether state-directed financial flows can be a tool for political power.

This section reviews and evaluates four broad arguments about the political significance of the new financial imbalances. Classical liberals and proponents of the dollar's global role both emphasize the benefits of growing dollar reserves and the increase in emerging market investment in the United States. Others worry about potential asymmetries that could be exploited for political gain—and the difficulties faced by a hegemon that relies on foreigners' financial support.

THE LIBERAL ARGUMENT: FINANCIAL TIES—LIKE TRADE—CREATE COMMON INTERESTS

Political scientists generally have paid more attention to the growth of Sino-American trade than to the growth of Sino-American financial interdependence. Many have made the classical liberal internationalist

argument: the growth of trade will shift the U.S.-China relationship away from zero-sum competition for power toward a win-win world, where both China and the United States benefit from growing commercial ties. China's economic linkages with the rest of the world will create constituencies inside China that will encourage China to act as a "responsible stakeholder" and constituencies outside of China that favor China's peaceful integration into the global system. China will consequently develop within the existing global political order rather than challenge it.[18]

Some such analysis explicitly extends the core liberal argument beyond trade to include financial flows. Cambridge University's Helen Thompson summarizes the core "liberal" argument[19]:

> As the economic interdependence of states has grown so, liberals believe, have common interests and values, making military conflict less likely. … [O]n this basis, liberals can be sanguine about the general consequences of U.S. debt. If debt makes the economies of states more interdependent, it should reinforce their common interests.

The *Financial Times*' Alphaville blog echoes the liberal argument when it suggests that investment ties among countries could "moderate political spats rather than exacerbate … them."[20]

This argument neglects the differing interests of creditors and debtors. Creditors generally want the debtor to adopt policies that maintain the value of the creditor's claims—even if this requires painful domestic economic adjustments. Creditors of the United States, for example, might want the United States to direct its monetary policy at maintaining the dollar's value even if this meant limiting economic activity in the United States. Latin America's historic dependence on U.S. banks, the U.S. capital market, and U.S.-influenced international financial institutions like the IMF has not always produced political harmony between the United States and Latin America.[21]

Moreover, financial interdependence that arises from the expansion of central bank and sovereign fund claims could itself be a source of friction. The *Financial Times*' Gideon Rachman has argued that sovereign equity investments fit into the broader liberal argument, as new forms of interdependence will create common interests: "If governments in China, Russia, and the Middle East have large investments in the United States and the European Union, then they also have a direct stake in the continuing prosperity of America and the EU."[22] This argument seems too sanguine. As Martin Wolf, also of the *Financial Times*, has observed, state-led globalization is not really consistent with a liberal international order based on limited government intervention in markets.[23] Recipient countries with a tradition of limited state ownership are likely to worry about a rapid rise in investments by foreign governments. Trade with China has not generated much angst in Australia, as Australia's resource-based economy complements China's economy nicely. But the recent wave of investment in Australian mining companies by Chinese firms has generated tension; Australia worries that Chinese state investors are pursuing China's strategic interests, which may not coincide with Australia's economic interests. Countries, like the United States, that oppose Chinese intervention in the foreign exchange market may not always welcome state investment financed by the proceeds of such intervention—particularly if Chinese state firms appear able to borrow foreign exchange from the government on subsidized terms. Rather than moderating existing spats, state investment abroad may create new ones.

The Dollar as a Strategic Asset

Political scientists, economists, and historians have highlighted the advantages that the United States derives from the dollar's status as a reserve currency—namely, stable, low-cost external financing from countries that must hold dollars as part of their international reserves. On this view, Chinese and Gulf states' demand for U.S. debt is a strategic asset. The danger lies not in a continued buildup of official reserves but in an interruption in this process. In a *Foreign Affairs* article,

David Levey and Stuart Brown write, "If anything, the world's appetite for U.S. assets bolsters U.S. predominance rather than undermines it."[24]

The dollar's reserve currency status is central to the "exorbitant privilege" that allows the United States to "finance [its] international deficits easily" even as it adopts macroeconomic policies directed at domestic stabilization.[25] Former Federal Reserve chairman Paul Volcker's description of the United States in the 1960s still resonates: "External financing constraints were something that ordinary countries had to worry about, not the unquestioned leader of the free world, whose currency everybody wanted." Cornell's Jonathan Kirshner more directly links the dollar's global status to the United States' ability to project power abroad: safe haven flows into the United States during global political confrontation have meant that the United States generally has not had to worry about a simultaneous political and financial crisis.

The argument that the ability to issue debt, especially low-cost debt, is a strategic asset is not unique to the postwar United States. Historian Niall Ferguson has noted that Britain's ability to avoid the periodic "conversions" (debt restructurings) employed by other European powers facilitated its rise to global power. Britain was able to borrow from private investors at lower rates than other European powers and thus to sustain a higher debt stock. This allowed the British state to spread the costs of war over time. A debt market consequently is one side of Ferguson's "square of power." Two other sides of the square, an efficient tax administration and an independent central bank, indirectly supported the debt market.[26]

The dollar's global role arguably constitutes one side of a new "square" of power. Central bank demand for dollars helps the United States to spread the costs of the "war on terror" over time, limiting the need for domestic sacrifices that might undermine domestic support for U.S. involvement abroad. This analogy, though, is imprecise. Britain's rise to global power in the nineteenth century was marked by the development of domestic institutions that allowed it to borrow from its own citizens, not from other governments. HM Treasury relied on

the British public's confidence in the Bank of England. The U.S. Treasury relies on the confidence of the Chinese public in China's state banks, their willingness to buy the People's Bank of China's (PBoC) sterilization bills, and the willingness of China's State Administration of Foreign Exchange to add to its holdings of U.S. debt. This highlights a second distinction between Britain in the nineteenth century and the United States today: Britain was a creditor nation, whereas the United State is a debtor. Ferguson recently suggested that the United States may have more in common with the fading Ottoman Empire than with the rising British Empire. In the 1870s, the sale of Ottoman assets—or revenue streams—to creditors augured a shift in the global balance of power.[27]

To be sure, it is helpful to the United States to be able to borrow in crisis. But when the United States exercises that option, it reduces its ability to borrow in the future: though foreigners have shown an extraordinarily large appetite for U.S. assets, this appetite is still finite. Those who value foreigners' willingness to finance the United States should be the first to caution against saturating the world's central banks with dollars. The ability to borrow if necessary is a strategic asset. Sustained borrowing from foreign governments is not.

FINANCIAL POWER AND FINANCIAL INTERDEPENDENCE, CIRCA 2008

The classical liberal argument that economic interaction creates stabilizing interdependence was qualified in an important way by scholars Robert O. Keohane and Joseph Nye, who pointed out that interdependence can be asymmetrical.[28] Two countries may be mutually dependent on the benefits of trade or financial flows, but if one country has more to lose from a disruption, the other can exert leverage by threatening to break up the interchange. To illustrate the point crudely, all countries gain from peace. But if one country believes it will suffer lighter losses than its rival in the event of war, it can credibly threaten to attack it.

The significance of financial interdependence between the United States and its creditors therefore hinges on who would lose more from a disruption. Economist Albert O. Hirschman argues that asymmetries generally work to the advantage of larger nations: access to a large market matters far more to a small country than access to a small market matters to a large country[29]. Equally, the provision of a reserve currency historically has created asymmetries that worked in favor of the large country that supplied the reserve currency. Smaller countries could not reduce their reserves—or switch to a less liquid reserve currency—without damaging their own financial stability. In a crisis, a country needed dollars, not Russian rubles. Consequently, the supplier of the reserve currency could count on a steady, but limited, source of cheap financing from the world's central banks.

However, the enormous expansion of the emerging world's stock of reserves has potentially changed this power dynamic.[30] Most emerging market central banks now have more reserves than they need to assure their external financial stability. Their financial health would not be at risk if they stopped adding to their reserves—or even sold some of them. Indeed, a slower pace of reserve growth would help many emerging market central banks to combat inflation. This increases the United States' vulnerability to a change in foreign government policy.

Changes in the global monetary system—notably, the creation of the euro—have added to the United States' potential vulnerability. The euro is now the dominant reserve currency of most of Europe and a potential challenger to the dollar as the world's leading reserve currency.[31] The availability of an alternative store of value historically has tended to increase the leverage of the holders of a reserve currency relative to the provider of the reserve currency. Half a century ago, holders of "sterling balances" could threaten to convert their sterling reserves to dollars, draining Britain of its dollars. Concerns about the scale of Kuwait's sterling holdings and its support for the policies of Eyptian president Gamal Abdel Nasser even led Britain to ask Kuwait not to add to its sterling holdings in the 1960s.[32] In the Bretton Woods system that existed until 1971, holders of dollars could use the threat to convert their dollars into gold to gain leverage over the United

States—a threat that both Germany and Japan were loath to use because of their military dependence on the United States. Today, the Gulf states' need for U.S. military protection arguably limits their capacity to exert leverage over the United States by threatening to switch from dollars to euros. But China and many others with large dollar holdings—including Russia—are in a rather different strategic position.

These shifts may not matter. Economists Michael Dooley, Peter M. Garber, and David Folkerts-Landau argue that foreign central banks will continue to accumulate dollar reserves, not because they need them to defend the external value of their currencies against a potential speculative attack, but effectively for the opposite reason—by buying dollars steadily, they seek to keep their currencies cheap vis-à-vis the dollar. The authors argue that the benefits of large-scale reserve growth in the "periphery" that provides low-interest financing to the center—the United States and Europe—are so strong that neither party has an incentive to exploit rising interdependence for political gain.[33] Asia will ignore the costs associated with holding its exchange rate below its fair market value to obtain the benefits of a modern export-oriented industrial sector that absorbs Asia's underutilized rural labor force. The United States and Europe will accept the decline of their tradables sector in exchange for cheap credit. [34] The United States gets a particularly good deal: the "Bretton Woods II" system, unlike the initial Bretton Woods system, does not require the United States to defend the dollar's external value. That is one reason why this system has persisted; its ongoing operation does not constrain the United States' macroeconomic policy autonomy. Even so, much hinges on the ongoing willingness of significant creditors to add to their dollar claims, as the withdrawal of this credit could force the United States to make painful economic choices. As argued in section three below, such willingness cannot be relied upon.

If China or Russia threatened to reduce holdings of dollars, what would be the consequence? The United States' commitment to allowing the market to set the dollar's value helps to limit its vulnerability. Britain's commitment to maintaining sterling's peg to the dollar al-

lowed countries with large sterling holdings to deplete Britain's reserves. The United States has made no similar commitment to maintain the euro (or renminbi [RMB]) value of the dollar. In a crisis, the dollar's market value would adjust rather than the United States' reserves. So long as U.S. debts are denominated in dollars, dollar depreciation poses relatively little direct financial threat to the United States. The United States' foreign creditors would just see the external purchasing power of their dollar holdings fall.

Even so, a Chinese or Russian decision to reduce holdings of dollars would probably inflict more pain on the United States than vice versa. Alternative sources of external financing would probably not be willing to lend to the United States on a comparable scale at the same terms.[35] Few private investors are willing to lend on terms that imply likely losses. The high level of leverage in the U.S. financial system—and among U.S. households—only increases the U.S. economy's sensitivity to an external shock. A sharp rise in U.S. interest rates that triggered a broad fall in asset prices would likely force a widespread sell-off of assets, and a deleveraging of the financial system. U.S. policymakers do not need to imagine what this would be like. They just need to remember the painful deleveraging that followed the "subprime crisis" in August 2007.

Can a Debtor Supply the Public Good of Financial Stability?

A single dominant state has often been associated with economic and financial stability.[36] A liberal hegemon—Britain in the nineteenth century, the United States after World War II[37]—defends a global system based on open markets and provides the public good of international financial stability by acting as the global lender of last resort. The United States' apparent decline in the 1970s gave rise to a debate over whether a hegemon could operate in concert with its allies to provide the global public goods that it could no longer supply on its own.[38] This debate subsided in the 1990s. The United States reasserted its financial and economic leadership on the back of an improved fiscal position and a policy of working in concert with the other members of

the Group of Seven (G7) to respond—through the IMF—to a series of financial crises in emerging economies.

However, the capacity of a group of countries to act in concert to provide global financial stability is again relevant. The current global financial system is marked not just by new actors, but by actors who are largely outside of the existing institutional architecture for financial and monetary cooperation. Major emerging economies are not members of the G7. Many view the IMF with deep skepticism. Today's financial imbalances are in part a reflection of important countries' decisions to "opt out" of the existing institutional architecture, as many countries initially built reserves in part to avoid the need to turn to the IMF for financing. The main sources of support for the Bretton Woods II system—China's commitment to a managed exchange rate, the reluctance of many emerging economies to appreciate faster than China, Russia's commitment to peg to a basket that includes the dollar, and the Saudi dollar peg—are the product of national decisions, not international negotiation.[39] Who, in such a system, would coordinate a global response to financial crises?

To be sure, the Federal Reserve—not emerging market central banks—has taken the lead in managing the recent U.S. credit crisis, creating the appearance of continued U.S. leadership. The New York Fed organized the merger of Bear Stearns with JPMorgan and supplied, through a range of new facilities, liquidity to both the banks and large broker-dealers. But the United States' policy response has drawn heavily on the resources of the emerging markets. Sovereign funds that provided capital to U.S. financial institutions offer the most obvious example. The willingness of emerging market central banks to continue to add to their dollar holdings has been less visible but more important.[40] If foreign sovereign funds and central banks had decided not to carry on buying dollar assets, the Fed's vulnerability would have become more apparent. The flight from credit risk by other sovereign investors (notably Chinese state banks) after taking losses on their (limited) subprime exposure was perhaps a warning sign of how foreigners could behave in a future crisis.[41]

Framed most harshly, the current financial crisis raises the question of whether the United States—and U.S.-led international institutions—can provide the public good of global financial stability when it has outsourced the maintenance of its own financial stability to China and the Gulf region. The rapid rise in the financial power of the emerging world has created a large gap between the existing institutional architecture and current reality. The formal architecture for international monetary and financial cooperation continues to be centered around institutions created on the assumption that the United States and the large European economies are the world's leading creditor countries. If existing institutions do not evolve to reflect the growing financial clout of the emerging world, they risk being bypassed—or replaced. But new (or reformed) institutions that better map to the current distribution of financial power have not been created—let alone tested in a crisis.

Rising Risks

The preceding section acknowledged the liberal internationalist hope that interdependence is stabilizing. It highlighted the benefits associated with supplying a global reserve currency, notably a stable source of external financing from the world's central banks. However, it argued that recent developments have increased the risk that the U.S. need for financing from other governments could constrain U.S. policy. These developments include the sheer scale of the United States' need for external financing, the large stocks of reserves held by many emerging economies, the emergence of a potential alternative reserve currency, the awkward political relationship between the United States and many of its largest creditors, and the weakness of current institutions for international monetary and financial cooperation.

U.S. policymakers need to face this growing vulnerability. Continuing to assume that external financing will be readily available, no matter what happens, risks repeating the error of British leaders half a century ago. Historians looking back at the Suez crisis have concluded that Britain's hubris added to its vulnerability.[42] Unlike France, Britain did not obtain IMF financing to shore up its reserves in advance. It feared that an effort to secure financing would be interpreted as a sign of weakness. British leaders recognized their need for American financing. But they underestimated the strength of American opposition to what the United States perceived as an effort to cling to an outdated empire—and wrongly assumed that the United States would never deny financing to a long-standing ally.

For U.S. policymakers today, complacency is tempting because of comforting arguments that it is not in creditors' interests to precipitate a crisis. One comforting argument is that it would take a decision by a

major creditor to dump all dollar reserves to cause a run on the dollar—and that this sort of decision is so drastic as to be unlikely. But history contradicts this argument. During the Suez crisis, both British chancellor Harold Macmillan and Prime Minister Anthony Eden were convinced that the U.S. government was behind the run on the pound. But the U.S. government actually reduced its sterling holdings by only four million pounds—or around $11 million dollars—between the end of September 1956 and the end of December, a fraction of the $450 million drain from September through November with which HM Treasury had to contend.[43] The United States did not need to sell pounds to put pressure on Britain, just as Russia, China, or Saudi Arabia might not need to sell dollars to put pressure on the United States today. As W. Scott Lucas writes: "The Americans did not have to sabotage the pound to influence Britain ... they merely had to refuse to support it."[44]

Contrary to what the comforting narrative might suggest, a country seeking to use its holdings of dollars to influence U.S. policy has options that fall short of the "nuclear option" of dumping large quantities of dollar reserves.

- A creditor government could sell holdings of "risk" assets and purchase "safe" U.S. assets, creating instability in certain segments of the market. This could be done without triggering the appreciation of its own currency against the dollar or directly jeopardizing its exports.
- A creditor government could change how it intervenes in the currency market. A country, for example, could halt its accumulation of dollars without ending all intervention in the currency market if it sells all the dollars it buys in the market for other currencies.
- A creditor government could stop intervening in the currency market, halting its accumulation of foreign assets, whether in dollars or other currencies.
- A creditor government could halt its intervention and sell its existing stocks of dollars and dollar-denominated financial assets, the

"nuclear option." If it held a large equity portfolio, this could include large stock sales.

In each case, market equilibrium would be restored when private creditors stepped in to buy U.S. dollars and U.S. securities, making up for the shortfall in official demand—or by dollar purchases by another central bank. Options that involve selling one U.S. asset and buying another would generally have a smaller impact than options that involve ending all new purchases of U.S. assets. Options that imply replacing dollar purchases with euro purchases would likely have a smaller impact than options that imply ending all new euro or dollar purchases. And ending new dollar purchases would have a smaller market impact than outright dollar sales—though for a country whose dollar holdings are growing as rapidly as China's, the difference may be rather academic. Size matters. The annual increase in China's reserves, together with the growth in the external portfolio of China's sovereign wealth fund and its state banks, reached $600 billion in 2007 and could reach $800 billion in 2008—a sum that easily exceeds the stock of reserves held by countries like Saudi Arabia, India, Korea, Brazil, and even Russia.

It is commonly argued that China's government will not stop buying dollars—let alone start selling—because it does not want to drive down the market value of its existing one-trillion-plus dollar portfolio. This argument, though, misses two important points. First, as noted above, China's government could disrupt U.S. asset markets without directly driving down the value of the dollar: A large-scale switch of holdings from one type of dollar instrument to another could accomplish this. Second, it is in China's financial interest to stop buying dollars sooner rather than later. Buying dollars today allows China to avoid registering a fall in the value of its portfolio today, but it only adds to the size of China's dollar portfolio and thus to China's expected future loss. U.S. financial stability relies on China's ongoing preference to take larger losses in the future rather than a smaller loss today.

Assuming that China's own assessment of the relative costs and benefits of this policy will never change is a risk. The size of China's potential loss is increasing rapidly.

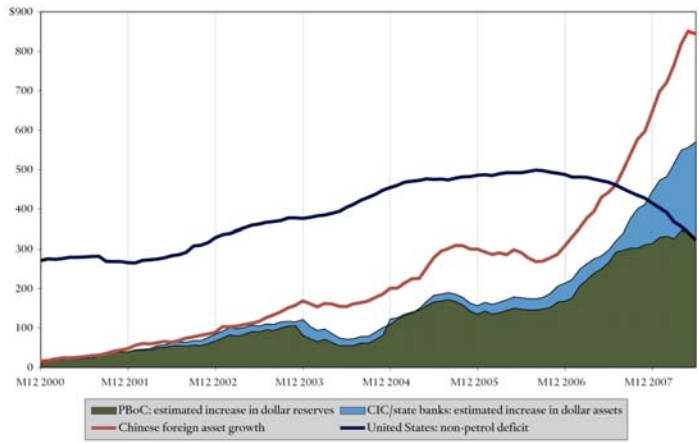
Two calculations are illustrative:

- If the renminbi is undervalued by 33 percent against a basket of euros and dollars that corresponds with China's external assets, the expected loss on China's 2007 reserve accumulation is over 5 percent of China's 2007 GDP. U.S. Marshall Plan aid to Europe after World War II had a different purpose. But it only cost the U.S. taxpayers an average of 1.1 percent of U.S. GDP a year from 1947 to 1951.[45]
- If China's total foreign holdings rise to $3 trillion by the end of 2009—an increase that is consistent with China's current pace of foreign asset accumulation—a 33 percent RMB appreciation against the dollar and euro would produce a $1 trillion financial loss.[46] That is a large sum even for a nation of over a billion people.[47]

The coalition in China that has supported its policy of accumulating dollars is already being challenged. Strong export growth has not translated into impressive overall employment growth. Labor income is falling as a share of Chinese GDP.[48] Difficulties raising Chinese interest rates when U.S. interest rates are low have crimped the ability of China's central bank to use monetary policy to steer China's own economy. The losses on the central bank's intervention are starting to become more visible. The domestic outcry over the CIC's investment in the private-equity group Blackstone suggests that China's citizens could react negatively when the scale of China's losses on its dollar holdings becomes known. China's leaders will have a strong incentive to claim that the losses stem from poor U.S. policies, not poor investment decisions by China's leaders. China's interest in supporting the United States to ensure the health of its exports has been diminished by the development of other markets: Chinese exports to Europe now exceed exports to the United States; exports to Africa, Russia, and the

Middle East are growing far faster than exports to the United States. At the same time, Chinese financing of the U.S. is rising: Chinese purchase of dollar-denominated financial assets now almost certainly exceed the United States non-oil trade deficit (Figure 8). A growing sense that the "economics" of China's managed exchange rate are no longer in China's interest might combine with a rise in Sino-American political friction—whether over Taiwan, Tibet, or China's growing interest in securing stable commodity supplies—to trigger a reassessment of Chinese policy.

Figure 8: Estimated Chinese Dollar Asset Growth vs. the U.S. Non-Petrol Deficit
Rolling 12M Sums, $billion

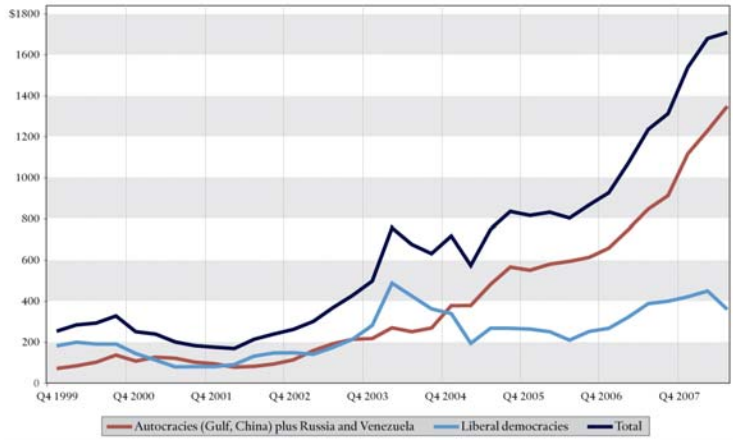


Source: BEA and author's estimates.

The fear of such a reassessment could constrain U.S. policy choices. But the United States is also vulnerable to a loss of foreign financing triggered not by its own policies but by political change abroad. The large share of total foreign official assets accumulation comes from autocratic governments—and the correspondingly large role that autocratic governments play in the financing of the United States—illustrated in Figure 9—is striking. This is not an accident. Autocratic

governments do not have to explain why domestic spending and investment have been held down to maintain large external surpluses. India, for example, would likely face more difficulty than China has if it opted to sell government bonds to finance a sovereign fund that invests abroad. Influential voices would argue that those funds should be invested in improving India's own infrastructure.[49] Moreover, autocratic governments have a strong incentive to "over-insure" against financial crises that might make them subject to IMF—or G7—conditionality.

Figure 9: Growth Foreign Assets of Democratic Relative to Authoritarian Governments
Rolling 4th Quarter Sums, $billion



Source: National data (foreign exchange reserves) and author's estimates (Gulf SWFs, CIC).

One perverse result: democratic change in countries with a large stock of U.S. assets could be a threat to U.S. financial stability. A more democratic Gulf region almost certainly would be far less willing to hold U.S. assets—whether because of concerns about the risk of financial losses, concerns about financing American foreign policy in the Middle East, or a desire to spend more at home. A more democratic China would face similar pressures. A large gap between a country's

portfolio and the portfolio that a majority of its citizens would prefer is itself a risk.

The United States' growing debts and ongoing need for external financing are not just a potential financial vulnerability. They also have reduced the United States' ability to use its own financial power to shape other countries' policies—what might be called "soft" financial power. After World War II (if not before), financial globalization often meant financial Americanization. Foreign borrowers looking to raise funds tended to issue bonds denominated in dollars, made use of New York law, and met the Securities and Exchange Commission's standards for disclosure. The United States shaped global norms—and could use the threat to limit countries' access to the U.S. financial market to try to shape their behavior. Today, borrowers from around the world looking to raise funds already are traveling to the Gulf states or to China rather than New York to explore their options. There is less pressure on other countries to conform to U.S. financial norms—and less scope for the U.S. government to use other countries' desire to raise funds in the United States to shape their policies. It is likely to be hard for a large net borrower to implement effective financial sanctions[50]; no one relies on it for financing.

The U.S. government's greatest source of financial leverage historically has been its ability to determine the conditions for helping countries facing financial trouble. So long as Europe and Japan coordinated policy through the G7 and preferred to lend together through the IMF rather than lend bilaterally, an emerging economy had to choose between no finance or finance on the IMF's terms. Troubled countries could not play rival sources of financing against each other in a quest for easier terms. That is why the United States sought to prevent the formation of a Japanese-led Asian Monetary Fund that offered an alternative to the IMF during the Asian crisis. China, incidentally, supported the United States: it feared cementing Japanese leadership of a pan-Asian financial institution more than it disliked the IMF's crisis management. Today, emerging economies like China, Russia, India, Saudi Arabia, Korea, and even Brazil not only do not need the IMF; they increasingly are in a position to compete with it. Saudi Arabia

already backstops Lebanon. Venezuela helped Argentina repay the IMF. Chinese development financing provides an alternative to World Bank lending. Asia is exploring the creation of a reserve pool that could serve as a precursor to a regional monetary fund. If a small emerging economy got into trouble now, it undoubtedly would seek regional financing on more generous terms than those offered by the IMF. The likely result: the United States will have less influence, and non-democratic countries will have a much larger voice in global economic governance.

During the Cold War, the two sides had to accept constraints on their actions in order to maintain the stability of the balance of nuclear terror. So far, maintaining the stability of what former Treasury secretary Lawrence Summers memorably called the balance of financial terror has constrained the creditors far more obviously than the debtors.[51] China has had to direct a large share of its savings abroad and accept a negative real return on its external assets. The Gulf countries have kept a far higher share of their rising portfolios in dollars than warranted by their trade with the United States even as the dollar's global purchasing power has declined. The United States has had to keep its markets open to the world's goods and accept a rise in its external debt. It has not, however, had to adjust its foreign policy to match the preferences of its creditors.

This could change. Holders of U.S. debt would not need to pressure the United States overtly: American policymakers could simply refrain from adopting positions likely to antagonize important creditors.[52] The high cost of a catastrophic failure of the existing system means that scenarios that hinge on subtle forms of pressure are more credible than scenarios that hinge on overt threats. A rise in Sino-American tension over Taiwan might be associated with a rise in Treasury rates. Small Chinese sales—or cessation of new purchases—could prompt a major adjustment, as markets anticipate larger sales in the future. A serious confrontation in the UN might prompt similar worries. U.S. policymakers would—like British policymakers in the 1950s—worry that other governments were trying to move the market against the United States. Jonathan Kirshner has warned that the United States

could "find itself uncharacteristically under financial stress during crucial moments of international political confrontation." The costs associated with a policy course that a major U.S. creditor opposed would rise—particularly if friendly countries responded by taking steps to protect their own portfolio against downside risks rather than coming to the United States' aid.

Recommendations

The economic weight of China, India, Russia, Brazil, the Gulf states, and other emerging economies is likely to rise in the twenty-first century. Even if China's growth slows from its current pace, China is likely to replace the United States as the world's largest economy within the next twenty-five years—or, from China's point of view, China is poised to regain its historic position of preeminence after a temporary absence. The small economic size of China and India relative to the United States and Europe for much of the twentieth century is likely to have been an aberration.

This shift on its own would imply large changes in the global economy and in the institutions of global economic governance. Right now, though, the rise in the relative economic importance of these new actors is accompanied by two other major changes: emerging economies have become large net creditors and governments have displaced private financial institutions as the crucial drivers of financial globalization. The increase in the foreign assets of the emerging world's governments in 2008 could top $1.5 trillion, accounting for the entire net flow of funds from the emerging world to the United States and Europe. Three countries—China, Russia, and Saudi Arabia—will likely account for over $1 trillion of the increase. This government-driven capital flow reflects policy choices, not the natural evolution of the global economy. China's large population suggests that China should be among the world's largest economies; it does not suggest that China's government should be the largest source of credit to the United States.

The United States' heavy reliance on ongoing financing from a limited number of governments—several of whom do not share U.S.

democratic values—is a strategic vulnerability. This does not mean foreign creditors are certain or even likely to use their financial assets as a weapon. It does mean that they could do so if they want. Just as the Pentagon prepares against threats that are not certain to materialize, the United States should act to insulate itself from the possibility that a foreign government may opt to reduce its purchases of dollar assets, whether in reaction to a U.S. policy decision or as a byproduct of political change. The magnitude of U.S. reliance on financing from foreign governments is such that a cessation of this flow could administer a shock to the U.S. economy akin to the recent subprime credit crisis.

To reduce this vulnerability, the United States should aim to bring the U.S. external deficit down to a level that can be financed more readily by private demand. But in the absence of a crisis, the United States' need for external financing won't disappear all that quickly—and the United States will need to navigate through a period where its financial stability will depend on the willingness of foreign governments to add additional U.S. stocks and bonds to their already large portfolios. During the subprime crisis, financial firms learned that it is better to secure access to liquidity before it is really needed. The U.S. government should take note. The United States' foreign exchange reserves have not kept pace with the growth in the U.S. economy, let alone the growth in the U.S. external debt. They should be increased. The United States has managed to limit its own reserve holdings in part because the Fed has swap lines with foreign central banks that allow the United States to borrow foreign exchange by posting dollars as collateral. The United States should review these lines to see if they could also be drawn upon in the event that a political crisis morphs into a financial crisis.

As part of its review of the United States' financial defenses, the next U.S. administration should also initiate a dialogue with important U.S. allies to review potential joint responses to a sudden shift in the financial portfolio of a major U.S. creditor. Any attempt by one major U.S. creditor to engineer a dollar crisis would give a host of other countries leverage: other countries could either add to the pressure on the United States by trying to reduce their dollar holdings, or step in

and provide the United States with support. In the absence of a previously negotiated commitment, other central banks might opt to sell—not out of a desire to put pressure on the United States, but rather out of a desire to protect the value of their reserves. U.S. allies have an incentive to respond favorably to U.S. diplomacy on this issue. Large dollar sales are not just a threat to the United States. They are a threat to all holding dollar-denominated assets—and to European countries that have an interest in avoiding unwelcome upward pressure on the euro.

If large emerging economies made greater use of multilateral institutions—the IMF and World Bank as well as the Bank for International Settlements—to invest their excess reserves, the risk that a creditor might initiate a sudden and disruptive portfolio adjustment would fall. There are, of course, limits on the volume of reserves emerging markets are willing to hand over to multilateral institutions. But they might hand over some—in part to avoid the political difficulties associated with investing in risky assets themselves—and in the process give the international financial institutions a new mission. Right now the IMF's formula for calculating a member's voting weight includes the country's total reserves. That rewards, in some very small way, excessive reserve accumulation. To increase the incentives for multilateral management, the formulas used to assess IMF and World Bank voting weights could be adjusted to only count those reserves managed multilaterally.[53] These changes should be viewed as a complement—not as a substitute—for ongoing efforts to give emerging market economies a greater voice in the governance of the existing multilateral institutions. Even if China's reserves are not counted, its economic size warrants a bigger vote.

In the long run, though, the United States needs to reduce its vulnerability, not just manage it. The United States' current reliance on other governments for financing reflects the United States' own policy choices—notably its fiscal deficit, ongoing subsidies for household borrowing, and limited energy taxes. But it also reflects the policy choices of other countries. That complicates the challenge. The United States cannot prevent emerging economies from intervening in the

foreign exchange market to keep their currencies from appreciating, or from adopting policies that restrict their domestic demand growth in order to avoid overheating in the face of an undervalued exchange rate. It cannot decide whether or not an oil-exporting economy limits domestic spending and investment in order to build up its already considerable foreign assets. Yet all these policies shape the size of the emerging world's surplus, the pace of growth in the emerging world's foreign exchange reserves, the availability (and price) of dollar credit to the U.S. economy, and ultimately the size of the U.S. deficit.

The United States cannot force other countries to change their policies, but it should try to catalyze policy changes in its creditors that would facilitate a global adjustment. For example, rather than encouraging oil-exporting countries to build up assets in sovereign wealth funds, the United States should encourage the oil-exporting economies to use surplus oil revenues to pay a variable "oil dividend" to all its citizens. The United States should also encourage a new multilateral push for greater exchange rate adjustment in the world's large creditor countries. The IMF recently noted that there has not been a significant broad-based appreciation of the currencies of those countries with the largest current account surpluses. This is a major change from the 1980s. Undervalued exchange rates do not simply contribute to large current account surpluses. They also reduce the incentive for private investors in the country with an undervalued exchange rate to hold foreign claims, concentrating the management of the emerging world's surplus savings in state hands. The United States should indicate—with European support, if possible—that ongoing intervention in the foreign exchange market by countries with large current account surpluses violates their commitments under the IMF's Articles of Agreement. The credibility of a U.S. call for the IMF to initiate special consultations with China over its exchange rate regime would be enhanced if it also supported exchange rate adjustment in the Gulf states.

To date, the purchase of U.S. equities by sovereign wealth funds has been small relative to purchases of U.S. bonds by central banks. It is possible—though not certain—that this could change: The sale of U.S. equities to emerging market sovereign wealth funds, or the purchase of

U.S. companies by state-owned firms with access to cheap financing from their governments, could become the dominant means of financing the U.S. external deficit. Existing U.S. policies are designed to prevent foreign investors—including sovereign investors—from buying assets that would jeopardize U.S. national security. These policies do not address the full range of issues raised by the development of sovereign wealth funds and growing external investment of state firms. The absence of transparency from sovereign funds—several of which do not disclose their size, let alone the broad contours of their portfolios—could make it harder to evaluate how sovereign investors are influencing global markets. The United States and most European countries (Norway is the obvious exception) do not have sovereign funds of their own and consequently have difficulty leading by their own example—though state pension funds in the United States and Europe typically do disclose both their external fund managers and, with a lag, their main holdings.[54] The United States should encourage sovereign investors—aggressive central banks as well as sovereign funds—to meet a similar standard. If agreement on such a standard proves elusive, the United States could consider requiring the disclosure of sovereign holdings in a U.S. company that exceed 1 percent of the company's market capitalization. This would help outside observers to assess how—if at all—sovereign investors are influencing the companies in which they have invested, as well as allow more accurate analysis of how the investment choices of sovereign funds and central banks are influencing a host of markets. Such a shift would no doubt cause discomfort for some existing sovereign funds. However, global norms should evolve along with the size of sovereign investors—and their growing potential to influence (and distort) markets.

The steps the United States can take on its own to reduce its need for external financing are well known. The U.S. fiscal deficit is rising with the U.S. slowdown. However, it is still not all that large relative to the fiscal deficits of many other countries. But that is the wrong metric. It is large relative to the United States' very low level of private savings. Restoring balance to the federal budget does not imply abandoning countercyclical fiscal policy, only reducing the average fiscal deficit

over the economic cycle. Recent estimates[55] suggest that cutting the fiscal deficit by a dollar increases national savings by between twenty and forty cents. Steps to encourage more private savings—for example, making enrollment in 401(k) plans the default for workers who do not opt out—are important, but their impact is likely to be more modest.

The United States could also do more to reduce its demand for energy, including imported energy. The United States' petroleum deficit now significantly exceeds its non-petroleum deficit. Policies—such as taxes on energy consumption—that reduce U.S. energy demand would tend to take pressure off global markets. Policies that increase U.S. supply could have a similar impact on prices once the new supply comes online, though they would not yield the same environmental benefits. If the United States succeeded in bringing down the world market price for energy, the savings surplus of the emerging world would likely fall along with the U.S. deficit: oil-exporting economies would be likely to scale back the growth of their central bank reserves and sovereign funds rather than scale back their own spending. That would contribute to global adjustment on both sides of the ledger: surpluses abroad would fall alongside the U.S. deficit.

Conclusion

While the United States' existing external debts will not go away, policies could be put in place to slow their growth. A more financially balanced world—one where the United States runs smaller deficits and large emerging economies run smaller surpluses—is possible. The U.S. need for external financing reduces its resilience to a host of shocks, political as well as economic. The recent subprime crisis was triggered by a fall in private demand for risky housing debt, not a fall in central bank demand for dollars. It nonetheless highlights the risk associated with ignoring latent vulnerabilities. The United States has run a current account deficit for some time. But never in the past has the growth in the foreign assets of other governments been so central to the financing of such a large deficit. Reducing the United States' current reliance on foreign governments to finance its deficit should be an important priority for the next president.

About the Author

Brad W. Setser is a fellow for geoeconomics at the Council on Foreign Relations (CFR). He most recently was a senior economist for RGE Monitor, an online financial and economic information company. In 2003, he was an international affairs fellow at the Council, where he wrote, with Nouriel Roubini, *Bailouts or Bail-Ins: Responding to Financial Crises in Emerging Markets* (Peterson Institute), a book examining International Monetary Fund policy toward crises in emerging market economies.

Dr. Setser has also been a research associate at the Global Economic Governance Programme at University College, Oxford, and a visiting scholar at the IMF. He served in the U.S. Treasury from 1997 to 2001, where he worked extensively on the reform of the international financial architecture, sovereign debt restructurings, and U.S. policy toward the IMF. He ended his time at the Treasury as the acting director of the Office of International Monetary and Financial Policy.

Dr. Setser is a CFR term member. He earned a BA from Harvard University, a DEA from Institut d'Etudes Politiques de Paris, and MPhil and DPhil degrees from Oxford University.

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Endnotes

[1] Niall Ferguson, *The Cash Nexus: Money and Power in the Modern World, 1700–2000* (New York: Basic Books, 2001)

[2] W. Scott Lucas. *Divided We Stand: Britain, the U.S. and the Suez Crisis* (London: Hodder & Stoughton, 1991), p. 293.

[3] James M. Boughton, "Was Suez in 1956 the First Financial Crisis of the Twenty-First Century?" *Finance & Development*, September 2001.

[4] Australia runs a larger current account deficit than the United States—but its trade deficit is smaller. Much of Australia's deficit reflects interest payments on its external debt. Spain runs a large deficit—but now that it is part of the euro zone it makes more sense to look at the euro zone's aggregate balance.

[5] Chinese central bank financing of the United States has increased quite rapidly over the past few years. China probably provided the United States with roughly $150 billion in financing in 2004, a bit more in 2005, $250 billion in 2006 (China added $230 billion to its reserves in 2006, but private actors—overwhelmingly the state banks—bought an additional $110 billion in debt), and between $350 billion and $400 billion in 2007.

[6] Eswar Prasad, Raghuram Rajan, and Arvind Subramanian, "Foreign Capital and Economic Growth," Research Department, IMF, August 11, 2006.

[7] "Imbalancing Act," Economist.com, March 27, 2008, available at http://www.economist.com/blogs/freeexchange/2008/03/imbalancing_act.cfm. Chinese reserve growth has actually accelerated since this calculation was done.

[8] The native born population of Qatar and one of the Emirates—Abu Dhabi—now have a per capita GDP well in excess of the United States or Europe.

[9] Kristin J. Forbes, "Why Do Foreigners Invest in the United States?," National Bureau of Economic Research (NBER) Working Paper no. 13908, April 2008. Forbes notes that "from 2002 to 2006, average annual return for the U.S. equity market index was the lowest in the sample of 52 countries, and in the U.S. bond market was lower than 43 out of 47 bond markets around the world."

[10] Gross private demand for U.S. long-term financial assets (long-term debt securities, portfolio equity, and foreign direct investment) has been stagnant since 2000; the fall in net private inflows reflects a rise in U.S. demand for foreign long-term assets in the absence of any increase in (private) demand for long-term U.S. assets. Total gross private capital flows have increased as a result of a rise in short-term flows, a rise that—particularly in 2006 and 2007—likely reflected the rapid expansion of the offshore "shadow banking system." However, gross inflows have fallen sharply since the August 2007 U.S. subprime crisis.

[11] That total includes the capital gains from the rise in the dollar value of the emerging world's euros, pounds, and yen. Stripping out those gains, however, does not bring the total down much—

particularly if the buildup of foreign assets by China's banks and the reserve growth of Japan and Asia's newly industrialized economies are added to the total. The author estimates that total official asset growth approached $1400 billion in 2007 net of valuation gains. See http://blogs.cfr.org/setser/2007/06/27/reserve-diversification-what-does-the-imf-data-tell-us/.

[12] The mid-2006 survey of foreign portfolio investment revised Chinese purchases of long-term debt between mid-2005 and mid-2006 up by $90 billion, and total official purchases by $130 billion. The mid-2007 survey revised Chinese debt purchases up by about $70 billion, and official purchases of debt up by $100 billion. Counting equities, Chinese purchases were revised up by close to $90 billion and total official purchases by around $130 billion (after adjusting roughly for valuation gains). Even the survey data understates official purchases—as it, among other things, does not capture the large sums the large Gulf funds have handed over to private fund managers. The U.S. data consequently understates both the Persian Gulf's annual purchases of U.S. assets and the Gulf's total holdings. The U.S. Treasury recognizes these limitations; see the 2007 Survey of Portfolio Investment in the United States available at http://www.treas.gov/tic/shl2007r.pdf.

[13] Francis E. Warnock and Veronica Cacdac Warnock, "International Capital Flows and U.S. Interest Rates," International Finance Discussion Papers no. 840, Board of Governors of the Federal Reserve System, September 2005. The authors found that central bank demand for U.S. Treasury bonds lowered their yields by over one hundred basis points during the peak of Japanese intervention in late 2003 and 2004 and by a somewhat lower amount in 2005—a number consistent with the estimates of L. Frey and G. Moëc in "US long-term yields and forex interventions by foreign central banks," Banque de France Bulletin Digest, no. 137, May 2005, pp. 19–32. Other studies using a different approach have found a smaller impact. See Glenn D. Rudebusch, Eric T. Swanson, and Tao Wu, "The Bond Yield 'Conundrum' from a Macro-Finance Perspective," Federal Reserve Bank of San Francisco Working Paper, May 2006. The authors argued that the persistence of the conundrum (low bond yields) even after central bank purchases fell in 2005 is evidence that central banks have a modest impact on the market. However, many of these studies have used the Treasury International Capital (TIC) data to estimate official flows—a potential problem as the gap between the TIC data and official purchases in the revised data is growing over time. Central bank purchases were as high in 2006 as in 2004 in the quarterly balance of payments data, but not in the unrevised TIC data series.

[14] IMF lending increased by almost $30 billion between the end of quarter 3 2007 and the end of quarter 3 1998. IMF lending rose by $40 billion over a two-year period between 2001 and 2003, but this rise spaced out evenly, producing two four-quarter rises of around $20 billion.

[15] Sovereign investors also may have participated in recent public issues of convertibles/other recapitalization vehicles. The Swiss bank UBS also raised $9.54 billion from Singapore's GIC to offset its subprime-related losses, and received another $1.8 billion from an unnamed investor in the Middle East. Barclays recently raised close to $9 billion from a rights issue that included heavy participation by both Qatar's Investment Authority and the "private" investment fund of Qatar's prime minister. See http://uk.biz.yahoo.com/25062008/325/barclays-gets-4-5-billion-pound-boost.html.

[16] If Greenspan is right, how China allocates its reserves between the dollar and the euro matters less than total Chinese purchases of dollars and euros. While a rise in the U.S. deficit offset most of the rise in the emerging world's surplus from 2002 to 2005, in 2006 and 2007 a rise in the EU's deficit provided the main counterpart to the still-growing emerging world surplus.

[17] Robert O. Keohane and Joseph S. Nye. *Power and Interdependence: World Politics in Transition* (Boston: Little, Brown and Company, 1977).

[18] Thomas P.M. Barnett pushes the liberal argument further, arguing that the United States, Europe, China, and India form an "integrating core" of the global economy that shares a common interest in cooperating to stabilize a set of unstable countries in a geographic arc from Africa through the Middle East to Central Asia that have failed to benefit from globalization. Thomas P.M. Barnett. *The Pentagon's New Map: War and Peace in the Twenty-First Century* (New York: Putnam, 2005). The "core" countries thus constitute natural allies.

[19] Helen Thompson, "Debt and Power: The United States' Debt in Historical Perspective," *International Relations*, vol. 21, no. 3, September 2007, pp. 305–323. Thompson herself goes on to criticize the liberal argument.

[20] Helen Thomas, "China to go Scandi in bid to appease U.S. angst," *Financial Times* Alphaville blog, April 7, 2008, available at http://ftalphaville.ft.com/blog/2008/04/07/12110/china-to-go-scandi-in-bid-to-appease-us-angst/.

[21] Creditors' dependence on a debtor for repayment, of course, often gives a debtor a measure of power. But creditors also have tools to protect themselves against the risk of nonpayment. They can, for example, shorten the maturity of their loans so the debtor depends on the creditor's willingness to roll over its maturing debts without changing its terms. Indeed, the steps creditors take to assure payment—and their desire to see the debtor adopt policies that protect creditor interests—are one common source of tension.

[22] Gideon Rachman, "Do not panic over foreign wealth," *Financial Times*, April 28, 2008, available at http://www.ft.com/cms/s/0/df23012a-1538-11dd-996c-0000779fd2ac.html.

[23] Martin Wolf, "The Brave New World of State Capitalism," *Financial Times*, October 16, 2007.

[24] David H. Levey and Stuart S. Brown, "The Overstretch Myth," *Foreign Affairs*, March/April 2005.

[25] Jeffrey Frankel, "Geopolitical Implications if the U.S. $ Loses Its Role as Top International Currency," February 29, 2008, available at http://content.ksg.harvard.edu/blog/jeff_frankels_weblog/2008/02/29/geopolitical-implications-if-the-us-loses-its-role-as-premier-international-currency/.

[26] Niall Ferguson, *The Cash Nexus: Money and Power in the Modern World, 1700–2000* (New York: Basic Books, 2001)

[27] "On closer inspection, we are indeed living through a global shift in the balance of power very similar to that which occurred in the 1870s. … The empire that suffered these setbacks in the 1870s was the Ottoman Empire. Today it is the U.S." Niall Ferguson, "An Ottoman Warning for America," *Financial Times*, January 7, 2008.

[28] Robert O. Keophane and Joseph Nye, *Power and Independence: World Politics in Transition* (Boston: Little Brown, 1977).

[29] Albert O. Hirschman, *National Power and the Structure of Foreign Trade* (Berkeley: University of California Press, 1980).

[30] The U.S. share of the global pool of foreign exchange reserves is now quite small. U.S. holdings of foreign exchange—$45.8 billion at the end of 2007—constituted less than 1 percent of all foreign exchange reserves. Adding in the United States' $13.8 billion of SDR and its $165 billion of gold (end 2006 value) only helps a little. The United States share of global reserves is well below its share (25 percent in 2007, at market exchange rates) of the world economy.

[31] Menzie D. Chinn and Jacob A. Frankel, "The Euro May Over the Next 15 Years Surpass the Dollar as Leading International Currency," NBER Working Paper no. 13909, National Bureau of Economic Research, April 2008. Between 1998 and 2007, central banks that report data to the IMF have increased their euro holdings from €185 billion to €735 billion. Adding a reasonable estimate of the euro holdings of those emerging economies that do not report data to the IMF would bring total euro holdings up from €250 billion at the of 1998 to around €1150 billion at the end of 2007.

Over this time, though, central bank dollar holdings have increased by even more—rising from roughly 1 trillion euros in 1998 ($1.15 trillion) to around 3 trillion euros ($4.5 trillion) at the end of 2007.

[32] Jonathan Kirshner, "Currency and Coercion in the Twenty-First Century," *International Monetary Power*, David M. Andrews, ed. (Ithaca: Cornell University Press, 2006).

[33] Michael P. Dooley, David Folkerts-Landau, and Peter M. Garber, "The Revived Bretton Woods System: The Effects of Periphery Intervention and Reserve Management on Interest Rates & Exchange Rates in Center Countries," NBER Working Paper no. W10332, March 2004.

[34] Export subsidies are classically considered to benefit the consumer at the expense of the producer. China's financial losses are the United States' financial gain—the source, in some sense, of the United States' current "exorbitant" privilege. However, these gains have not been equally distributed. Workers, notably in manufacturing, who have to compete with Chinese labor have faced strong pressure on their wages and benefits. Workers released from the manufacturing sector likely produced downward pressure on wages in other sectors—mitigating the gains from low-priced Chinese imports. By contrast, the U.S. Treasury benefited from lower borrowing costs, as did American firms with the market power to capture the price savings from sourcing production in China. The biggest winners, though, were all those holding assets—whether homeowners or private-equity shops—whose value role as interest rates fell. Niall Ferguson and Moritz Schularick, "'Chimerica' and the Global Asset Market Boom," *International Finance,* vol. 10, no. 3, winter 2007, pp. 215–239.

[35] Helen Thompson, "Debt and Power: The United States' Debt in Historical Perspective," *International Relations*, vol. 21, no. 3, September 2007, pp. 305–323.

[36] Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (John Wiley & Sons, 2005) and Robert Gilpin, *Global Political Economy: Understanding the International Economic Order* (Princeton: Princeton University Press, 2001).

[37] Europe's dependence on U.S. financing during the postwar period of a "dollar shortage" was not without its tensions, even with the goodwill generated by the Marshall Plan. U.S. postwar financial support to France was conditional on the elimination of French quotas that restricted the number of screens available to show American movies—setting the stage for a dispute that endures to the present day.

[38] Robert O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton: Princeton University Press, 1984).

[39] The dollar's dominant role stems from the choice of the emerging economies rather than from the formal institutional commitment that marked the initial Bretton Woods system. Harold James, "The U.S. Dollar: A Political Instrument or A Measure of Value," Princeton University and University of Florence, available at http://www.sps.cam.ac.uk/pol_sawyer/documents/papers/james_debt-empire.pdf.

[40] Emerging market economies—at least those that report data to the IMF—have increased the share of their new reserves held in dollar-denominated financial assets in order to keep the dollar's share of their overall reserves roughly constant. This combined with faster reserve growth to produce a significant increase in their dollar holdings. Some non-reporting emerging economies, notably China, may have reduced the share of their new flow going into dollars—but the evidence is ambiguous. Even if China diversified at the margins, the acceleration in its overall reserve growth was so strong that it still added dollars to their portfolio at a faster pace than ever before. See http://blogs.cfr.org/setser/2007/06/27/reserve-diversification-what-does-the-imf-data-tell-us/ for analysis of the IMF's latest COFER data.

[41] PBoC data indicates that the foreign portfolio holdings of Chinese banks fell from $196 billion at the end of June 2007 to $160 billion at the end of December—a major reversal from the $57 billion

increase in portfolio holdings in 2006. In quarter 4 2007, central banks added $74 billion to their short-term U.S. holdings. The enormous rise in central banks' custodial holdings at the New York Federal Reserve bank in 2008 suggests that the "flight away from risk" among official creditors has continued.

[42] Diane B. Kuntz, *The Economic Diplomacy of the Suez Canal* (Chapel Hill: The University of North Carolina Press, 1991).

[43] Lucas believes Britain mortgaged another $130 million in reserves through the forward sale of dollars and U.S. treasuries for sterling in November, so the total fall in Britain's reserves during the crisis was more like $580 million.

[44] W. Scott Lucas, *Divided We Stand: Britain, the United States, and the Suez Crisis* (London: Hodder & Stoughton, 1991), p. 293.

[45] Niall Ferguson, "How Much Did the Marshall Plan Really Matter?" *New Yorker,* August 27, 2007.

[46] The precise amount depends on the difference between China's domestic cost of borrowing and the interest income on its dollar assets, the timing of China's dollar and euro purchases, and the timing of the cumulative move in the dollar/RMB, the euro/RMB, and other currency pairs.

[47] The losses on China's U.S. holdings would account for around $600 billion to $700 billion of the total. At the end of 2007, the U.S. data—which tend to undercount China's holdings—show that China holds $990 billion of U.S. debt and $30 billion of U.S. portfolio equity. Looking forward, China's dollar holding are likely to continue to account for a majority of its total holdings, in part because of the constraints associated with China's exchange rate regime.

[48] Louis Kuijis, "How will China's Saving-Investment Balance Evolve?" World Bank Policy Research Working Paper no. 3958, July 1, 2006. Jahangir Aziz and Li Cui, "Explaining China's Low Consumption: The Neglected Role of Household Income," IMF Working Paper 07/181.

[49] *Asian Development Outlook 2008* (Manila: Asian Development Bank, 2008) reviews the difficulties of using foreign assets to support domestic infrastructure investment; in practice, using a foreign asset to finance domestic investment requires borrowing funds domestically to buy the foreign asset and therefore resembles running a larger fiscal deficit and not accumulating foreign assets in the first place.

[50] Benn Steil, "A rising euro threatens American dominance," *Financial Times*, April 22, 2008, available at http://www.ft.com/cms/s/0/afb28736-1082-11dd-b8d6-0000779fd2ac.html.

[51] Lawrence H. Summers, "The U.S. Current Account Deficit and the Global Economy," speech delivered at the Per Jacobson Foundation, October 4, 2004, available at http://www.perjacobsson.org/2004/100304.pdf and Lawrence H. Summers, "The United States and the Global Adjustment Process," speech delivered at the Peterson Institute for International Economics, March 23, 2004, available at http://www.petersoninstitute.org/publications/papers/paper.cfm?ResearchID=200.

[52] Flynt Leverett, "Black is the New Green," *National Interest,* January/February 2008.

[53] Michael D. Bordo and Harold James, "A Long Term Perspective on the Euro," NBER Working Paper no. 13815, National Bureau of Economic Research, February 2008.

[54] Edwin M. Truman, "A Blue Print for Sovereign Wealth Funds Best Practices," Peterson Institute, Policy Brief 08-3.

[55] Menzie Chinn, "Twin Deficits Redux," Econbrowser blog, October 4, 2006, available at http://www.econbrowser.com/archives/2006/10/twin_deficits_r.html, and Menzie D. Chinn, *Getting Serious About the Twin Deficits* (New York: Council on Foreign Relations Press, 2005).

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