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Power Relationships and the Political Economy of Global Imbalances

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ABSTRACT *Large global economic and financial imbalances have already contributed to the global financial crisis and the euro zone crisis. A substantial retreat into protectionism may be generated. Huge current account surpluses and deficits have caused economic and financial dislocations in both emerging and advanced economies. In this paper, we argue that such global problem is a result of domestic political pressures that generate strong incentives for governments to postpone needed policy adjustments and the inability of international power relationships to force such adjustments prior to the outbreak of crises. Our analysis leads to the pessimistic conclusion that the pressures from both the public and private sector to bring about substantial policy adjustments before a crisis breaks out are quite weak. In the case of U.S.-China economic imbalances, we find that although China does not have a major policy objective to maintain large current account surpluses as would be implied by the frequent charges that China is practicing mercantilism, political polarization in the USA might make it almost impossible to secure agreement on effective actions. In the case of euro crisis, nor are we optimistic that euro zone will undertake any time soon the types of forceful policy actions necessary to bring the euro crisis under control.*

KEY WORDS: Global financial crisis; international power relationship; global imbalance; currency war; international financial market; domestic political economy

JEL CLASSIFICATION: F50

1. Introduction

Large global economic and financial imbalances continue to put strains on the world economy. These have already contributed to the global financial crisis and the euro zone crisis. They continue to raise concerns that more crises may be in store and that a substantial retreat into protectionism may be generated. Discussions of potential "currency wars" have become common in the media.[1] Huge current account surpluses and deficits have caused economic and financial dislocations in a number of economies, both emerging and advanced.

Largely as a result of the global recession generated by the global financial crisis that was set in motion by the bursting of the housing bubble in the USA, the

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magnitude of the global imbalances fell sharply over the last several years, but most projections indicate that this is largely a temporary phenomena. There is little basis for believing that the major global imbalances are disappearing on their own. Nor can we accept the rosy view associated with the Bretton Woods II (BWII) hypothesis that imbalances of such magnitude reflect an equilibrium situation.

In this paper, we draw on the political economy and international relations literature to discuss the domestic political pressures that generate strong incentives for governments to postpone needed policy adjustments and the inability of international power relationships to force such adjustments prior to the outbreak of crises. We also explore whether international financial markets can be counted on to appear such pressures.

In Section 2, we discuss why global imbalances really are a problem. Section 3 briefly reviews the standard views on the types of policy adjustments that are needed by surplus and as well as deficit countries and discusses the often recurring question of how adjustment should be shared among surplus and deficit countries. We focus on two key areas of imbalance: the China–USA case and the imbalances with the euro zone, the consequences of which are spilling over to the global economy. In Section 4, we discuss how domestic political pressures limit the abilities or willingness of governments in both surplus and deficit countries to take strong adjustment actions.[2] Section 5 turns to analysis of the roles of international power relationships and argues that contrary to popular arguments the huge increase in China's holdings of dollars has not led to the creation of a dominance of power for China. In Section 6, we analyse the power of financial markets to exert power to force countries to undertake needed adjustments and argue that frequently this power only comes into play after crises have erupted. Section 7 concludes, on a less than optimistic note.

2. Is There Really a Problem?

Until fairly recently the primary focus of the debates over global imbalances has been on the large US current account deficits and the large surpluses of many emerging market (EM) countries. In this context imbalances are to be understood as current account surpluses and deficits, rather than overall payments imbalances.[3] The global imbalances between oil exporting and importing countries that were a primary focus of the 1970s still exist, but have generally faded as a major focus of international discussion. The imbalance between the US and the EM countries dropped in magnitude during the global recession generated by the global financial crisis, but this seems to be largely a temporary phenomenon.

For many countries this improvement has already begun to reverse. The exception is China's current account surplus that has been virtually eliminated in early 2012. However, most forecasts see a substantial surplus re-emerging, but the level is somewhat lower than the predictions of a few years ago. Recently the International Monetary Fund (IMF) has changed its characterization of the Renminbi (RMB) from being "substantially" to only "moderately" undervalued. Not entirely surprisingly Chinese officials took exception to even this new judgement and argued that the RMB was not undervalued at all. All through the period of declining current account surpluses, however, China has continued to accumulate reserves at a rapid rate as a result of overall balance of payments surpluses.[4]

A recent IMF study (Ahuja *et al.*, 2012) provides a careful analysis of recent developments in China's current account and its outlook for the medium term future, i.e. the next four or five years. Using a number of different methods of analysis, this study produced estimates that centred around increases from the recent depressed levels to around 4–5% of Gross Domestic Product (GDP). Such figures are well below China's peak surpluses that reached 10% of GDP but still are quite substantial, especially when it is recognized that because of China's rapid growth a constant sized surplus as a per cent of GDP implies an increasing surplus as a per cent of global GDP. Thus it would be unwise to assume that large imbalances are being sufficiently corrected without the need for further policy actions.

Several prominent economists had argued that these current account imbalances are not a source of potential instability but rather are the equilibrium result of EMs' objectives of reserve accumulation and export led growth and the role the US plays in financial intermediation for many EM economies. In this view the global imbalances should not be a source of worry. This has become generally known as the BWII view first put forward by Dooley *et al*. (2003).[5]

We acknowledge the insights provided by some of the analysis provided by the advocates of the BWII view and agree that not all of the magnitude of the current account imbalances reflect a disequilibrium that needs to be corrected. In the initial years following the Asian crisis of 1997–1998, many Asian countries had a need to substantially increase their international reserve holdings and this was accomplished by running balance of payments surpluses and increasing their dollar holdings. There is little agreement about precise estimates of optimal reserve holdings, but by the middle of the first decade of this century many of the Asian economies had accumulated international reserves far in excess of any reasonable estimates of their need.[6] The continuing imbalances and resulting excessive reserve accumulations imply a huge allocative inefficiency with net transfers being made from lower to higher income countries, an example of the Lucas paradox.

The continued current account deficits in advanced economies have given rise to political tensions over perceived losses of domestic jobs. This is particularly acute in the USA. Successive US administrations have so far held off most of the resulting calls for protectionist policies but it is not clear how long such success can continue, raising the danger of international trade wars. This is discussed further in Section 4.

Perhaps the greatest concern, however, is that the BWII is too optimistic about the sustainability of these imbalances. Many empirical studies have found that small current account deficits are not a cause for alarm, but that continuing large deficits make countries quite prone to crises.[7] The USA does occupy a special position in the international financial system that results in net capital inflows as long as confidence in the dollar is maintained. But we have seen many cases of large capital inflows swiftly reversing, and the euro crisis shows that it is not only EMs that are at risk of such sudden stops. There is no reason to believe that the dollar could not also prove vulnerable to this problem.

A loss of confidence in the financial markets would lead to a rapid fall in capital inflows to the USA and precipitate a dollar crisis that would cause repercussions across the globe. If we had a frictionless adjustment process, a sudden stop of capital flows to the USA would present no problem under flexible exchange rates. The resulting depreciation of the dollar would automatically bring about a stimulation of the US trade balance and all would be well. Such a scenario is put forward with apparent seriousness in Conard's recent best-selling book (2012, pp. 65–66). Only later does he note the danger of "panicked withdrawals". Nor even under floating rates can we expect the adjustment process in response to a large reversal of capital flows to operate quickly. Short-term elastic ties in the foreign exchange market tend to be low, as illustrated by the J-curve effect, so that quick adjustment would require a substantial overshooting of depreciation as occurred during the Asian Financial Crisis in the late 1990s.

Advocates of the BWII view often argue that if such drops in private capital inflows occur, then large official dollar holders will be willing to make up the difference. This has indeed occurred with fluctuations in private flows to the USA over the past decade, but the size of these fluctuations has been relatively moderate. There was similar official cushioning during the last stages of the original Bretton Woods system. The eventual breakdown of the system showed, however, that the willingness of the large official dollar holders to perform this stabilizing role was not infinite.[8] As long as the US deficits remained moderate this stabilizing role worked, but when the magnitude of the US deficits began to soar, a crisis could no longer be avoided.

In the last few years, these concerns about a drying up of capital inflows to the USA have been at least partially replaced by concerns about financial flows in the other direction. Monetary easing in the USA, and many other advanced economies, as a result of their recessions, led to an outpouring of funds to the EMs. The resulting pressures for appreciation in many EM countries led to the fear of falling export growth and generated a new phase of what Brazilian Finance Minister Guido Mantega labelled a "currency war". While there remain disagreements about whether these developments really reflected inappropriate policy behaviour on the part of the USA, the reversal of large financial flows to the EMs in 2012 and the resulting downward pressure on their currencies has led to a truce in this currency wars phase of the global imbalance debate. A headline in the Financial Times in mid-summer 2012 reported "Temperature drops in G20 currency wars" with the subheading "Leaders likely to focus on euro zone rather than global imbalances" (Beattie & McGregor, 2012).

While the US deficit problem remains far from solved, in 2012 by far the greatest financial threat to the global economy is the continued escalation of the Euro crisis. To the German government the crisis was caused by fiscal irresponsibility in the crisis countries. There is certainly truth in this perspective, although with exceptions such as Ireland and Spain, but it is still not sufficiently appreciated that a major cause of the crisis was the large current account imbalances that emerged within the euro zone.[9] Rather than promoting convergence, the euphoria that accompanied the fall of interest rates in the southern part of Europe, encouraged rapid wage increases along with higher public spending and resulted in increasing losses of competitiveness and growing current account deficits while low wage increases and high productivity growth in Germany and some of the other Northern Economies led to increasing current account surpluses.

As long as confidence (or over optimism) continued these imbalances were largely regional, with the current account surpluses and deficits of the euro countries largely offsetting each other so that the resulting euro zone current account with the rest of the world was roughly in balance. But once the Greek crisis hit, the failure of strong unified action by euro zone governments led to increasing loss of confidence in the financial markets with major repercussions on the global economy.

While the euro crisis has understandably diverted attention from the US current account deficit, the sudden stop of financial flows to the European crisis countries should serve as a strong warning that international financial markets can turn quickly. The concern that continued global imbalance could end in a major crisis is well founded.

3. Debates About Who Should Adjust

There are several strong analogies between the euro zone imbalances and those facing the global economy. The most important contributors to the emergence of the external imbalances were the same: overspending by both the public and private sectors in the deficit countries and insufficient domestic demand expansion coupled with export-oriented growth strategies in the surplus countries. The external imbalances were largely a reflection of the lack of balance in domestic economies. For convenience we will treat the euro imbalances as Germany versus Southern Europe and the global imbalances as China versus the USA.

There is unusually widespread agreement among economists about what surplus and deficit countries need to do in the long term to correct these imbalances. It essentially requires a reversal of the policies that generated the imbalances in the first place,[10] i.e. improved competitiveness and reduced spending and increased savings in the deficit countries and real appreciation and increased domestic spending in the surplus countries.[11]

In the case of China the standard argument, accepted by many Chinese officials, is that the external imbalance is accompanied by a major imbalance in domestic spending, with investment being far too high and consumer spending far too low.[12] Some writers, such as Conard (2012), have disputed the view of inadequate consumer spending in China on the grounds that the level of consumer spending has been rising quite rapidly. This argument is unconvincing, however, since all forms of spending are growing at high rates in China. The ratio of consumer to investment spending has not been rising and there are growing indications of quite low productivity from many of the investments in China.[13] Indeed, this imbalance has worsened in recent years as cyclical considerations have led the government to enact enormous increases in domestic spending and in China this can be done most quickly by expanding investment.

The IMF's April 2012 Regional Economic Outlook for Asia and the Pacific expressed concerns that if not accompanied by substantial declines in Chinese investment as a per cent of GDP the projected reduction in China's current account surpluses from their peaks would create greater domestic imbalances. In a section on "Is China Rebalancing?" this IMF report finds that despite the increase in official statements on the need to rebalance, this has not yet begun to show up in the statistics. Investment has continued to increase as a share of GDP. A considerable part of this is due to the stimulus programmes in response to the global financial crisis and thus there is a good chance that this will be temporary, but despite efforts to improve the provision of health care and low-income housing the IMF reports that there as yet is little evidence of a decline in precautionary saving by households and their spending as a per cent of GDP has not begun to rise, much less return to the levels of a decade ago.

Debates about who should adjust are not new. During the Bretton Woods era a substantial literature has been developed on the issue of the appropriate apportionment of adjustment responsibilities.[14] Under the textbook rules of the gold standard with flexible wages and prices, adjustment would be automatic and shared equally between surplus and deficit countries (why adjustment in the euro zone did not operate this way will be discussed below). The same type of automatic shared adjustment would occur under an ideal-type system of floating exchange rates. In today's world of considerable short-run rigidities, however, countries are loath to allow automatic adjustments that may generate depressed growth and high unemployment.

In such cases the minimization of aggregate economic costs would involve placing more of the needed adjustment on surplus countries. This was qualified, however, by concerns that putting too little of the burden on deficit countries would encourage them to relax efforts to avoid generating serious disequilibrium in the first place, the moral hazard problem emphasized so strongly by the German government.

Equity considerations can also be important. The natural argument is that whoever caused the disequilibrium should have the major responsibility for correcting it. This view of course leads to the major debates and disagreements about the causes of the disequilibria as we have seen in both the Sino-US and euro zone imbalances.

Many officials and scholars in the USA argued that a global savings glut was the major cause of the US sub-prime crisis by generating excessively low-interest rates.[15] While the capital inflows from abroad undoubtedly contributed to the magnitude of the crisis, there are plenty of home grown reasons that are more than sufficient to explain the US crisis[16]. While US officials have emphasized China's undervalued exchange rate, China in turn has pointed to what it sees as excessively loose monetary and fiscal policies in the USA and financial deregulation. In general economists agree with each country's criticism of the other's policies.

In the euro zone German officials have tended to focus almost exclusively on fiscal excesses in the deficit countries. While certainly true for Greece, Ireland and Spain had strong fiscal positions before the crisis. In these countries the major problem was real estate bubbles. The failure of their regulatory authorities bear a major responsibility for allowing their property markets to get out of hand, but a major contributing factor was the easy financing coming from the rest of Europe. German officials have not found it convenient to acknowledge the important role that German banks played in the bubble process.

An added equity consideration concerns the general distribution of benefits from the operation of the system. At the global level it is often argued that the system allowed China to get away with mercantilist policies while the USA is often seen as benefiting unfairly from its world banker role (similar conflicting view about unfair advantages were present during the operation of the Bretton Woods system). Where the USA complained of the inability to unilaterally change its exchange rate and France complained of the exorbitant privilege given to the USA through the easy financing generated by the international role of the dollar.[17]

With respect to the euro zone crisis there have been assertions that Germany has been the major beneficiary of the euro and hence should shoulder more costs of saving the system. This view is based on Germany's huge increase in exports. As with the case of China's undervalued exchange rate, such arguments are basically mercantilist. In opposition, a standard trade theory view suggests that Germany's trade surplus has been subsidizing the rest of Europe. It has reduced the standard of living of German citizens, while stimulating the consumption in the deficit countries. On this view economic fairness does not imply that Germany has an obligation to the crisis countries in the euro zone.

Despite these conflicting arguments, most economists and officials, with the exception of Germany, agree that the needed reductions in current account imbalances in the euro zone should entail actions by both surpluses and deficit countries. The directions of reductions in internal imbalances needed to reduce external imbalances are clear. However, the relative magnitude of the most appropriate distribution of adjustments in surplus versus deficit countries is not, nor are the best ways to adjust policies to help bring about domestic rebalancing.

Most economists agree that changes in competitiveness, i.e. in real exchange rates, should play an important role in helping to bring about both domestic and external rebalancing as opposed to relying on adjustments of demand alone. Following the literature on optimal currency area theory, except for quite small open economies, it is efficient to use changes in nominal exchange rates to help bring about the needed changes in real rates. Within the euro zone exchange rate adjustments are ruled out. This leaves only changes in productivity and wages and prices. Germany, of course, calls for so-called "internal devaluations", i.e. wage and price falls in the deficit countries.

In contrast to the high degree of flexibility of economies assumed in many of the new classical macroeconomic models, labour market inflexibilities and price stickiness mean that such adjustments will be accompanied in the short and medium terms by high unemployment and slow or negative growth as we are currently seeing in the deficit countries in the euro zone. Policies to increase the flexibility of economies and other structural reforms are urgently needed. Some progress is being made on this score, but the positive effects of such measures are likely to be felt only slowly. Thus it is hard to see how an efficient and equitable sharing of adjustment responsibilities within the euro zone would not entail a substantial amount of inflation in the surplus countries.

In the case of China and the USA, the principal controversy among economists has concerned the role of exchange rate adjustments. While often missed in the political debates, most economists recognize that exchange rate adjustments alone would not be sufficient to bring about the needed internal and external rebalancing but believe that they can play a valuable role in combination with domestic policy adjustments. However, a small but vocal minority has been strongly opposed to China appreciating the RMB. These are generally global monetarists who believe that in a world so globalized exchange rate adjustments just do not work. And from an opposing perspective some argue low elasticities and the importance of the substantial import content of China's exports means that exchange rate adjustments would have a very limited impact on net trade flows.[18]

Unfortunately economists' arguments have played only a relatively minor role in actual policy decisions to deal with imbalances. The adjustments that have been forced on the deficit countries in the euro zone and the quite limited adjustment in macroeconomic policies by the USA and China and the surplus countries in the euro zone have been much more a function of domestic political economy and international power relationships. It is to these that we now turn.

4. Domestic Political Economy Pressures

The most straightforward impediments to adopting needed policy adjustments is the opposition of economic interest groups who have been gaining from the policies that have been generating the disequilibrium (Frieden, 1991; Fearon, 1994; Simmons, 1994; Milner, 1997; Martin, 2000; Gourevitch, 2002; Bueno de Mesquita *et al.*, 2004; Tsebelis, 2011). Such pressures have been extensively analysed in the literature on the political economy of trade policy. From this standpoint an undervalued exchange rate acts like an across the board subsidy to exports and tax on imports. This increases the economic positions of workers, managers and owners in export and import competing industries. Of course it hurts the majority of the public as consumers but they are generally much less organized and politically influential. Such pressures to avoid adjustment do not operate only in democracies. The desires of interest groups to avoid adjustments that will undermine their favoured positions are a potent force under almost any type of political system. Concern with the short-run distributional effects has been a major factor in the Chinese government's resistance to substantial appreciation of the RMB. Both direct lobbying by powerful groups and general concerns with social stability have been important.

With respect to deficit countries exchange rate depreciations face weaker political obstacles, although these can still be considerable where abandoning a pegged exchange rate is at issue. In such cases a blow to the government's reputation is often added to complaints about the rising cost of imports. The net political pressures from gainers and losers can vary substantially depending on institutional settings and the distribution of political power among groups. Special interest opposition to adjustment policies also frequently applies to efforts to raise taxes and cut government spending. In Greece for instance, some of the strongest opposition to fiscal adjustments has come from government workers who substantial pay cuts or even losing their jobs.

Time inconsistency problems are of major importance. Adjustment policies typically generate large initial costs that are quite obvious, while the benefits take longer to occur and often are much less transparent, especially when they take the form of avoiding crises.[19] Where public pressures are based on short-time horizons, officials face strong disincentives to take adjustment actions in a timely fashion.

Economists' advocacy of inflation targeting and central bank independence, and, more controversially, limits on the size of budget deficits, are examples of efforts to use institutional mechanisms to reduce problems of time inconsistency. Interest group pressures and the limited knowledge of a high proportion of the general public about the full ramifications of government economic policies can often generate strong political forces both to avoid implementation of sensible economic policies and to adopt questionable policies in other types of situations.

An example of pressures to avoid implementation is how the opposition of interest groups and the general public has constrained the ability of governments in Southern Europe to implement reforms to which they have agreed with their euro partners and the European Central Bank and IMF.

An example of pressures to implement "bad" policies is the political pressure in the USA to "get tough with China" and impose trade sanctions against what are perceived as widespread unfair trade practices adopted by China. (There is likely considerable truth in US perceptions of Chinese unfair trade practices, but little public awareness of the USA's trade practices and the dangers of starting a trade war.) In the USA, a recent public opinion poll on US trade relationships with China found that 62% of people wanted tougher laws against China on trade issues and only 29% were worried that this might start a trade war; 94% were worried about American jobs being shifted abroad (Politi, 2012).

The political difficulties of bringing about the needed rebalancing are well illustrated in a recent article by Michael Pettis (2012). Pettis puts particular emphasis on the need to reduce the distortions generated by underpriced factors of production that create incentives to over expand investment. Estimates of the total size of the distortions in factor prices run as high as 10% of GDP (see Yiping & Kunyu, 2010). Pettis argues that forcing up interest rates through reducing the "financial repression" tax will not only increase consumption through the higher income that the public would earn on their savings, but also reduce investment and economic growth. This slower growth need not stimulate substantial social unrest if it is accompanied with more rapid wage growth. This process of rebalancing would, however, reduce the wealth of the political elites, which they would resist "ferociously".

Failure to bring about domestic rebalancing is not just an internal problem for China. The substantial overinvestment by China, especially in real estate, has brought a substantial increase in the expected levels of bad debt and this will only get worse if future investment is not reigned back. As Ahuja *et al.* (2012) argue, a continuation of trends from the recent past "...has the potential to generate macroeconomic and financial instability...which...will undoubtedly have consequences for global macroeconomic and financial stability" (p. 20). Thus a dollar crisis is not the only danger from the continuation of large internal and external imbalances.

5. International Power Relationships

While traditional power analysis in the international relations literature focuses on countries' economic and military capabilities, in recent decades much more nuanced concepts of power relationships have been developed. Due in large part to the decline in the willingness of countries to use military means to achieve economic objectives (gunboat diplomacy) the fungibility of country's power across issue areas has decline substantially. Thus countries' relative power can vary greatly from one issue area to another (Keohane & Nye, 1977; Baldwin, 2002; Barnett & Duvall, 2004). In contrast to the traditional view of the realist school of international relations, countries do not behave as unified rational actors (Morgenthau, 1948; Waltz, 1979; Keohane, 1986; Baldwin, 1993). Domestic factors are often important. These include political pressures from the general public and interest groups (Frieden, 1991; Fearon, 1994;

Simmons, 1994; Milner, 1997; Martin, 2000; Gourevitch, 2002; Bueno de Mesquita *et al.*, 2004; Tsebelis, 2011). The desires of interest groups to avoid adjustments that will undermine their favoured positions are a potent force under almost any type of political system.

An important distinction in modern international power analysis is that between positive and negative power. Positive power refers to the ability to use threats and rewards (hard power) and moral suasion (soft power) to get others to behave differently than they otherwise would. Negative power reflects the ability to keep others or external events from forcing you to do things against your will. It is recognized that both positive and negative power can vary substantially from one issue area to another. Thus generally to be useful, power analysis must specify analysis in terms of the specifics of the power to get whom to do what. Thus, for example, on some specific issues where military force and economic sanctions are ruled out small countries are frequently able to stand up to large ones, i.e. their defensive powers may be substantial even though they have little, if any, positive power.

Unfortunately despite all of the advances in the analysis of power in the international political economy literature, some scholars and research institutes still continue to emphasize aggregate measures of economic power. A recent example is Subramanian (2011), who makes international reserves an important part of his index and concludes that China has become more powerful than the USA. This may well be true in some areas. But as we will argue below, it is extremely misleading with respect to US–China financial relationships.[20]

It is well known that the hard power of international and regional financial institutions (IFIs) is largely limited to situations where countries are in dire need of official financing, i.e. where the defensive power of these countries is low. While many of these institutions do have the legal authority to impose economic sanctions, for a variety of political reasons they have been hesitant to do so. This is an example of the importance of not focusing on capabilities alone. They are of little use if the political ability to transform capabilities into actions is lacking. Thus, for example, while Germany clearly had the aggregate resources to give countries like Greece a combination of carrots and sticks, i.e. generous financing conditional on gradual, domestically feasible adjustments in Greece, domestic political opposition in Germany has made financing on a much larger scale impossible even if this had been favoured by the Merkel administration. Institutional arrangements can also be important. Germany's initial contribution to the European Stability Mechanism required a ruling by its constitutional Court.

Such reality implies that the ability of IFIs to induce policy changes in surplus countries must rely on moral suasion or shaming, i.e. soft power. While such efforts are often worth making, their effectiveness has been rather limited.[21] Even where officials of the country needing adjustment become convinced that it should be undertaken, domestic political concerns may sharply limit their willingness to try to implement these adjustments. This scenario seems to have considerable explanatory power for the behaviour of China in recent years.

Despite the strong limitations the international efforts of institutions like the IMF and groups like the G20 are likely worth the resources devoted to them.[22] Their greatest effectiveness is when they give government officials added political leverage to do what they would like to do any way. Such strategies can backfire, however, where the public views such actions as caving in to foreign forces. This is one of the reasons why economic sanctions are often counter-productive in promoting changes in policy in target countries. Korea provides a good example. Resentment of IMF policies during the Asian Financial Crisis is still strong, so in Korea arguments that something should be done because of IMF recommendations would be a losing political strategy.

These limitations on the IFI's abilities to induce policy adjustments in surplus countries apply to the efforts of individual countries as well, indeed, likely even more strongly, as pressure from individual countries is usually considered much less legitimate (while legitimacy is a slippery concept that is difficult for economists to deal with, there is a great deal of literature in political science that demonstrates its importance for many issues).[23]

The realist school of international relations with its focus on national power relationships would not be surprised by the limited effectiveness of international institutions (Mearsheimer, 1994/1995). Nor would they be surprised by the inability of Spain, much less Greece, to get Germany to agree to follow more expansionary macroeconomic policies. With respect to the USA and China, they would expect the relationships to be more evenly balanced so that many of them would not be surprised by a standoff.[24] However, it is hardly consistent with realist models that the USA would have such little success in pressuring countries like Korea and Taiwan to reduce their current account surpluses. (While each of the non-China surpluses of EM countries is not a major contributor to global imbalances in their own right, collectively they do make a substantial contribution.)

Also conflicting with the unified rational actor views of many realists and optimal policy economists[25] is that adjustments to reduce their surpluses are often in the overall economic interests of these countries. The limited degree to which countries adopt such policies seems largely due to two factors. One is that they hold mental models that conflict with standard economic analysis. Here the modern mercantilist school of realists would not be surprised. While discredited among most economists since the days of David Hume and Adam Smith, the natural superiority of exports over imports is still a widely held notion among officials and the public.

This view is abetted by mainstream economists who advocate export-oriented growth strategies. There is much to be said for such strategies, for the short and medium terms, especially when contrasted with the protectionist import substitution policies that once were so popular in Latin America. There is no economic reason, however, that an emphasis on exports cannot be balanced by rapidly growing imports as well. Thus the case for export led growth does not support the mercantilist view that persistent current account surplus are a desirable policy objective for the longer term. Where economies have become heavily export dependent, however, the lack of high flexibility of economies can make it difficult at times to stimulate sufficiently domestic sectors of the economy. In such cases policies to promote rebalancing of the economy over the longer turn are called for. In the short run, however, in some countries the limited ability of policy measures to boost domestic demand sufficiently provides strong pressures to keep exports growing. How to improve the effectiveness of policies to boost domestic demand is a priority topic for research.

Perhaps the strongest source of pressure for surplus countries to appreciate their exchange rates comes from the inflation that continued large surpluses can bring. Under the idealized model of the gold standard, symmetric adjustments occurred automatically as reserve losses led to monetary contractions and deflation in deficit countries while reserve accumulations led to monetary expansion and inflation in surplus countries, the famous Hume specie flow mechanism. While the actual experiences with gold standards were far less automatic than this model, in the post Second World War era, these pressures on surplus countries broke down substantially. Surplus countries largely sterilized their reserve inflows and thus contained inflationary pressures.

Of course such sterilization is easier in a world of low than of high capital mobility. The general increase in international capital mobility and integration of financial markets has led numerous writers to assume that for many countries today capital mobility is virtually perfect, making effective sterilization impossible. While this view is contradicted by the empirical evidence (see Ouyang *et al.*, 2008), it has led to arguments that by tethering the RMB to the dollar China has effectively turned over its monetary policy to the USA. Such analysis is faulty on two counts. First, China has allowed considerable appreciation of the RMB against the dollar since 2005. Such appreciation has not been sufficient to eliminate the persistent large surpluses, however. Second, the People's Bank of China has been quite successful in sterilizing the domestic monetary effects of these surpluses (see Burdekin & Siklos, 2008 and Ouyang *et al.*, 2010).

China has indeed suffered a number of bouts of inflation but the largest of these occurred before global imbalances became a major issue and all of these, including the more recent milder inflations, have been largely domestically driven. The evidence of strong sterilization by countries like Korea (Willett, 2009) suggests that it is not just China's capital controls that keep national financial markets in many countries from being perfectly integrated. It is true that the People's Bank of China is finding that it has to work harder to implement its sterilization policies within China. That helps to explain why its officials have been some of the strongest advocates with the government of more rapid appreciation. But higher rates of inflation in China are unlikely to play a major role in correcting global imbalances. An automatic adjustment mechanism is not at work so countries such as China have considerable defensive power to avoid full adjustment.

The same is likely to apply with respect to Germany. Monetary behaviour within the euro zone does much more closely approximate the automatic adjustment mechanism of the idealized gold standard than does the operation of the current international monetary system more generally. Within a common currency area the rate of money growth within a particular country is set by the aggregate rate of money growth in the currency area adjusted for that country's balance of payments surplus or deficit. Just as under the gold standard surplus counties will have above average rates of money growth and deficit countries will have below average growth rate.

It must be remembered, however, that this system operates with respect to the overall balance of payments, not current accounts alone. Private capital flows allowed and indeed helped generate increasing current account deficits for a number of the euro countries by financing above average rates of wage and price increases in countries such as Greece.[26]

Once the crisis hit, such private financing dried up quickly and overall balances began to more closely approximate current account imbalances. As a result inflationary pressures on Germany are beginning to increase and the German government has expressed some willingness to allow this mechanism to operate, but only in a very limited way. Given the strong downward wage rigidity in most of the crisis countries, many economists have argued that most of the needed mutual price adjustments should be placed on the surplus countries. In economic terms this could be rather easily done by the European Central Bank (ECB) through a substantial loosening of its monetary policy to increase the average rate of inflation in the euro zone. However, this would violate the ECB's mandate and is something that the ECB is extremely unlikely to do. Thus the burden of adjustment to the mutual imbalances in the euro zone is likely to continue to fall most heavily on the crisis countries unless this is offset by official financing. The surplus countries have been willing to provide such financing combined with requirements for adjustment. This seems clearly a sensible approach but their have been strongly conflicting views about the appropriate mix of financing versus short-run adjustment.

There is an argument, especially popular in Germany, that this is only fair that most of the burden of adjustment be placed on the crisis countries since they are the ones that triggered the crisis. There is some truth to this view, but in its extreme form it overlooks that the lending behaviour of the financial institutions in the North played a considerable role in financing the activities that generated a huge number of bad debts. Where governments feel that for survival they must cater to political pressures based on short-term benefits, rebalancing economies becomes far more difficult.

One important barrier to adjustment is the role of special interests. Almost any adjustment will harm some groups in the short run. Export interests, which include workers as well as managers and owners, will be hurt by appreciation or inflation, especially in the short run. These groups do not have political influence just in democracies. Concerns that a large appreciation could generate substantial social instability appear to have been a major factor influencing the limited willingness of the Chinese government to allow appreciation of the RMB. Likewise the political clout of the state-owned enterprises has been a major factor in limiting China's move away from its high rate of investment – a substantial portion of which is not highly productive. State ownership does not always bring state control.

In the USA, almost everyone agrees in the abstract that a substantial reduction in the huge government budget deficits is needed, over the long term. However, there is little agreement about how to realize such reductions. The sharp political divide in the USA creates a strong status quo bias. Thus the ability of the USA to use its enormous economic strength to bring its budget deficit under control is sharply limited by its internal political weakness.

Many have argued that these continued reserve increases reflected a new mercantilism in Asia. This could be consistent with realist views, but we are doubtful that such behaviour primarily reflects the classic mercantilist object of large-trade surpluses as a source of power. More likely in our view is that these later reserve accumulations reflected a status quo bias generated by a desire to limit adjustment costs and political pressures in the face of balance of payments surpluses.[27] The substantial variability of international financial flows characterized by frequent capital surges and sudden stops lends support to the sensibility of minimizing short-run adjustments.[28]

The massive reserve accumulations have substantially increased the defensive power of these countries. Some have also argued that the large accumulation of reserves, especially for China, has also increased their positive power. This is certainly true in some areas as facilitating greater foreign investment and foreign aid and hence gaining greater influence with respect to some types of policy issues, for example, increasing quotas in the IMF. However, these large reserve increases have brought little actual increase in China's positive power to influence US economic policies.

Worries are frequently expressed in the USA that China's huge reserve holdings could make US policies hostage to potential withdrawals of its dollar holdings. It is certainly true that China's dollar stockpile does give it the ability to impose considerable harm on the US economy.

Once again, however, analysis of capabilities alone can give a very misleading picture of effective power. One must also consider the ability and cost of using such capabilities. The Chinese government does have the political ability to use this weapon. It has no need to clear an attack on the dollar with any legislative body. Here the costs of such actions are the main inhibiting factor. A plunging dollar would sharply reduce the value of China's remaining dollar holdings and could generate an international financial crisis that would spread harm around the globe. In addition to these direct economic and financial costs China could also suffer a serious blow to its international reputation.

Countries have frequently showed willingness to bear some economic costs to sanction other countries but these costs have generally been much more limited than would occur from a Chinese attack on the dollar. (While the dividing line might be unclear, such an attack should be distinguished from China's quite reasonable desire to gradually reduce the portion of its reserves held in dollars as part of a strategy of diversification.)

It is well known that a bank has considerable power over those to whom it has made small loans but that a large borrower may have considerable leverage over the bank since a default could endanger the solvency of the bank. The large size of its dollar holdings has substantially reduced China's freedom of action in this area. The China–US financial relationship is one of mutual dependence where it would take considerable provocation for either party to do more than bluff.

A similar situation held in the latter days of the Bretton Woods system where small dollar holders retained freedom to convert dollars while large dollar holders were inhibited by the danger that if they made conversions this might bring down the system.[29] To a lesser degree the large borrower inhibition applies in the euro case as well. German and French financial institutions hold huge amounts of private and public debt of the crisis countries. Many have argued that concerns for the financial conditions of their own banks have had a substantial influence on the willingness of the Northern European countries to provide official financing for the crisis countries (of course these countries would not publicly admit this).

Such analysis suggests that the large debtor factor places substantial constraints over the ability of other countries to use their official dollar holdings to force the

USA to do its share to help correct global imbalances. The ultimate breakdown of the Bretton Woods system also illustrates, however, that the large borrower constraints are not absolute. They were quite sufficient to provide stability in the face of small- and medium-size imbalances, but not the huge ones that developed from the financing of the Vietnam War (again see Willett, 1977). If the USA continues to fail to make substantial steps towards improving its longer-term fiscal position, a repeat of the Bretton Woods collapse is a real danger.

6. The Role of International Financial Markets

In recent years power analysis by scholars in international political economy has paid increasing attention to the roles of non-state actors, especially the financial markets. While early predictions that increasing globalization would lead to a withering away of the state have proven to be greatly exaggerated, beliefs that international financial markets exert strong (and to some commentators, excessively harsh) discipline over national monetary and fiscal policies enjoy considerable currency, as evidenced, for example, by Thomas Friedman's discussion of "the electronic herd" in his popular book *The Lexus and the Olive Tree*. We now turn to this aspect of power in the following section.

The view that global financial markets provide strong discipline over national monetary and fiscal policies has certainly proved true in the euro zone once the crisis began. In the strong form of the financial discipline hypothesis, however, financial markets should begin to give early warning signals as disequilibrium starts to emerge. In the far-sighted rational expectations models that have come to play an important role in modern macroeconomic analysis in academia, financial markets would play just this role. Alas in actual experience they have frequently failed to perform in this way. We have already discussed this failure with respect to the euro zone. The Latin American debt crisis of the 1980s, the Asian crisis of the 1990s, the Argentine default of 2001, and the recent US sub-prime crisis provide other vivid examples.[30]

New developments in behavioural and neuroeconomics and finance, complexity economics, limited information, uncertainty and principal-agent problems are beginning to offer explanations for why financial markets and international capital flows may behave quite differently at different times and why we sometimes see capital surges and asset market bubbles followed by sudden stops and busts (for discussion and references see Willett, 2010, 2012).

Indeed contrary to the discipline hypothesis it has become popular among some former government officials such as Alan Greenspan and even a number of academics to argue that financial inflows into the USA were a major cause of the sub-prime crisis and substantially eased the pressures to reduce US budget deficits by providing cheap financing. It is quite plausible to argue that these capital inflows played a role in increasing the magnitudes of these disequilibria, but it is hardly plausible that they were the primary cause. Domestic considerations can provide plenty of explanation without the need to bring in international influences.[31]

Of course not all capital inflows reverse. There have been a number of interesting exercises trying to estimate the plausible range of sustainable capital flows into the USA. These are unlikely to have great explanatory power, however. We just do not, yet, understand the behaviour of international financial flows sufficiently. The ultimate determinant of a high proportion of these capital flows is confidence.

The current low levels of US interest rates should not be taken as a sign that all is well as would be the case with far sighted efficient financial markets. We now know that investors (and borrowers) not infrequently suffer from cognitive biases that lead them to ignore initial warning signs. These biases were generally evolutionarily adaptive over thousands of years but are frequently less well suited for dealing with a number of aspects of the modern world such as financial market and investment and borrowing decisions. Tendencies towards over optimism and short-time horizons have been well documented as has confirmation bias that leads to giving much more weight to developments that are consistent with prior views. The result of these biases is that market participants often do not respond fully to warning signals of possible danger in the future as long as things are going well in the present.[32] The continuation of the current capital inflows into the USA is dependent on sustained confidence. If such confidence is abused too frequently it can evaporate very quickly. The most likely potential cause of such a collapse of confidence at the present time is the danger of a failure to come to grips with the USA's long-run budget deficit problems.

7. Concluding Remarks

Our analysis of domestic political economy considerations and international power relationships leads to the pessimistic conclusion that the pressures from both the public and private sector to bring about substantial policy adjustments before a crisis breaks out are quite weak. One optimistic consideration, however, is that in our judgement China does not have a major policy objective to maintain large current account surpluses as would be implied by the frequent charges that China is practicing mercantilism. In our view considerably more important is the Chinese government's desire to avoid imposing substantial adjustment costs on important sectors of its economy. On this view, the Chinese government will be more willing to allow gradual adjustments over time than if the mercantilist view is correct. We are less optimistic about the situation where political polarization in the USA has made it almost impossible to secure agreement on effective actions. Nor are we optimistic that the euro zone will undertake any time soon the types of forceful policy actions necessary to bring the euro crisis under control.

One can always hope that exogenous developments can lead to a substantial long-lasting reduction in global imbalances, as they did temporarily during the recent global recession, but it is certainly not prudent to rely on this hope. Efforts such as moral suasion through the G20, the IMF, etc. are well worth continuing. Their costs are low, but past experience suggests that the benefits will be low also.[33]

Thus in our view, it is wise for major governments, central banks and IFIs to begin to quickly develop contingency plans for dealing with a potential large sudden stop in net capital flows to the USA. Needed measures include further expansion of central bank swap lines and of the resources of the IMF.[34] The failure to bring the euro crisis under control illustrates the importance of swift, forceful official actions in the face of serious crises. In the euro zone continued efforts by governments to understate the severity of problems and to underfund financial rescue facilities has clearly been shown to be a losing strategy. Let us hope that our international officials learn from this.

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Notes

[1] For discussion of the currency wars debates see the analysis and references in Bird and Willett (2011) and Rickards (2011).

[2] Such political economy considerations are also discussed in the accompanying paper by Bird.

[3] For data on the size of recent current account imbalances, see the accompanying paper by Bird.

[4] An exception is the second quarter of 2012.

[5] For discussions of this approach see Bird (2006), Bird and Willett (2008), and Eichengreen (2006).

[6] See the analysis and references in Aizenman and Lee (2005), Li *et al.* (2009) and Willett (2009). Today China holds the most international reserves in the world. These almost three times the size of the next highest country, Japan.

[7] For recent empirical studies and references to the literature see Angkinand *et al.* (2009) and Reinhart and Rogoff (2009).

[8] On the Bretton Woods experience see Willett (1977). For discussions of how large a stabilizing role official dollar holders are likely to play in the current system see the analysis and references in Bird and Willett (2008) and Eichengreen (2006).

[9] See the analysis and references in Willett *et al.* (2010) and Willett and Whilborg (forthcoming).

[10] It is not always true that the best adjustment policies are to reverse the policies that generated the imbalances, but this is often the case.

[11] At present the aftermath of the global financial crisis and resulting high unemployment in the USA and Southern Europe raise an important complication about whether short-run stimulus should be applied to restore growth before needed longer-term fiscal rebalancing policies are fully adopted in the deficit countries. The German view that fiscal austerity will promote economic growth in the short run has clearly failed, but the best way to combine short-run and long-run objectives is far from clear. We abstract from this important question and focus on the longer-term issues.

[12] In a large relatively closed economy it would be surprising for low levels of consumer demand to be accompanied by high investment. In an open economy high investment may be driven by export demand and despite its large size China's economic structure has become heavily export dependent. Perhaps even more important, however, is the large proportion of investment in China that is state rather than market driven and hence less influenced by consumer demand.

[13] The ratio of consumption to investment in China has been in continuing decline since reaching its peak at 1.75% in 2000 and dropped to 1.04% in 2010.

[14] See, for example, the analyses and references in Bergsten *et al.* (1970).

[15] For analysis and references to literature on this subject see Obstfeld and Rogoff (2010).

[16] These include widespread views that at the national level house prices always increase, financial deregulation, the relaxation of lending standards, excessive faith in deficient risk models and products of financial engineering and government policies to promote housing for lower income families. For analysis and references see Lo (2012), and Willett (2012).

[17] On the details of these debates, see Willett (1977).

[18] For different views on whether exchange rate adjustments are appropriate for china see Chung and Eichengreen (2007), Liang *et al.* (2009) and McKinnon and Schnatel (2012). For a review of estimates of the extent of China's undervaluation see Cline (2008).

[19] For more detailed discussions of how these factors can be important in delaying needed adjustments see Bird and Willett (2008) and Walter and Willett (2010).

[20] For a more detailed critique of this index see Chiu and Willett (2012).

[21] See the analysis and references in Bird (2003) and his paper in this issue.

[22] See the analysis and references in Bird and Willett (2007) and Bird (2012).

[23] See Pauly (1997, 2002).
[24] For analysis and discussion of the literature on the relative power of the USA and China see Chiu and Willett (2012).
[25] This refers to the tendency of some economists, fortunately diminished by the increasing attention that economists pay to political economy considerations, to model policies that lead to maximum aggregate economic efficiency and then assume that these are the policies that governments will adopt.
[26] As is well known from the Balassa–Samuelson analysis, in a common currency countries with above average inflation growth would also have above average price inflation without this causing balance of payments disequilibrium. For countries like Greece, however, there were below average productivity increases so this mechanism cannot explain their higher wage and price inflation. See Willett *et al.* (2010).
[27] See Li *et al.* (2009).
[28] For analysis of the variability of these flows, see Efremidze *et al.* (2011).
[29] See Willett (1977).
[30] For detailed analysis of the failure of financial markets to provide strong discipline in the face of emerging crises see Angkinand *et al.* (2012), Willett (2000) and Willett and Wihlborg (forthcoming).
[31] See, for example, the analysis and references in Lo (2012) and Willett (2009, 2012). Research suggests that there were many causes of the crisis. Removal of any one or two of the contributing factors would have been extremely unlikely to have kept the crisis from occurring.
[32] For discussion and references see Willett (2009, 2012).
[33] On the limited progress made so far see the accompanying paper by Bird.
[34] The accompanying paper by Bird discusses the reasons why it is easier to get cooperation on financing than on adjustment.

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