Institut für Makroökonomie
und Konjunkturforschung
Macroeconomic Policy Institute

Working Paper

13/2011

Explaining Global Financial Imbalances: A Critique of the Saving Glut and Reserve Currency Hypotheses

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Revised November 1, 2011

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Abstract

This paper examines three different explanations of the global financial imbalances. It begins with the neoliberal globalization hypothesis that explains the imbalances as the product of the model of globalization implemented over the past thirty years. It then examines the saving glut and reserve currency hypotheses. The paper concludes by arguing that both the saving glut and reserve currency hypotheses are inconsistent with the empirical record and both provide a misleading guide for policy.

Key words: Global financial imbalances, globalization, saving glut, reserve currency.

JEL reference: F40, F41, F32, F23.

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Paper prepared for the 15th annual conference of the Research Network on Macroeconomics and Macroeconomic Policies, "From crisis to growth? The challenges of imbalances, debt, and limited resources", held in Berlin, Germany, October 28 – 29, 2011.

I Introduction

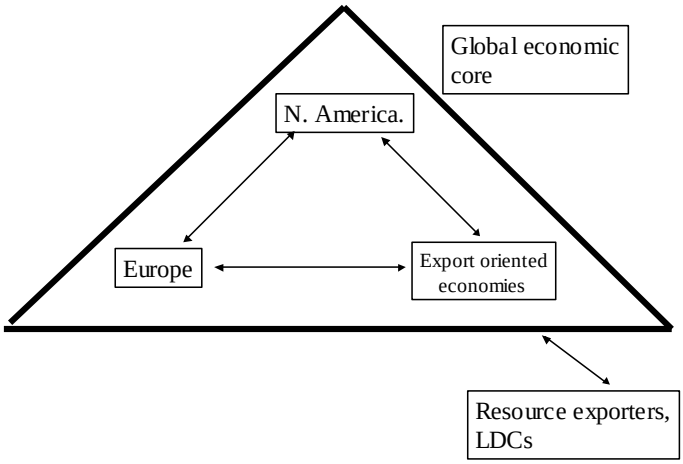
The global financial imbalances associated with the U.S. trade deficit are widely viewed as an important causal factor behind the financial crisis of 2008 and the Great Recession. This paper examines three different explanations of the global financial imbalances. It begins with the neoliberal globalization hypothesis that explains the imbalances as the product of the model of globalization implemented over the past thirty years. It then examines the saving glut and reserve currency hypotheses. The paper concludes by arguing that both the saving glut and reserve accumulation hypotheses are inconsistent with the empirical record and both provide a misleading guide for policy.

II What are global financial imbalances?

Global financial imbalances concern the US trade deficit, which equals the trade surplus of the rest of the world. Figure 1 provides a heuristic map of the global economy which consists of four parts. The global economic core consists of North America, Europe, and the export-oriented emerging economies. The bold line triangle binding the core together symbolizes global trade rules, the global financial architecture, and the global production and sourcing networks established under globalization. The resource based economies and less developed countries are placed outside of the core. This placement outside the core reflects the fact that the less developed economies are substantially disengaged from the core, while the resource based economies conform to traditional periphery status in terms center – periphery relations.[1]

[1] Japan, China and other East Asian economies can be considered as part of the export oriented economies. Brazil, Russia, Australia and Latin American economies are part of the resource-based bloc. India is a little difficult to peg. Despite its size and recent economic growth success it should probably be placed with the less developed countries because of its still relatively low level of global engagement.

Figure 1. An economic map of the world.



Broadly speaking, North America has run trade deficits with all regions. Europe has run a surplus with North America and a deficit with the export-oriented economies, while the export-oriented economies have run surpluses with both North America and Europe. In recent years, the resource exporting economies have run an aggregate trade surplus on the back of higher commodity prices. Lastly, within the North America region the US has run large trade deficits with its NAFTA trade partners, Canada and Mexico.

Table 1 provides a decomposition of the US goods trade deficit in 2007, the peak year of the last business cycle prior to the onset of the Great Recession. In 2007, the US ran large trade deficits with every major economic region. The Pacific Rim region (which includes China, Japan, South Korea and Taiwan) accounted for 46 percent of the US trade deficit, and China alone accounted for 32 percent of the US deficit.

Table 1. A decomposition of the US goods trade deficit in 2007 ($ billions).

	$ billions	Percent (%)
Total	-808.8	100
Pacific Rim	-372.3	46.0
China	-258.5	32.0
Canada & Mexico	-143.0	17.7
European Union	-110.2	13.6
OPEC	-117.2	14.5
Other	192.4	23.8

Source: Census Bureau.

III The neoliberal globalization hypothesis

What caused the global financial imbalances? The first hypothesis to be examined is the neoliberal globalization hypothesis (Palley, 2006a, 2009) which sees the imbalances as the product of the process of globalization which took off in the 1980s. Table 2 shows the U.S. trade balance by business cycle peak year for the period 1960 – 2007. From 1960 to 1980 US trade was roughly in balance, but after 1980 the US started running steadily increasing trade deficits that reached 5.7 percent of GDP in 2007. The critical feature of Table 1 is that it shows the US trade deficit has been a long-evolving issue.

Table 2. The U.S. goods trade deficit by business cycle peaks, 1960 – 2007.
Sources: Economic Report of the President, 2009 and author's calculations.

Peak year	Trade deficit ($ millions)	GDP ($ billions)	Trade deficit/ GDP (%)
1960	3,508	526.4	0.7
1969	91	984.6	0.0
1973	1,900	1,382.7	0.1
1980	-25,500	2,789.5	-0.9
1981	-28,023	3,128.4	-0.9
1990	-111,037	5,803.1	-1.9
2001	-429,519	10,128.0	-4.2
2007	-819,373	13,807.5	-5.9

With historical hindsight, the completion of the Tokyo GATT round in 1979 can now be seen to mark the end of the era of free trade and the beginning of the era of neoliberal globalization that has produced the global imbalances. Though policymakers and big business have both continued using the arguments of conventional neoclassical trade theory to justify the push for globalization, the reality is there has been significant structural change within the global economy compared with the era of free trade and these arguments camouflage another agenda.

With regard to policymakers, pre-1980 economic policy was framed by Keynesian logic and policymakers viewed trade deficits with concern as they represented a leakage of aggregate demand (AD). After 1980, policymakers increasingly turned a blind eye to trade deficits and even started viewing them as semi-virtuous because trade helped constrain inflation.

Policymakers' new attitude to trade deficits has been supported by the economics profession. Conventional neoclassical trade theory has continued to provide the justification for trade. However, because it is a theory of balanced trade the theory has had to be modified to explain the emergence of large persistent trade deficits. This was

done by introducing cross-country differences in inter-temporal consumption choices. That left unchanged the core theory regarding the benefits of trade based on comparative advantage, but trade deficits were now presented as a good thing, reflecting market choices that benefit economic agents. In the 1990s, trade deficits were also dismissed by appeal to "new economy" chatter that claimed the US could support its trade deficits because of the faster growth technology and globalization supposedly generated. In the 2000s, an additional justification of the trade deficit was provided by the New Bretton Woods hypothesis (Dooley et al., 2003, 2004) that argued developing countries needed to run trade deficits to accumulate US assets that were collateral for FDI. Another justification was also provided by the dark matter hypothesis (Hausmann and Sturzenegger, 2005) that argued US trade deficits were of no concern because of the higher rate of return the US earned on its foreign investments.

With regard to business, the narrative is more complicated and requires distinguishing between US domestic and multi-national manufacturers. Multi-national manufacturers have been the significant beneficiaries of corporate globalization, whereas domestic manufacturers have suffered from low cost foreign competition. That difference explains the split between organizations like the National Association of Manufacturers and the US Business and Industry Council. The former represents large multi-nationals and has been a vocal proponent of the policies associated with corporate globalization: the latter represents smaller domestic manufacturers and has opposed those policies.

In the early 1980s expanded trade openness was viewed as a means of disciplining industrial labor unions and reversing the profit squeeze of the late 1960s and 1970s. However, large business was still subject to commercial injury from imports and

misaligned exchange rates. That explains the Reagan administration's willingness to broker voluntary limits on Japanese car imports in 1981 and to push for a depreciation of the dollar via the Plaza accord of 1985.

Later in the decade with the beginning of the Uruguay GATT round (1986 – 1994), trade opening became part of the logic of creating a "global production zone" in which American firms could produce and export back to the US, or from which they could source cheaper inputs. Though sold to the US public in terms of creating a global market place in which US manufacturers could sell, the real goal was to create a global production zone from which American firms could self-supply and source.

The important feature is that after 1980, both US policymakers and US big business came to see trade as an instrument for disciplining wages, increasing profits, and controlling inflation. This drove a new agenda that explains why the era of neoliberal globalization has systematically produced unbalanced trade that culminated in the global financial imbalances problem. The Keynesian free trade era (1945 – 1980) produced roughly balanced trade because both policymakers and business were averse to trade deficits as they drained aggregate demand (AD). In the neoliberal era, policymakers have had no interest in constraining trade deficits, while big business has actively benefitted from imports.

The critical feature driving the new global production zone model has been increased international mobility of means of production (capital and technology) resulting from improvements in transportation, e-communication, and ability to manage globally diversified production networks. These improvements created the possibility of configuring global production around the principle of global cost arbitrage.

The new reality was captured in late 1990s Jack Welch, then CEO of General Electric, who talked of ideally having “every plant you own on a barge”. The economic logic was that factories should float between countries to take advantage of lowest costs, be they due to under-valued exchange rates, low taxes, subsidies, or a surfeit of cheap labor. Moreover, the ability to float factories on barges creates a race to the bottom competitive dynamic in which firms can persistently weaken the link between wages and productivity growth while also pushing for lower taxes, increased subsidies, and reduced regulation (Palley, 2007).

Trade remains central within the new model because goods must cross borders; hence, the need for trade agreements. However, the economic logic can be described as “barge economics”, which is fundamentally different from comparative advantage - though comparative advantage and the theory of free trade are still invoked to provide cover for the new order.

The global production zone model took off in the 1990s and it was implemented in three stages: the 1994 North America Free Trade Agreement (NAFTA), the “strong dollar” policy put in place after East Asia financial crisis of 1997, and granting China permanent normal trading relations (PNTR) in 2000. These three stages were encompassed by the broader process of the Uruguay GATT round that led to the establishment of the World Trade Organization (WTO) in 1996.

NAFTA represents a decisive historical break in that it fused the US, Canada, and Mexico into a unified production zone. Its importance is that it joined developed and developing economies for the first time, establishing the template corporations wanted. In doing so it changed the significance of exchange rates in two ways. First, exchange rates

had previously mattered for trade, but now they mattered for the location of production and investment. Second, it changed the attitude of US corporations to exchange rates. Previously manufacturing corporations had supported a weaker dollar to fend off imports. Now, they shifted in favor of a strong dollar because that lowered the price of imported products and increased their profit margins. This changed attitude to the exchange rate was supported by the emergence of "big box" retailers such as Wal-Mart, which sourced significantly from abroad and came to dominate the US retail trade in the 1980s.[2] Finally, NAFTA created a precedent for strong dollar policy because the US accepted the devaluation of the peso as part of the solution to Mexico's financial crisis of 1994

As shown in Table 3, after the introduction of NAFTA the US trade surplus with Mexico turned to deficit and continued increasing thereafter. Within the US economy, manufacturing plants were closed and production and investment were diverted to Mexico. The threat of shifting jobs to Mexico was also used to suppress wages and batter unions (Bronfenbrenner, 2000; Bronfenbrenner and Luce, 2004).

Table 3. US goods trade balance with Mexico before and after NAFTA ($ billions)
Source: Census Bureau.

1991	**1992**	**1993**	**1994**	**1995**	**1996**	**2000**	**2005**	**2007**
2.1	5.4	1.7	1.3	-15.8	-17.5	-24.5	-49.7	-74.6

[2] The role of retailing in pushing globalization has gone largely unnoticed by economists. Research by Gereffi (1994) and Hamilton (2005) highlights retailing's critical significance. See also Palley (2008) for a broader discussion of the role of retailing in shaping neoliberal globalization and outsourcing.

The second stage in implementation of the global production zone model came with the strong dollar policy adopted after the East Asia financial crisis of 1997. Following the precedent established by the 1994 peso crisis, US policymakers ensured large dollar loans were made to crisis countries and the US also accepted large exchange rate depreciations by the crisis countries. This policy was strongly supported by both US big box retailers and by multi-national corporations that were looking to offshore production. The result was the creation of a permanent incentive for US corporations to downsize domestic manufacturing and increase foreign manufacturing.

As shown in Table 4, paralleling NAFTA, there was an immediate massive and persistent increase in the US trade deficit with Pacific Rim countries. US manufacturing was put into recession in 1998, two years before the economy went into recession. The new arrangement also made the US consumer the global buyer of first and last resort. That meant the global economy became dependent on the US consumer, and it explains why global economy slowed so sharply when the US economy crashed in late 2008.

Table 4. US goods trade balance with Pacific rim countries ($ billions).
Source: Census Bureau.

1995	**1996**	**1997**	**1998**	**1999**	**2000**
-108.1	-101.8	-121.6	-160.4	-186.0	-215.4

The third and final stage in implementing the new model was passage of China PNTR in 2000. This gave China permanent access to US market with limited safeguards

and no defense against China's exchange rate policies. For US corporations, it cemented the structure of globalization they wanted and formally incorporated China into the global production zone. As shown in Table 5, once again the result was a surge in the US bilateral (China) trade deficit. Corporate profits increased, while US manufacturing employment and investment suffered. There were also negative effects on Mexico as production and investment were diverted to China because of its lower labor costs.

Table 5. US goods trade balance with China before and after PNTR ($ billions)
Source: Census Bureau.

1998	1999	2000	2001	2002	2003	2004	2005	2007
-56.9	-68.7	-83.9	-83.1	-103.1	-124.1	-161.9	-201.5	-256.2

Though initiated and driven by the US, the global production zone model rests on a global grand bargain. EM economies were initially forced into this bargain but have since come to embrace it. This pattern shows the inherently political character of neoliberal globalization. It also complicates understanding the position of EM economies as they were initially bullied into signing on, but have since become willing participants.

In the 1980s and early 1990s EM economies were compelled to abandon their prior import-substitution led development strategies and open their economies to trade and foreign investment. During this phase the IMF and World Bank were critical through their enforcement of "structural reform" policies. Thus, the Fund and the Bank used the financial leverage provided by the 1980s debt crisis to force neoliberal policy reforms,

especially in Latin America. These reforms included abandonment of state-led development policies that used strategic protection.

The IMF and World Bank policies were also bolstered by a new consensus in the economics profession about the benefits of trade-openness and export-led growth (Palley, 2011). This new consensus was justified by the economic success of the four East Asian tigers (South Korea, Hong Kong, Singapore, and Taiwan) which were held up as representative of what was possible.

By the mid-1990s global elites had established a new global policy consensus – the so-called "Washington Consensus" (Williamson, 1990) – and EM policymakers began to increasingly embrace US-sponsored neoliberal globalization.[3] EM policymakers therefore became more receptive to the new arrangements, which they saw as offering access to the US market and the promise of FDI. This receptivity is epitomized by Mexico's debate in 1993 over the ratification of NAFTA which was sold to the Mexican electorate as a pathway to development.

For EM economies, FDI and the relocation of production offered the prospect of transfers of technology, productive capacity, and managerial expertise. Trade surpluses also helped relieve financial constraints on growth. These benefits were amplified by the US's adoption of a strong dollar policy after 1997, which endorsed the exchange rate devaluations produced by the 1997 East Asian financial crisis. Those devaluations super-charged the FDI based export-led growth model that was already in place. In effect, EM economies stumbled upon a formula of export-led growth on steroids and they have stuck with it since. However, maintaining the formula has required recycling trade surpluses

[3] The term "Washington Consensus" was introduced by economist John Williamson to characterize a new consensus about economic reform that had developed over the course of the 1980s, significantly driven by the IMF and World Bank.

into dollar reserves to sustain the undervalued exchange rates needed to ensure export competitiveness and attractiveness as an FDI destination.

For China, the process of engagement with the new model has been slightly different, reflecting its different political structure. Thus, rather than being pushed into adopting the new model, China established a purposeful development strategy in which export-led growth and attracting FDI were pillar strategies (Palley, 2006b). Not only has this strategy been applied in manufacturing, it has also been applied in the retailing and financial sectors. Thus, retailing firms like Wal-Mart have been given access to the Chinese market in order to introduce state of the art retailing and distribution technology and methods. In banking, large US banks have been permitted to enter into partnerships with Chinese state owned banks to modernize the domestic banking sector. However, the process has been strictly managed and joint-ventures have been the preferred approach wherever possible as they bolster Chinese control.

From a development standpoint, the downside of the model for EM economies has been the need for suppression of wages and regulatory standards in order to maintain competitiveness vis-à-vis each other. Furthermore, since EM trade surpluses have been the reflection of US trade deficits, capital has flowed north. This is contrary to the predictions of conventional growth theory which argues resources should flow to developing economies where capital is scarce and rates of return higher. The logic is simple: neoliberal globalization creates a division of labor where consumers are in the north and producers are in the south (Palley, 2006a). Investment flows south through FDI by multi-nationals, but the fruits of that investment (i.e. production) flow north. Though the long run sustainability of such a system is doubtful, from the perspective of firms and

countries that has not been an issue. Firms have been able to earn profits, while countries have benefitted from the employment and financial benefits of FDI and export surpluses.

In sum, the neoliberal globalization hypothesis argues the US trade deficit, and associated global financial imbalances, is the product of neoliberal globalization that has shaped the international economic order since 1980. The new production structure, based on the global production zone model, inevitably produced unbalanced trade. It also created a political economy that justified trade imbalances and ensured no action would be taken to rein them in. For US policymakers, the new production structure constrained inflation and it also supported living standards via lower prices which offset the effect of stagnant wages. For US business, the new structure permanently pressured union labor and increased profits from foreign sourcing. EM economies were initially bullied into accepting the new model, but then came to embrace it because of the benefits of FDI and export-led growth.

IV The saving glut hypothesis

One country's trade deficit is by definition another country's trade surplus. This has prompted Federal Reserve Chairman Ben Bernanke (2005) to introduce the savings glut hypothesis which frames the global imbalance problem as the product of excessive saving by emerging market economies, rather than insufficient US saving.

The saving glut hypothesis persists with the conventional classical macroeconomic argument that trade deficits are a saving problem. However, rather than blaming the deficit country for too little saving, it blames the surplus country for too much saving.

> "I will argue that over the past decade a combination of diverse forces has created a significant increase in the global supply of saving – a saving glut –

> which helps explain both the increase in the U.S. current account deficit and the relatively low level of long-term real interest rates in the world today (Bernanke, 2005)."

In a nutshell, the argument is emerging market economies (particularly China) increased their exports and ran large trade surpluses (saving), and those surpluses in turn lowered US interest rates giving rise to the house price bubble.

The first problem with the saving glut hypothesis concerns its misunderstanding of the microeconomics of modern trade, which misrepresents the nature of Chinese exports and misleadingly labels them as "Chinese savings". Table 6 shows the vast bulk of Chinese exports are produced by foreign multi-nationals. Fifty percent of Chinese exports are produced by fully owned foreign subsidiaries, and a further twenty-six percent of exports are produced by joint-ventures involving foreign corporations. When viewed in this light it becomes clear that the issue is not Chinese saving but globalization. Both the U.S. trade deficit and China's trade surplus are the product of neoliberal globalization.

Table 6. Decomposition by firm ownership structure of Chinese exports and imports in 2005.
Source:Manova and Zhang, 2008

	All firms	**Foreign-owned**	**Joint ventures**	**Private domestic**	**State-owned**
Exports	100%	50.4	26.3	13.1	10.3

Viewed through the lens of international industrial organization, it becomes clear that the issue is not excessive Chinese saving but globalization. The real cause of China's

trade surplus with the US is US trade policy, MNC foreign direct investment in China, and China's undervalued exchange rate, cheap labor, and lax regulatory standards (including labor and environment). That combination has made foreign production facilities in China super-competitive internationally, and it is a fundamentally different story from excess saving.

A second failing of the saving glut hypothesis is that it is inconsistent with its own microeconomic foundations. According to conventional microeconomic theory people ratchet up their saving as they age and prepare for retirement. The US has an aging population, and according to standard microeconomic theory US households are ratcheting up their saving in preparation for retirement. Consequently, Chairman Bernanke's logic predicts the US should have produced a US trade surplus. Yet instead, the surpluses were run up in emerging market economies and China which have populations that are still youthful and where the incentive should have been to consume, invest, and run trade deficits. That is the exact opposite of what happened.

This leads to a third difficulty. Having failed to explain why the US ran deficits rather than the surpluses predicted by microeconomics, the saving glut hypothesis argues this outcome was because US interest rates were distorted. According to the saving glut story China dumped its excess savings in the US, thereby causing downward distortion of US interest rates that caused a consumption and house price bubble that ended up injuring the US economy.

Not only does this "bait and switch" (i.e. making interest rates the issue) confuse the issue, it also introduces multiple additional analytical problems. The first thing to notice is that though couched in the language of trade and export-led growth, the

hypothesis is essentially a "financial theory" and its focus is on interest rates and not on production off-shoring and factory closures.

The attempt to explain the US trade deficit as the product of distorted interest rates makes no sense. First, it is inconsistent with the fact that the trade deficit had been increasing for twenty years. Second, it is theoretically incoherent. That is because the saving glut hypothesis is simply an updated global statement of 1930s classical loanable funds interest rate theory that Keynes discredited in his *General Theory*.[4] Loanable funds theory claims interest rates are determined by demand and supply of real saving; trade surpluses are accounted for as real saving, and ergo they affect interest rates in an integrated global economy: hence, the claim that China's trade surplus significantly determines US interest rates and China injured the US by distorting US interest rates.

The problem is loanable funds theory relies on the fiction of a loanable funds market. According to its reasoning, China hands its exports over to US consumers in return for bonds. However, that does not happen. The true sequence of transactions involves an exchange of exports for money followed by an exchange of money for bonds.

How does China get dollars? It does so by getting US consumers to buy Chinese goods. This is why the under-valued exchange rate is so important because it makes Chinese goods cheap compared to US goods, thereby diverting spending to Chinese goods. Only after the trade surplus has been created by the under-valued exchange rate does China enter the bond market. That is a very different story from the saving glut hypothesis which makes Chinese saving decisions the ultimate cause of the US trade deficit.

[4] This point is also made by Bibow (2008).

Moreover, taking account of the sequence of transactions reveals the logical inconsistency of the saving glut hypothesis. According to its reasoning China used its surplus to lower interest rates, but lower interest rates are supposedly the cause of the surplus as they enticed US households to spend rather than save.

The saving glut hypothesis is an incoherent theory of the US trade deficit that relies on an incoherent theory of US interest rate determination. However, though China did not drive US interest rates in the manner claimed by the saving glut hypothesis, this does not mean China had no influence on US interest rates. It did, but for reasons that have nothing to do with the saving glut argument of China buying bonds. The main channel of influence was via the flood of Chinese exports which weakened US manufacturing and the domestic economy. That caused the Federal Reserve to lower interest rates to ward off a double-dip recession in 2001 - 4. This is the Keynesian channel (China caused US macroeconomic weakness) and it is completely different from Chairman Bernanke's saving glut story (China pumped up the bond market).

That said, China may have had some second-order effects on the structure of relative interest rates (but not the overall level). This is because China largely bought safer government bonds which increased demand for these safer assets and lowered their interest rate. However, it correspondingly shifted money away from riskier assets, raising their interest rate.

Lastly, now that China has accumulated over a trillion dollars of US bonds it can affect US interest rates by dumping those bonds. However, that again is completely unrelated to the saving glut hypothesis.

A fourth and final problem with the saving glut hypothesis is it has difficulty explaining why the US has been injured by China. Indeed, *prima facie*, rather than suffering from China's predatory exchange rate policies, the saving glut story says the US economy benefitted from it. That is because according to its microeconomic foundations, when foreign countries subsidize their exports, via under-valued exchange rates or other means, those countries are effectively giving a gift (a "free lunch") by selling below cost. For believers in the saving glut hypothesis savings are a boon so that China inflicted no damage on the real economy. If there was any damage it was self-inflicted via financial markets that misallocated Chinese saving. Thus, the policy implication of the saving glut hypothesis is full-speed ahead with globalization but modestly regulate financial markets. That policy recommendation further misdirects attention.

There is a reason for the popularity of the saving glut hypothesis. Conventional classical macroeconomic explanations of the trade deficit based on saving shortage arguments (i.e. excess consumption or twin deficit arguments) are implausible at a time of massive aggregate demand shortage. That creates a huge gap in conventional macroeconomics and the saving glut hypothesis fills the gap. It avoids criticizing the neoliberal project of corporate globalization; avoids identifying the role of US trade policy in creating the trade deficit; redirects attention to interest rates and financial market reform; and cleverly captures the language of Keynesian demand shortage when in reality it has nothing to with Keynesian arguments and policy recommendations. That makes the saving glut hypothesis brilliant political propaganda but it is incoherent economics.

V The reserve currency hypothesis

A third hypothesis is that the reserve currency role of the dollar caused the trade deficit. This argument begins with the observation that the dollar occupies a special place as the world's number one reserve currency. It then argues that the 1997 East Asian financial crisis highlighted the cost of being exposed to sudden capital flight and being short of dollar reserves. Countries therefore embarked on a process of reserve acquisition by running large trade surpluses fuelled by undervalued exchange rates. The goal was to accumulate large holdings of reserves to provide insurance against future capital flight, but the flip side of this dollar accumulation was large US trade deficits.

This hypothesis has been advanced by Bibow (2008) of the Levy Institute who writes:

> "The developing world has increasingly come to pursue policies that resulted in current account surpluses and thus net capital exports – destined primarily for the capital-rich United States. The hypothesis put forward here is that systematic deficiencies in the international monetary and financial order have been the root cause behind today's situation."

A similar argument has been made by IMF economists Lagos, Duttagupta, and Goyal (2009):

> "The global crisis resurrected deep-rooted concerns about the functioning of the international monetary system. Despite its relative stability, the current "non-system" has the inherent weakness of a set-up with a dominant country-issued reserve currency, wherein the reserve issuer runs fiscal and external deficits to meet growing world demand for reserve assets and where there is no ready mechanism forcing surplus or reserve-issuing countries to adjust. The problem has amplified in recent years in line with a sharp rise in the demand for reserves, reflecting in part emerging markets' tendency to self-insure against costly capital account crisis."

This line of reasoning ties back to the work of Robert Triffin (1961, 1968) who argued that the U.S. ran a trade deficit in the 1960s for the same reason – namely, to supply net dollar assets to the rest of the world. It also fits with the New Bretton Woods hypothesis

(Dooley et al., 2003, 2004) where the argument is the US ran trade deficits that enabled EM economies to earn hard currency financial collateral to provide security for FDI.

The dollar reserve shortage hypothesis has a grain of truth but it is also very misleading. The East Asian economies were victimized by capital flight in 1997, which likely increased the demand among their central banks for international reserves to protect against future capital flight. However, the hypothesis has several problems.

Problem number one is that the US trade deficit, which is at the root of global financial imbalances, had been evident for almost two decades prior to the East Asian financial crisis of 1997. The reserve currency hypothesis, which explains the imbalances in terms of the response to the 1997 crisis, therefore makes little sense as an explanation when seen in the context of that longer timeline.

Problem number two is that over the last decade East Asian economies have accumulated foreign reserves far in excess of what can be justified in terms of financial precaution. If self-insurance against capital flight via reserve accumulation were the real cause behind the imbalances, the imbalances should have been resolved once sufficient reserves had been accumulated.

Problem number three is that China, which has been the single largest contributor to the global imbalances, has also engaged in massive reserve accumulation even though it was unaffected by the financial crisis of 1997 because of its capital controls. China's experience clearly shows it is the growth strategy that is the cause of the imbalance problem rather than the desire for precautionary dollar reserves to insure against capital flight. Moreover, China has amplified the imbalance problem because its undervalued

exchange rate prompts other East Asian economies to undervalue their exchange rates so as to remain internationally competitive vis-à-vis China.

A better explanation for the policies of the East Asian economies is that the massive exchange rate depreciations produced by the 1997 crisis, which were explicitly endorsed as part of the Clinton administration's "strong dollar" policy, spurred East Asian export growth. The US's strong dollar policy response to the crisis and its willingness to accept East Asian exchange rate devaluation represented an extension of policy that had already been tried in Mexico in 1994. Moreover, the policy was adopted just as the US was beginning its ten year consumption spending boom fuelled by domestic debt and the house price bubble. These developments put the export-led growth model into hyper-drive and East Asian economies have therefore stuck with the model because it worked so well, and not because they have needed additional foreign reserves.

Viewed in this light, at most, the 1997 crisis may have given EM countries another reason to run trade surpluses and accumulate reserves. However, the architecture of neoliberal globalization US policy had already calibrated the global system so as to inevitably produce global imbalances.

This system automatically augments the dollar's special standing. However, that augmented standing is not monetary in the sense of the dollar being superior money. Instead, it is due to the fact that the US economy is the largest market and EM economies are unable to generate sufficient domestic demand to purchase what they can produce. The moment countries can organize sufficient domestic demand so that they have no need of the US market, the need for reserve accumulation and dollar's special status will diminish significantly (Palley, 2006c).

VI Conclusion: explanation matters

This paper has presented three competing explanations of the US trade deficit and the global financial imbalances problem. It argues that the only way to comprehensively understand and explain the problem is in terms of the economic and political dynamics unleashed by neoliberal globalization.

All three hypotheses emphasize reserve accumulation via trade surpluses, but only the structural Keynesian hypothesis gives a comprehensive account consistent with all stages of the problem and without logical inconsistencies. The process of globalization created a structure whereby the US inevitably ran increasingly large trade deficits driven by persistent corporate off-shoring of production, strong dollar policy, and policymaker disregard for trade deficits. EM economies increasingly bought into the US sponsored model of neoliberal globalization.

The East Asian currency devaluations and US strong dollar policy response were an extension of policy already in place and tried under NAFTA. The policy met all the needs of domestic political actors. The Federal Reserve liked it as it kept a lid on inflation at a time the economy was booming. US politicians liked it because it lowered prices of imports and helped offset the effects of wage stagnation. US multinationals and big box retailers liked it because they got the benefit of cheap East Asian sourcing. And the EM economies liked it because it super-charged the export-led growth model.

From a policy standpoint the saving glut hypothesis is dangerously misleading. It masquerades as Keynesianism but offers no Keynesian solutions. It also actively supports and deflects criticism of neoliberal corporate globalization, which is the root cause of the global imbalances.

From a policy standpoint the reserve currency hypothesis is also dangerously misleading. That is because it too misdirects attention away from the fundamental problem of corporate globalization, and directs attention to the need for a new global reserve currency or asset. That provides EM countries with a reason to refuse to change.

There may be an independent case for global monetary reform but such reform will not address the real causes of global imbalances. Doing so requires rules to constrain the arbitrage excesses of barge economics; global exchange rate management that prevents undervalued exchange rates that cause trade imbalances; and sensible capital controls that protect economies against capital flight and enable domestic demand-led growth.[5] That is a very different diagnosis from one that identifies the reserve status of the dollar as the source of the problem.

[5] Kregel (2010) reaches a similar conclusion.

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Publisher: Hans-Böckler-Stiftung, Hans-Böckler-Str. 39, 40476 Düsseldorf, Germany
Phone: +49-211-7778-331, IMK@boeckler.de, http://www.imk-boeckler.de

IMK Working Paper is an online publication series available at:
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ISSN: 1861-2199

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