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GLOBAL IMBALANCES AND US MILITARY EXPENSES

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Abstract:
Within the 2007/8 crisis literature, global imbalances counted as one reason for the crisis onset. The related academic debate fueled the political one over the US – China complex relationship, and vice-versa. The article argues that the global Current Account imbalances, independently of their contribution to the 2007/8 financial crisis burst, fed US military expenses as well. The main argument is that since: 1) public resources finance military expenses; 2) US run double deficits again after 2000's; 3) US were particularly hit from the 2007 crisis; 4) global imbalances were already established when the crisis occur; How US did manage to maintain the same level of defense expenses and even slightly increase them in 2009, if not thanks to the global imbalances themselves that injected liquidity in the US?

Contents:

INTRODUCTION.

By global imbalances, I refer mainly, to the other-than-US-countries' accumulation of dollar reserves and generally their Current-Account surplus, versus US deficit. Especially to China's, that is the today major holder of US-Treasury securities and became the second largest economy after USA, in 2010. (Prasad, E (2011), Harold, J. (2010).

The article focuses on the period after 2000 because prior, in the 1990's, domestic growth may justify increasing US military expenses, since it allowed to almost eliminate the US double deficits by the end of the decade. But, after the Asian crisis (1998) and the following recession 2000-2001, USA's double deficit rose again, significantly. However, US has not only been able to respond to the 11/9/2001 terrorist attack by military intervening in the Middle East after 2003, but to further increase military expenses as part of its GDP (up to 2009, at least), despite the economic losses due to the financial crisis.

Then, how US financed its increased military expenses and operations? The article answers: from abroad, via selling US-Treasury bonds that East-Asian countries were eager to accumulate as reserves. The bottom-reason is the role of the dollar as international reserve currency.

The purpose of this paper is to show the relation between global imbalances and US military expenses and that the former not only counted as one reason amid other for the recent financial crisis, abut also fueled defense expenses and thus, US military operations.

To this end, given the US fiscal and Current Account (CA) deficits, I examine the relation between US Treasury bonds as international reserves, and military expenses; because, the US-Treasury finances public expenses as health, education, research, administration costs and certainly, defense expenses. So, the military-expenses-growing while double deficits persist, means that a part from the public income- that include resources from selling Treasury bonds abroad- is channeled to the military expenses. This is even more reliable to say, since revenue from domestic taxes has fallen, either because of domestic politics or the crisis effects.

Therefore, I will look for the trends on currency (dollar) reserves, whose an important part consists of Treasury bonds, especially of the US; and how much of US Treasury bonds China holds, because China holds the largest part. Next, to certify that additional resources from abroad were necessary for US domestic/government purposes, I will examine the trends on public debt, deficit and current account balance for US and advanced economies, versus CA-surplus countries and especially China. The result shows, that the negative performance of the US public finances could not afford alone an increase in defense expenditure. Then to be sure, that the whole income from the Treasury-bond-sales was not diffused only in other domestic purposes, I will look to the trends of the military expenses.

The research found that US military expenses increased, as ratio to the GDP, constantly, even throughout the crisis, at least till 2009. Their part to the total governmental expenses declined slightly only in 2009, when recovery had already begun. So, US did not allocate all its public resources to the domestic relief of crisis. This is understandable, since US was involved in the Middle East operations prior to the crisis and after the 11/9/2001 terrorist attack. But, under this scope China's (and other surplus countries) purchases of US Treasury bonds financed –indirectly - US military operations.

The article owes to the interdependence theory, especially the complex one (Keohane, R. & Nye, J., 1989)

The article is organized as follows: The first section introduces the global imbalances as causes of the crisis and the main traits of the academic debate for the adjustment. Then, it shortly refers to the rise of the today global imbalances.

The second section provides a short historic point of view.

The third shows the interrelation among the phenomena and supports the argument.

The last concludes that among other expenses, the military are supported mainly by selling US-Treasury bonds and securities.

1. GLOBAL IMBALANCES AS ROOT CAUSES OF THE FINANCIAL CRISIS

Global (Current Account) imbalances have been famous not only for the asymmetries and the capital flows non-adjustment they cause to the today monetary system, but also as one of the root causes for the 2007-8 financial crisis.

Merrouche & Nier (2010 December, IMF) recently summarized much of the academic literature on the global-imbalances accusations for the crisis burst.[1] Needless to say, there is no consensus among researchers on the crisis-causes, especially the prime one. However, the convergence of three factors: global imbalances, Fed's monetary policy, inadequate regulation and supervision, seem to resume the debate. But, it is not just a technical debate.

The prior blame on global imbalances often came to accuse the surpluses countries, for causing instability and non-adjustment within the International Monetary System (IMS) due to their reserves-accumulation or to pegging their currency to the dollar through reserves-manipulation. For instance the US- China debate is a famous one to this case. In response, the Chinese side accuses US for devaluing the dollar assets and for not reliable behavior as leader of the IMS, etc. The debate fuelled the backstage of the G20 summits, as it was the case a few days before Toronto meeting (June 2010), when China allowed its currency to fluctuate.[2]

Therefore, to reduce global imbalances, by adjusting surpluses and deficits, is a major concern for the IMS and the international relations, that sometimes involve the role of international organizations. Williamson, J. (2011, January) summarized the main proposals. [3]

2. THE TODAY GLOBAL IMBALANCES

However, the trend of the today imbalances – at least up to the crisis - stems from 1996; Blanchard, O. & Milesi-Ferretti suggest the year 1996 as the one, where global imbalances marked a sustained increase - except the 2001-2002 recession.[4] Similarly, the crisis 2007/8 narrowed CA imbalances again.

Specifically, they point out three main periods leading up to the crisis: 1996-2000, 2001-2004 and 2005-2008. For the first period, the main surplus country as counterpart to the US deficit was Japan, instead China's surpluses are "large in absolute terms only during 2005-2008" (other surpluses countries were oil exporters and Germany) (ibid).

To our purpose, I will look at the US-Treasury-securities reserves. While the findings concern any surplus country that contain US Treasury securities in its international reserves, I will focus on China because it ranks first in international reserves (2010) and the robustness of its trade activities and GDP growth, excites the debate on US-China currency adjustment. Then, I will highlight another point of this debate by arguing on the military-expenses side.

China's reserves contained not only equities - as those of Fannie Mae and Freddie Mac [5] - but US Treasury's bonds, as well. Historically, since 2008, China became the major holder of US Treasury securities [6], while in 2007 this position belongs to Japan.

Accordingly to Prasad, E. (2011), China accumulated $448 billion foreign exchange reserves in 2010, amounting a stock of $ 2.85 trillion, while it diminished its trade-surplus from the year 2008.[7] Especially, China alone "held about $906 billion of treasury securities, as for October 2010", accordingly to the Treasury International Capital System (TIC).[8] Additionally, "China's share of outstanding U.S. government debt held by the public has risen steadily over the years and now (2010) stands at 10 percent, about one-fifth of all U.S. debt held by foreigners." (ibid, also in p.25, where the author exposes his findings since 2000).

While in November 2010, China's holdings in US-Treasury securities slightly declined from $906.8 billion in October, to $895.6 billion, Japan's slightly increased: from $875 billion in October, to $877.2 in November 2010. Japan ranks as second major holder after 2008, steadily. In the same TIC list, oil-exporter countries rank 4th in 2010, though they were third in 2009, and 4th both in 2008 and 2007. Instead UK, holds the 3rd rank in 2010, the 4th in 2009, the 5th in 2008.[9]

3. TRENDS & INTERRELATIONS: GLOBAL RESERVES, MILITARY EXPENSES, CURRENT ACCOUNT, PUBLIC FINANCES.

For the period 2005-2008 (the third for Blanchard & Milesi-Ferretti, 2009), China's reserves increased from $822.5 billion in 2005, to $1,950.3 billion in 2008, to continue their rise up to $2,348.8 billion in 2009 and $2,693.4 billion in 2010 (Table 1).[10] If we count gold and SDR reserves then total China's reserves amount to $ 831.45 in 2005 and $1,966.04 in 2008, while $2,452.9 billion in 2010 (Table 2).[11]

Japan also held $846.8 billion in 2005 that increased at 1,030.7 in 2008, and 1,048.9 in 2009. The oil-exporter Saudi Arabia held less, between $157.3 billion in 2005 and 451.6 in 2008 (Table 2).

On the other hand, the US CA deficit accounted (-)3.9% of the GDP in 2001, a year of recession and terrorist attack.[12] In 2002, it rose to (-)4.3% GDP and then kept increasing up to (-)6% GDP in 2006. Then, the crisis effect slowed it down gradually to (-)5.1% GDP in 2007, (-)2.7% GDP in 2009; but it raises again in (-)3.2% GDP in 2010.[13] So, during the period (2005-2008), the US CA deficit fluctuated between (-)5.9% and (-)4.7% of the GDP.

At the same time, US General-Government-Deficit arose from (-)2% GDP in 2006, to (-)6.7% in 2008.[14]

Consequently, US domestic savings were shrinking; additionally, US Foreign outward Direct Investment increased in 2005-2008, from $113 billion to $328 billion (Table 5).[15] However, military expenses did not decrease, as it can be seen in Tables 3 and 4. Indeed, the ratio of US military expenses over to the GDP was steady at 4% during 2005-2007, and even it arose to 4.3% in 2008. This was not the case for other countries: Russia reduced its ratio from 3.7% in 2005 to 3.5% in 2008. China, declined the same ratio from 2% in 2005 and 2006, to 1.9% in 2007 and 2008. As for the year 2009 that marks the first signs of recovery, most states rushed in allocating some additional resources to their 'hard' power (defense) expenditure. So, as third-countries currency- reserves and US double deficits arose, the US kept its ratio of military expenses to GDP at the same high level or slightly increased.

Besides, since 2008 the US allocated more public resources to the country's stimulus program that also comprised some tax-cuts. Indeed, in end 2007 the Bush-administration approved a $ 168 million stimulus plan including tax rebates for households and firms, that were applied in 2008.[16] In 2009, Obama-administration allocated new stimulus-measures of $787 billion, as follows: $ 299 billion to households (subventions, tax-cuts), $ 137 billion to firms and $351 billion to governments. Especially, that stimulus went towards \$244 billion in tax cuts, \$217 billion for State & local governments, \$120 billion in relief to individuals, \$101 billion in infrastructure, \$59.5 billion in energy efficiency spending and \$45.5 billion in human capital spending. [17]

So, where did the additional resources for the US military expenses come from, if not from the increasing part of the US-treasury securities in the reserves of the surpluses countries?

Moreover, defense expenses are part of the public expenses and figure in the general government budget, as the health-care, research-technology, education and other, usual public expenses do. Furthermore, empirical studies, found out that "fiscal balances . . .are more important drivers of Current Account (CA) imbalances than previously thought" (Gagnon, J., 2011, p.1,6), since usually, higher expenses than revenues entail higher deficits; and markets attribute them higher interest rate, because of the involved risk.

Besides, the macro-economic relation for the national product demonstrates the above interrelation: Y=C+I+G+(X-M), also Y=C+S+T; where Y=the national income or product; I=Investment; G=public expenses; X-M= total exports – total imports, i.e. the Current Account (CA) Balance that is part of the Balance of Payments (BP) and is properly accommodated to include capital transfers and Foreign Direct Investment; S=National Savings; T= taxes as public revenue.

Therefore, G-T= public deficit, M-X= CA or BP deficit. In equilibrium: C+I+G+(X-M) = C+S+T. Properly manipulating, the previous relation comes to: (G-T) =(S-I) + (M-X).

So, since defense expenses not only remained the same but also slightly increased, the only way to get them financed was by the Balance of Payments transfers and resources. As the military expenses belong to the public ones, the equivalent public resources come from selling Treasury bonds and securities.

CONCLUSION.

Many disagree on the crisis causes. Some scholars and policy makers, blame global imbalances as a root cause for the recent financial crisis. Their main argument relates to the China's accumulation of currency reserves that fueled US markets with liquidity, and the China's Current-Account-surplus. Therefore, the markets' 'invisible hand' could not prevent real-estate and the related assets prices from soaring. Others blame Fed's long-term interest-rates policy, or/and inadequate supervision, regulation, etc. But, though China accuses US monetary policy as unreliable (devaluing dollar by quantitative easing) fueling the debate, there is another function of the same Current Account and capital-flows imbalances:

Because of the US double deficits, especially after the 2001 recession, reserves-accumulation of US-Treasury bonds by third countries enabled USA to finance its military expenses and therefore to undertake military interventions (Iraq, Afghanistan).

The main argument is that, since the government budget finances military expenses, US increased military expenses in 2009 (while during the crisis they remained at the same level), despite USA run double deficits and were wounded by the crisis which surged domestically. On the other hand, global imbalances were already apparent since mid-1990's, fueling US with liquidity from abroad. The liquidity due to international currency-reserves comes for the most, from US-Treasury bonds purchases. On the other hand, US-Treasury finances public expenses, among them the military one. Therefore, resources from US Treasury bonds purchases abroad, financed US military expenses. Nevertheless, one may not claim that only the military expenses were supported by selling Us-Treasury bonds to foreigners; but that amid other uses, the military was one of them.

Endnotes:

1. One should also see, how other International Organization considered the causes of the crisis, like the UN Stiglitz Commision.
2. The People's Bank of China. (19/6/2010).
3. To mention also the work of Eichengreen, Stiglitz, and others.
4. O. Blanchard & Milesi-Ferretti, 2009, IMF, p.7, 19-20).
5. Roumeliotis, 2009, p. 420.
6. Treasury International Capital System (TIC). Historical data, retrieved 23/1/2011, http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfhhis01.txt
7. Prasad, E. & Gu, W. (2011, January 13), p. 2, 6.
8. ibid, p.7, 8.
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10. World Economic Outlook, October 2010, p. 202. http://www.imf.org/external/pubs/ft/weo/2010/02/
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17. Baily, Martin-Neil (July 1, 2010), p.10-11.

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Appendix:

1. CURRENCY RESERVES EMERGING AND DEVELOPING COUNTRIES IN US $ BILLION

	2002	2003	2004	2005	2006	2007	2008	2009	2010
TOTAL	1.032.50	1.363.1	1.814.30	2.309.20	3.078.60	4.374.70	4.957.00	5.518.30	6.194.40
Russia	44.6	73.8	121.5	176.5	296.2	467.6	412.7	417.8	468.7
China	292	409.2	615.5	822.5	1069.5	1.531.30	1.950.30	2.348.80	2.693.40
India	68.2	99.5	127.2	132.5	171.3	267.6	248	266.2	281.6
Brazil	37.5	48.9	52.5	53.3	85.2	179.5	192.9	237.4	274.9
Mexico	50.6	59	64.1	74.1	76.3	87.1	95.1	99.6	119.6

IMF. World Economic Outlook, October 2010,p. 202.
http://www.imf.org/external/pubs/ft/weo/2010/02/

2.RESERVES INCLUDING GOLD AND SDR, IN US$ BILLION

	2005	2006	2007	2008	2009
USA	188.25	221.08	277.54	294.04	404.09
Canada	33.01	35.06	41.08	43.87	54.35
Japan	846.89	895.321	973.29	1.030.76	1.048.99
France	74.35	98.23	115.48	103.3	131.78
UK	43.59	47.038	54.27	53.02	66.55
Germany	101.67	111.63	135.93	138.56	179.04
Italy	65.95	75.77	94310	105.64	131.49
Russia	182.27	303.77	478.82	426.27	439.34
Argentina	28.08	32.02	46.14	46.38	48
Brazil	53.79	85.84	180.33	193.78	238.53
Mexico	74.1	76.32	87.2	95.29	99.88
Turkey	52.49	63.26	76.49	73.67	74.93
South Africa	20.62	25.59	32.91	34.07	39.6
Saudi Arabia	157.38	228.95	309.4	451.62	420.98
India	137.82	178.05	276.57	257.42	284.68
Indonesia	34.73	42.59	56.93	51.64	66.11
China	831.41	1.080.76	1.546.36	1.966.04	2.452.90

Australia	43.25	55.07	26.9	32.92	41.74
Korea	210.55	239.14	262.53	201.54	270.43

World Bank. (2010). World Development Indicators 2010
http://data.worldbank.org/indicator/FI.RES.TOTL.CD/countries

3. MILITARY EXPENSES, as % of the GDP

	2005	2006	2007	2008	2009
USA	4	4	4	4.3	4.6
Canada	1.2	1.2	1.3	1.3	1.5
Japan	1	0.9	0.9	0.9	1
France	2.5	2.4	2.3	2.3	2.4
UK	2.4	2.4	2.4	2.5	2.7
Germany	1.4	1.3	1.3	1.3	1.4
Italy	1.9	1.8	1.7	1.7	1.7
Russia	3.7	3.6	3.4	3.5	4.3
Argentina	0.9	0.9	0.9	0.8	0.8
Brazil	1.5	1.5	1.5	1.4	1.7
Mexico	0.4	0.4	0.5	0.5	0.5
Turkey	2.5	2.5	2.2	2.2	2.8
South Africa	1.7	1.5	1.4	1.4	1.5
Saudi Arabia	8	8.3	9.2	8	11.2
India	2.8	2.5	2.4	2.7	3
Indonesia	1.2	1.2	1.2	1	0.9
China	2	2	1.9	1.9	2
Australia	2	2	1.9	1.9	2
Korea	2.6	2.6	2.6	2.8	2.9
World	2.5	2.4	2.4	2.4	2.7

World Bank. (2010). World Development Indicators 2010.
http://data.worldbank.org/indicator/MS.MIL.XPND.GD.ZS/countries

4. PER CENT OF MILITARY EXPENSES OVER GENERAL GOVERNMENT EXPENDITURE

	2005	**2006**	**2007**	**2008**	**2009**
USA	18.9	18.8	18.6	18.6	17.9
Canada	6.5	6.7	7.1	7.4	. . .
Japan	. . .	. . .	. . .	. . .	. . .
France	5.4	5.3	5.3	5.2	. . .
UK	5.9	5.9	6	5.9	. . .
Germany	4.4	4.3	4.4	4.5	
Italy	4.8	4.5	4.3	4.2	
Russia	. . .	18.4	15	16.3	. . .
Argentina	. . .	. . .	. . .	. . .	. . .
Brazila	. . .	6	6.2	5.9	. . .
Mexico	. . .	. . .	. . .	. . .	. . .

Turkey		11.5	8.9	9.7	. . .
South Africa	5.6	4.9	4.6	4.4	
Saudi Arabia	. . .	. . .	. . .	. . .	. . .
India	18.6	16.9	15.6	17.2	
Indonesia	. . .	. . .	. . .	. . .	. . .
China	18.3	17.9	. . .	. . .	. . .
Australia	7.6	8	7.9	8	. . .
Korea	13.3	12.9	13.1	14	. . .

World Bank. (2010). World Development Indicators 2010.
http://data.worldbank.org/indicator/MS.MIL.XPND.ZS/countries

5. FOREIGN DIRECT INVESTMENT, IN US $ CURRENT VALUE

	2005	2006	2007	2008	2009
USA	113	243	271	328	135
Canada	26	60	118	56	20
Japan	3	-7	22	25	12
France	85	72	98	65	60
UK	177	154	202	93	25
Germany	46	57	77	25	36
Italy	20	39	40	15	29
Russia	13	30	55	75	37
Argentina	5	6	6	10	4
Brazil	15	19	35	45	26
Mexico	22	20	27	23	11
Turkey	10	20	22	18	8
South Africa	7	-183	6	10	6
Saudi Arabia	12	18	24	39	10
India	8	20	25	41	35
Indonesia	8	5	7	9	5
China	79	78	138	148	78
Australia	-36	26	41	47	. . .
Korea	6	4	2	3	2

World Bank. (2010). World Development Indicators 2010,
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