THE EMERGENCE OF OIL PRODUCERS AS NET INTERNATIONAL CREDITORS: POSSIBLE IMPLICATIONS FOR THE GLOBAL FINANCIAL SYSTEM

Paper presented to the International Conference of Commercial Bank Economists

Milan, Italy

22nd June 2006

by

Saul Eslake

Chief Economist
Australia & New Zealand Banking Group Ltd

The US current account deficit and East Asian surpluses

For most of the past 15 years, as the US current account deficit has widened from less than US$100bn (1% of US GDP) in the early 1990s to over $800bn (nearly 6½% of GDP) in 2006, it has been paralleled by rising current account surpluses in Asia (from a little over $110bn in the early 1990s, to $405bn in 2005) and by the 'global current account discrepancy' which, after declining from $130bn in 1991 to $9.4bn in 1997, widened again to over $175bn in 2000 and 2001 before shrinking to an average of $73bn per annum since[1].

And although many observers from among the policy-making, academic and financial markets fraternities have from time to time expressed concern about the sustainability of these imbalances[2], they have in fact proved to be remarkably sustainable. When, as for much of 2003 and 2004, expected returns on US financial assets were perceived to be too low to compensate private investors for the risks associated with financing the US current account deficit, Asian central banks – in part out of a concern to prevent an appreciation of their own currencies against the US dollar and, according to Ben Bernanke and others[3], in order to accumulate higher levels of foreign exchange reserves as a form of 'insurance' against the occurrence of another financial crisis similar to that of 1997-98 – effectively stepped in as 'financier of last resort'.

Asian central banks' foreign reserves rose by $465bn in 2003 and by $535bn in 2004 (of which China accounted for $117bn and $207bn, respectively, and Japan for $201bn and $171bn). During these two years Asian central banks ran what could be termed 'the greatest vendor financing scheme the world has ever known', lending to American consumers – via the US budget, which was in deficit largely because the Bush Administration had cut taxes on American households without commensurately reducing its own spending – the money that American consumers needed to keep borrowing so that they could keep buying the products which Asian countries need to keep selling to American households so that Asian countries can in turn continue to enjoy rapid rates of export-led growth.

Since the Federal Reserve began 'normalizing' monetary policy in August 2004, with the result that from early 2005 onwards US interest rates have been higher than those in most other financial centres, most Asian central banks (other than the People's Bank of China) have withdrawn from this role: Asian central banks' foreign reserves increased by 'only' $254bn in 2005 (of which China accounted for $209bn), and thus far in 2006 have risen by only $91bn (of which China has accounted for $56bn).

---

[1] The current account surpluses and deficits of all the participants in the global economy should, in principle, sum to zero. A number of analysts have contended that, aside from differences due to timing and valuation discrepancies, the global current account discrepancy is partly attributable to the underestimation of US net investment income. See, for example, Tamim Bayoumi, 'The Global Current Account Discrepancy and other Statistical Problems' in International Monetary Fund, *World Economic Outlook*, October 2002 (Washington, DC), pp. 70-71; and William R. Cline, *The United States as a Debtor Nation*, Institute for International Economics (Washington DC), September 2005, p. 119.

[2] See, for example, Catherine Mann, 'Perspectives on the US current account deficit and sustainability', *Journal of Economic Perspectives* Volume 16, No. 3 (2002), pp. 131-152; OECD, *Economic Outlook* No. 79 (Paris: May 2006), p. 2; or Malcolm Knight (General Manager, Bank for International Settlements), *Notes for a presentation at the Brussels Economic Forum* (Brussels, 18 May 2006), p. 9.

[3] Ben Bernanke, 'The Global Savings Glut and the US Current Account Deficit', Homer Jones Lecture (14 April 2005); Ian Macfarlane, 'What are the Global Imbalances', Address to the Economic Society of Australia (Melbourne, 28 September 2005), reprinted in Reserve Bank of Australia *Statistical Bulletin* (Sydney, October 2005), pp. 19-27.

The sustainability thus far of large US current account deficits and East Asian surpluses highlights the fact that both the United States and the countries of East Asia have a strong (albeit rarely explicitly stated) mutual interest in their being sustained. As long as they are sustained, governments on both sides of the Pacific have no need to face discomfiting possibilities with potentially unpleasant policy implications – that Americans do not save 'enough' (themselves or through their government); and that Asian save 'too much' (or are denied the possibility of consuming as much as they might if not constrained by a variety of regulations restricting their access to consumer finance or mandating high levels of personal saving[4]).

The impact of high oil prices on the pattern of surpluses and deficits

The sustained rise in oil prices since the beginning of 2002 is significantly altering the distribution of current account surpluses and deficits around the world. Between 2002 and 2005 the value of oil exports has risen by $437bn to nearly $800bn, resulting in a substantial redistribution of income from oil importers to oil exporters.

Reflecting the United States' status as the world's largest oil importer, the US current account deficit has continued to widen, reaching an annual rate of $900bn (7% of GDP) in the fourth quarter of 2005. The IMF attributes about one half of the deterioration in the US current account deficit over the past two years to the direct impact of higher oil prices[5].

However, East Asia is also a substantial oil importer; in fact in 2004 East Asia (including Japan) imported almost 18mn barrels of oil a day, compared with the United States' nearly 13mn barrels a day[6]. Higher oil prices have capped the rise in East Asia's total surplus, which the IMF forecasts to decline from $405bn in 2005 to $388bn this year and $399bn in 2007 (notwithstanding a continuing increase in China's surplus from $159bn last year to $173bn in 2006 and to $190bn in 2007).

Oil exporters have thus far spent a somewhat smaller share of the additional revenues attributable to higher oil prices than during the oil shocks of the 1970s[7]. The combined current account surpluses of 23 oil-exporting economies[8] have risen from $87bn in 2002 to $422bn (equivalent to 9.7% of their combined GDP) in 2005, and are forecast by the IMF to reach around $520bn this year and next. Excluding the three OECD countries in this sample (Canada, Mexico and Norway), the combined surpluses have widened from $62bn in 2002 (5.2% of GDP) to $353bn (16.2% of GDP) in 2005, and are expected to reach $428bn in 2006 and 2007 (see Table 1 on page 3).

As Deutsche Bank's Chief Economist Norbert Walter has observed, this amounts to a 'substantial shift in the balance of power in the global economy' and one which 'has not received the attention it deserves'[9].

---

4 See, for example, Martin Wolf, 'The paradox of thrift: excess savings are storing up trouble for the world economy', *Financial Times* (13 June 2005).
5 IMF, *World Economic Outlook* (Washington DC), April 2006, p. 73.
6 BP, *Statistical Review of World Energy* (London), June 2005.
7 For a formal analysis see the IMF's *World Economic Outlook*, April 2006, pp. 79-81.
8 Algeria, Angola, Azerbaijan, Canada, Ecuador, Egypt, Equatorial Guinea, Gabon, Iran, Kazakhstan, Kuwait, Libya, Mexico, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, Trinidad and Tobago, the United Arab Emirates, Venezuela and Yemen.
9 Dr Norbert Walter, 'Talking Point' *Welt am Sonntag* (10 March 2006).

Table 1: Current account surpluses and deficits, 2002-2007

	Current account balances (US$bn)					
	2002	*2003*	*2004*	*2005*	*2006 (f)*	*2007 (f)*
United States	-475	-520	-668	-805	-864	-899
European Union	11	12	27	-54	-91	-77
East & South Asia -						
Japan	88	113	136	172	164	140
China	35	46	69	159	173	190
Other	92	120	115	82	75	76
Total	240	303	356	405	388	399
Oil exporters -						
Russia	29	35	59	87	106	99
Saudi Arabia	12	28	52	87	98	89
Norway	24	29	35	50	56	63
Kuwait	4	9	17	32	44	45
United Arab Emirates	4	8	12	29	41	43
Canada	13	13	22	25	39	38
Qatar	3	6	11	17	23	25
Venezuela	8	11	14	25	22	22
Algeria	4	9	11	22	22	21
Libya	1	5	7	16	19	22
Iran	4	1	4	15	18	18
Nigeria	-5	-2	3	12	16	20
Others	-14	-8	-4	5	16	18
Total	87	144	243	422	520	523
Total excl. OECD countries	62	111	194	353	429	428
Global current account discrepancy	-153	-69	-64	-88	-116	-143

Source: IMF, *World Economic Outlook* (April 2006) database.

As a generalization (to which Canada and Mexico, in particular, are obvious exceptions), these oil-exporting nations have a far less direct stake in the continuing health of the US economy than the East Asian nations out of whose surpluses the US current account deficit has been largely financed over the past decade.

The United States accounts for only 8½% of oil-exporting nations' total exports, a proportion which has declined by 5¾ percentage points since the second oil shock, while the oil-exporting nations source only 8¼% of their imports from the US, a decline of 11½ percentage points since the second oil shock. And, as discussed in more detail later in this paper, the political relationships between the United States and many of the more significant oil exporters are much more fraught than those between the US and its major East Asian trading partners.

It is thus quite possible that, should the private sector become again unwilling to finance the bulk of the US current account deficit, oil exporting nations will be far less willing to play the role of 'financier of last resort' to the United States in the way that East Asian nations did in 2003 and 2004.

And this could in turn provide a hitherto unanticipated source of instability in the global financial system.

What have oil exporters been doing with their surpluses so far?

In the mid-1970s, oil producers re-cycled the surpluses resulting from the first oil shock (of 1973) predominantly into bank deposits and money-market instruments, including the (at that time) relatively immature Euro-currency markets.[10] A good deal of these funds were on-lent by international banks to eager borrowers in the developing world, ultimately sowing the seeds of the 'third world debt crisis' of the early 1980s, when those borrowers were skewered by a combination of another sharp rise in oil prices (the second oil shock) and higher interest rates (reflecting the 'Volcker' shock of 1979).

By contrast, oil producers appear to have been accumulating most of their recent increases in oil revenues in portfolio investments assets, rather than in bank deposits. Although there is almost no information regarding the currency composition of these assets[11], the relative stability of the US dollar over the past three years suggests that the bulk of these assets have been held in US dollars and that oil exporting nations have, thus far at least, also contributed to the orderly financing of the US current account deficit.

Most non-OECD oil-exporting nations maintain fixed exchange rate regimes, with their currencies pegged to the US dollar. In the face of rising surpluses, in order to maintain their pegged exchange rates, the monetary authorities of these countries appear to have purchased increasing amounts of US dollars (in much the same way as the People's Bank of China has done in the face of similarly increasing current account surpluses and capital inflows), which are in turn reflected in an increase in the level of their foreign exchange reserves.

These foreign exchange market interventions require the creation of an equivalent amount of domestic currency which, if not subsequently 'sterilized' through the sale of government or central bank paper, expands the liquidity base of the domestic financial system. A significant monetary expansion, fuelled at least in part by foreign exchange market activities, appears to have been a significant contributor to the spectacular gains in Middle Eastern equity and real estate markets between 2003 and 2005 (ahead of significant correction in the early months of this year): at the end of 2005 the capitalization of the stock markets of the Gulf Co-operation Council (GCC) countries, Egypt, Jordan and Lebanon, exceeded that of the stock markets of Latin America[12].

The combined foreign exchange reserves of those (non-OECD) countries for which data are available[13] rose by $45bn in 2003, by $88bn in 2004 and by approximately $100bn in 2005 – a total of $273bn (see Table 2). This represents around 43% of the current account surpluses accumulated by these countries over this period. However, it is unlikely that the current account surpluses of oil-exporting nations would be fully reflected in movements in their foreign exchange reserves.

---

[10] For more details see IMF, *World Economic Outlook,* April 2006, pp. 85-87.

[11] The widely followed 'Treasury International Capital System' or 'TIC' data published monthly by the US Treasury are not particularly helpful in this regard as the transactions through which much of the US financial assets acquired by oil-producing nations are conducted are often routed through London or Caribbean financial centres (a practice which appears to have intensified since the introduction of the Orwellian-sounding 'Patriot Act' in the US, with its onerous reporting requirements and powers of asset sequestration). See Martin Feldstein, 'Why Uncle Sam's bonanza might not be all that it seems', *Financial Times,* 10 January 2006.

[12] IMF, *World Economic Outlook* April 2006, p. 53.

[13] Iran is the most important exception; data for the United Arab Emirates are published with a significant lag.

Table 2: Oil exporting nations – surpluses and international reserves

	Foreign exchange reserves (US$bn) as at end of -					*Cumulative increase in reserves Dec 2002-Dec 2005 ($ bn)*	*Cumulative current account surplus 2003-05 ($bn)*
	Dec 2002	*Dec 2003*	*Dec 2004*	*Dec 2005*	*Apr 2006*		
Russia	44	73	121	176	218	132	180
Saudi Arabia	17	18	23	24	22	7	167
Norway	31	36	43	46	48	15	113
Canada	33	32	30	31	34	-2	60
Kuwait	8	7	7	8	11	0	59
Venezuela	8	16	18	23	23	15	51
UAE	15	15	18	23[(a)]	na	8	50
Algeria	1	1	1	1	1	1	42
Qatar	1	3	3	4	5	3	34
Libya	13	18	24	38	38	25	28
Nigeria	7	7	16	28	33	21	14
Trinidad	2	3	3	5	5	3	5
Gabon	..	..	..	..	1	1	3
Oman	3	3	3	4	4	1	3
Kazakhstan	3	4	8	6	11	3	1
Mexico	50	58	63	73	77	23	-22
Total	236	292	385	492	554	256	791
Excl. OECD countries	122	167	249	342	395	273	639

(a) November 2005

Sources: International Monetary Fund, *International Financial Statistics* and *World Economic Outlook* (April 2006) database; Economics@ANZ calculations.

Some oil-exporting nations, such as Norway, Kuwait, Qatar and the United Arab Emirates, have long-established agencies which invest part of their oil revenues offshore, in effect partially 'quarantining' their domestic economies and financial systems from the monetary impact of the recent surge in oil revenues. With assets estimated at between $200bn and 'north of $500bn', the Abu Dhabi Investment Authority 'may be the world's biggest investment fund'[14].

Norway's State Petroleum Fund was established in 1990; at the beginning of this year it was combined with the National Insurance Scheme Fund to create the Government Pension Fund. The Global component of this Fund amounted to Nkr 1,390bn (US$220bn) at the end of 2005, and is expected to reach NKr 1,700 bn ($283bn or 84% of GDP) by the end of this year[15].

More recently, Mexico, Ecuador, Russia, Algeria, Libya, Nigeria and Trinidad and Tobago have also recently established 'stabilization funds' to absorb a proportion of their elevated oil revenues[16]. Russia's Stabilization Fund held assets of about $72bn as of June this year.

---

[14] 'Sitting pretty', *The Economist*, 10 June 2006 p. 49.

[15] 'Revised National Budget 2006', Norges Finansdepartementet Press Release No. 38/2006, 12 May 2006 (http://www.dep.no/fin/english/bn.html).

[16] 'Oil exporters learn to favour investment', *Financial Times*, 4 October 2005; 'Managing the Heritage and Stabilization Fund', Trinidad *Business Guardian* 17 March 2005.

Some countries have also used part of their windfall oil revenues to repay foreign debt ahead of schedule. The IMF estimates that around 10% of oil exporters' 2005 oil and gas revenues were allocated to debt prepayments[17]. Since these debts are likely to have been overwhelmingly denominated in US dollars, their prepayment is likely to have generated net demand for US dollars.

Estimates by the Economist Intelligence Unit suggest that the net foreign debt of a group of 14 non-OECD oil exporters has declined from a most recent peak of $313bn in 1998 to $33bn by the end of 2005; and that by the end of 2010 these countries could be net creditors to the tune of $324bn (see Table 3).

Table 3: Net debt of selected oil-exporting nations

	Net foreign debt (US$bn)						
	1999	*2002*	*2003*	*2004*	*2005*	*2006 (f)*	*2010 (f)*
Russia	162	100	98	87	34	-33	-154
Saudi Arabia	25	9	8	7	14	13	18
Venezuela	24	23	28	20	4	-39	-60
Nigeria	24	23	28	20	4	-39	-60
Algeria	23	-1	-10	-22	-40	-62	-113
Qatar	10	14	14	15	17	18	23
United Arab Emirates	8	5	9	12	11	10	na
Kuwait	5	4	6	5	7	9	na
Iran	4	-13	-13	16	-27	-38	-26
Oman	4	2	..	1	..	-2	na
Gabon	4	3	3	3	3	3	na
Kazakhstan	4	14	18	23	35	34	26
Trinidad & Tobago	2	1	..	..	-2	-4	na
Libya	-2	-10	-16	-22	-35	-42	na
Total	296	172	161	128	33	-128	-324

Source: Economist Intelligence Unit, via Thomson Financial Datastream, downloaded on 12 June 2006. Total for 2010 assumes 2010 values for those countries for which estimates are not provided are unchanged from those given for 2006.

By far the most dramatic turnaround in net financial position has been that of Russia.

Russia defaulted on its foreign debt in 1998, at a time when its net foreign debt exceeded US$166bn (and its foreign reserves were less than $10bn). By the end of last year, its net foreign debt had fallen to just $34bn (inclusive of foreign exchange reserves of $176bn, which had increased further to $218bn by the end of April this year. The EIU projections imply that Russia will become a net international creditor before the end of this year; and that its net international assets will have risen to over US$150bn by the end of 2010.

On these projections Algeria, Venezuela, Nigeria and Iran are also poised to become significant net international creditors by the end of this decade.

[17] IMF, *World Economic Outlook* April 2006 p. 76.

The prospect of many of this group of countries becoming net international creditors – in some cases by significant amounts – should serve to heighten attention on the question of what these nations might do with their enhanced financial power.

What will oil exporters do with their surplus funds in the future?

The foregoing discussion implies that as oil prices have risen over the past few years, oil-exporting nations appear to have used the bulk of their surpluses to increase their holdings of US$-denominated assets or to reduce their US$-denominated liabilities. Either way, they have contributed to the smooth financing of the growing US current account deficit. Given that, for most of this period, interest rates on US$-denominated financial instruments have been higher than on instruments denominated in most other currencies, this has been a perfectly rational decision.

However, the gap between interest rates on US$-denominated financial instruments and those denominated in other currencies is likely to start to narrow after some point during the next few years, as interest rates reach a peak in the United States (and possibly begin to decline some time in 2007 or later) but continue (or in the case of Japan, begin) to rise in other financial centres.

In those circumstances, is it reasonable or sensible to assume that oil-producing nations (or, for that matter, East Asian nations, many of whom will also still be running large current account surpluses) will continue to choose to hold the bulk of their foreign assets in US dollars?

As noted earlier, many of these countries have a much smaller direct interest in the continued health of the US economy than East Asian economies. And this question becomes even more pertinent given the deteriorating political relationship between the United States and many of their number.

Russia's relationship with the US has become increasingly wary as a result of Russian concern about US support for 'democratic revolutions' in countries that were formerly part of the Soviet Union, such as Ukraine and Georgia, and US concern about the increasingly authoritarian stance of President Vladimir Putin's administration. President Putin's second term expires in March 2008 and, as he is constitutionally barred from seeking a third term, his most likely successor at this stage appears to be one of the current Deputy Prime Ministers, Sergei Ivanov (who, like Vladimir Putin, is a former KGB operative) or Dmitry Medvedev.

Russia has already begun to diversify its foreign exchange reserves away from US dollars. According to a statement by Bank of Russia Chairman Sergei Ignatyev, as of 8 June this year only 50% of its reserves were held in US dollars, with 40% in euros and the remainder in yen and sterling. Similarly, only 45% of Russia's $71.5bn Budget Stabilization Fund, presently in roubles, is to be converted into US dollars, with another 45% to be converted into euros and 10% into sterling[18].

Now that Russia's central bank reserves are the world's fourth largest (after China, Japan and Taiwan), this policy is potentially of some significance for the stability of the US dollar should private investors at some point become less willing to finance the US current account deficit.

At the other end of the spectrum of relationships with the United States are Venezuela and Iran, the world's fifth and third largest oil exporters.

[18] *The Moscow Times*, 9 June 2006, p. 6.

Both of these countries are quite hostile towards the United States (and, particularly in the case of Iran, vice versa).

Venezuela's President, Hugo Chávez, sees himself as the heir to Cuba's Fidel Castro, and the progenitor of an *anti-Yanqui* coalition of Latin American countries opposed to the 'Washington consensus' of liberal economic policies and to US proposals for a Free Trade Area of the Americas. Banco Central de Venezuela (BCV) is not your usual central bank. Its 'essence, vision, mission, and public and civic responsibility were explicitly redefined in the Bolivarian Constitution' to include 'supplying the resources needed for nourishing the basic processes for the self-sustaining and independent development of society' and 'supporting … the creation of a regional block which would give greater bargaining power to dependent countries'[19]. Last year it 'participated in the creation, support and endowment of spiritual goods and knowledge'; and it even 'commissioned its own hymn' to mark its 65th anniversary.

It has also 'assimilated itself to … the leading role adopted by the Venezuelan State for accomplishing the dream of the Liberator, Simón Bolívar, that of creating a great regional block with world presence and bargaining power that can fortify the [South American] continent's sovereignty and autonomy'[20]

Venezuela has not made any early repayments of its foreign debt. Rather, it has transferred 'a portion of foreign currency proceeds from oil … to the National Development Fund (Fonden) before it becomes part of international reserves'[21]. In 2005 these transfers amounted to US$6bn; this, according to BCV, 'is in accordance with a dialectic view of political economy which gives real content to the famous phrase "Sowing oil"'[22].

Venezuela is also using part of its oil revenues to finance a range of international projects – including discounted oil for Caribbean and Central American countries – and to make low-interest loans to other South American governments which support its political agenda, such as Argentina and Bolivia.

Iran was nominated by US President George W. Bush as one of the three members of the 'axis of evil' in his 2002 State of the Union Address[23]. Perhaps not surprisingly – from its point of view – Iran, witnessing the contrasting experiences of the other two countries nominated by President Bush as co-members of that 'axis' (Iraq and North Korea), appears to have drawn the conclusion that the best way of avoiding 'regime change' is to acquire both nuclear weapons and a leader who can convince the world that he might be crazy enough to use them. In President Mahmoud Ahmedinejad Iran has found the latter, and appears to be devoting considerable effort to obtaining the former.

Despite being the world's third largest oil exporter, Iran's current account surpluses are not especially large ($15bn in 2005, or about 7½% of GDP). This is partly because Iran appears to be spending a larger proportion of its windfall revenues than other oil exporters[24]; for example government spending rose by nearly 30% in the 2004-05 fiscal year. Some of this has been driven by increasingly costly subsidies of petroleum products, wheat, sugar and milk.

---

19 Gastón Parra Luzardo, *Year-End Address of the President of the Central Bank of Venezuela* (Caracas, December 2005), pp. 7-8.
20 Ibid., p. 10.
21 Ibid., p. 12.
22 Ibid., p. 11.
23 January 29, 2002: see http://www.whitehouse.gov/news/releases/2002/01/20020129-11.html.
24 IMF, *World Economic Outlook* April 2006, pp. 74 and 80.

Iran has an Oil Stabilization Fund, with assets (as at end-October 2005) of US$10.4bn. However, rather than absorbing windfall revenues for subsequent disbursement during periods when oil prices are low, the OSF has become 'increasingly pro-cyclical'[25], with lending to the private sector through state-owned banks amounting to 1.6% of GDP in 2004-05.

Given the on-going tensions between Iran and the United States, with the possibility that the latter will seek to impose economic and other sanctions on the former, it seems plausible that Iran will be wary of adding to its holdings of US$-denominated assets.

The external financial affairs of Saudi Arabia, the world's largest oil exporter, are particularly opaque. The Kingdom's current account surplus has ballooned with rising oil prices, widening from $12bn (6% of GDP) in 2002 to $87bn (28% of GDP) in 2005 and expected to reach nearly $100bn (the fourth largest such surplus in the world, after China, Japan and Russia) in 2006. However Saudi Arabia's official reserves have risen by just $7bn since the end of 2001.

Official reserves represent a fairly small proportion of the total foreign assets of the Kingdom's central bank, the Saudi Arabian Monetary Authority (SAMA), which stood at nearly US$110bn by mid-2005. Saudi Arabia does not have an oil stabilization fund or a state investment authority, although Saudi Aramco is also believed to hold a substantial volume of foreign financial assets.

Saudi Arabia has traditionally been a firm ally of the United States, and remains so (notwithstanding the participation of 19 Saudi nationals in the September 11, 2001 terrorist attacks on the United States), as do other oil-producing states in the Gulf such as the United Arab Emirates, Qatar and Kuwait.

The hysterical reaction in the United States to the proposed acquisition earlier this year of the management of six ports by the UAE-based Dubai Ports World as part of its takeover of P&O (a British company which had operated these ports for years) would thus have come as a considerable shock to many in these countries. As President Bush initially remarked, 'it would send a terrible signal to friends and allies not to let this transaction go through'[26]. Nonetheless, the powerful House of Representatives Appropriations Committee voted 62-2 to block the sale, and President Bush duly allowed this 'terrible signal' to be transmitted.

Coming on top of bi-partisan efforts in Congress to impose tariffs on China unless it stops 'manipulating' its exchange rate, and Congress's blocking last year of the proposed acquisition of Unocal by China's National Overseas Oil Corporation (CNOOC), this constitutes strong evidence of a disturbingly limited understanding on the part of a large proportion of members of the US Congress of the United States' growing dependence on foreign capital[27]. As *The Economist* pointed out in April, 'debtors cannot afford to treat their creditors so rudely'[28].

In such an environment it would be surprising if official and private investors from the Middle East were not to become less sanguine about the United States as a 'safe haven' for their burgeoning investments. To date, however, there is no hard evidence that they have begun to do so.

---

[25] Institute for International Finance, *Islamic Republic of Iran*, December 2005.
[26] 22nd February 2006.
[27] To say nothing of the enduring wisdom of Mark Twain's assertion: 'Suppose you were an idiot. And suppose you were a member of Congress. But I repeat myself' (Albert Bigelow Paine, *Mark Twain: A Biography* (New York: Harper & Brothers, 1912), chapter 138.
[28] 'Economics focus: Money to burn', *The Economist*, 22 April 2006, p. 74.

Conclusion: a potential source of increased instability in global markets

At the outset it was noted that the financing of the ever-increasing US current account deficit has proceeded with almost none of the widely predicted adverse consequences for the stability of the US dollar, the level of US interest rates or the continued expansion of the US economy.

However it was also noted that this was in no small part due to the fact that for most of this decade interest rates on US$-denominated financial instruments have been higher than those on instruments denominated in plausible alternative 'safe haven' currencies; that during the period when this was not the case (2002-2004), Asian central banks were willing to play the role of 'financier of last resort'; and that one of the reasons for this willingness was the strong self-interest which Asian countries have in the continuing strength of the US dollar and of the US economy.

This happy constellation of circumstances may however be changing in a way which offers less assurance that the US current account deficit will continue to be financed in an orderly way.

First, US interest rates may be approaching a peak, while interest rates in other leading financial centres have only recently (or have not yet) begun to return to more 'normal' levels, implying that the premium between interest rates in the US and other financial centres is likely to narrow over the medium term, reducing the attraction of the US as a destination for private sector investments.

Second, most Asian economies are now confronting either rising inflation, or (in China's case) uncomfortably strong growth in domestic credit, which may make them less willing to 'print money' in order to prevent an appreciation of their own currencies against the US dollar, should the dollar come under downward pressure for any reason.

And third, Asian economies no longer account for the majority of the surpluses which are the counterpart to the US current account deficit. The significant increase in oil prices over the past three years, and the prospect that oil prices are likely to remain at elevated levels for the foreseeable future, means that oil-producing nations will accrue surpluses that are (in total) larger than those of East Asia. Moreover, these nations may be less inclined to ascribe as much value to sustained economic growth in the United States as East Asian nations have done.

Indeed some of them may, perversely, welcome instability in the US dollar or weakness in the US economy in the context of their (in many cases) less-than-amiable political relationship with the United States.

After all, if Norway's Government Pension Fund is willing to make investment decisions on grounds other than prospective investment returns[29], it should hardly come as a surprise if the governments of other oil-producing nations take political or strategic considerations into account when allocating their new-found wealth.

---

[29] On 6th June this year, the Norwegian Ministry of Finance announced that the Government Pension Fund (the successor to the Oil Stabilization Fund) would no longer invest in two US companies, Wal-Mart and Freeport McMoRan, because of what it described as 'serious/systematic violations of human rights and labour rights' and 'serious environmental damage', respectively. See Norges Finansdepartementet Press Release no. 44/2006, at http://odin.dep.no/fin/english/bn.html.

Most disturbingly of all, there appears to be only a limited understanding on the part of a broad range of policy-makers in the United States as to the risks associated with these developments.

Of course, for as long as oil-producing nations run current account surpluses, they will of necessity be capital exporters; and while the US incurs current account deficits of the magnitude it has in recent years, and is expected to in the years immediately ahead, the bulk of those capital exports will inevitably end up in the US in some form or other – albeit perhaps intermediated through other countries. However that does not guarantee that the terms on which the US imports capital, directly or indirectly, from oil-producing nations will remain as favourable as those on which it has previously imported capital from East Asia.

For all these reasons, the emergence of oil-producing nations as some of the world's largest international creditors represents an under-appreciated potential source of instability in the global financial system.