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The Political Economy of Reducing the United States Dollar's Role as a Global Reserve Currency

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The Political Economy of Reducing the United States Dollar's Role as a Global Reserve Currency

Josef T. Yap

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The Political Economy of Reducing the United States Dollar's Role as a Global Reserve Currency

Josef T. Yap

Abstract

Many have argued that the major source of the existing global macroeconomic imbalances are the twin deficits of the United States (US). However, there is still a debate about whether the global imbalances indeed pose a significant threat to the world economy. This matter is settled by arguing that the global imbalances acted as a 'handmaiden' to the 2008 financial crisis. One way to reduce global imbalances is to reform the international monetary system and reduce the role of the US dollar as a reserve currency. Robert Triffin was one of those critical of this "exorbitant" privilege granted to the US, which makes it both a system maker and privilege taker. The Triffin Dilemma captures the fundamental instability that underlies the dollar reserve system. However, there are major obstacles to this proposal. Some analysts including Triffin cited the US security umbrella as the primary reason the US and its major allies would want to retain the role of the dollar in global trade and finance despite the underlying inequities in the system. This is related to the imbalance in global governance which is largely US-centric. The imbalance in global governance is also reflected in the dominance of the US financial system brought about by the "first-mover advantage". Because of the inertia brought about by the imbalance in global governance, economic arguments to reform the international monetary system are likely to be trumped by political reality. The paper analyzes whether current efforts in East Asia in terms of financial and monetary cooperation and rebalancing of economic growth could significantly mitigate the adverse impacts of a global system that will still be dominated by the US dollar in the foreseeable future. It also explains why the People's Republic of China (PRC) is unlikely to make significant unilateral adjustments to reduce global macroeconomic imbalances.

Key Words: Reserve currency, fiduciary system, global imbalances, Triffin Dilemma

JEL Classification: JTY: F31, F33

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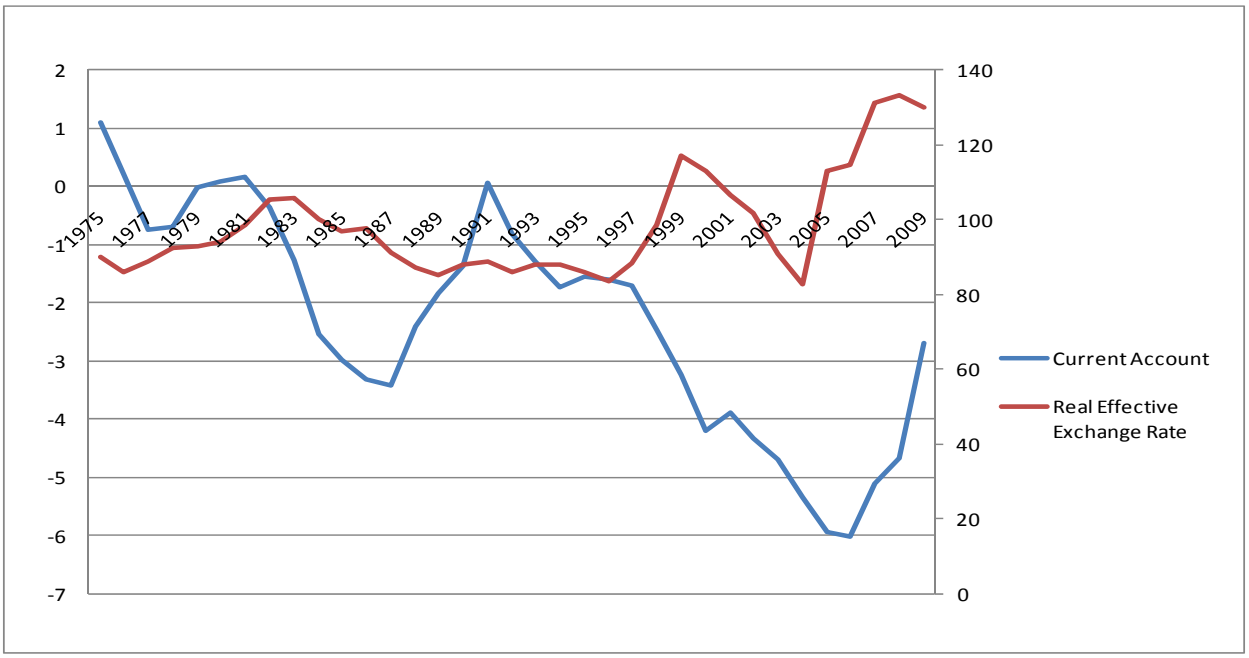
The Political Economy of Reducing the United States Dollar's Role as a Global Reserve Currency

Josef T. Yap[1]

1. INTRODUCTION

Just two years after the 2008 global financial and economic crisis, many economies are grappling with the problem of a rapidly depreciating US dollar (hereafter referred to as "dollar"). Exchange rate volatility has been a recurring problem since the dollar-gold exchange standard was abandoned in 1973 (Figure 1). This was compounded by a sharp increase in global macroeconomic imbalances during the past decade. Of greatest concern in matters related to the international monetary system are the periodic financial and currency crises that have buffeted the global economy. Some experts have argued that the volatile exchange rates, large macroeconomic imbalances, and increasingly frequent financial crises are largely due to an international monetary system that is inherently unstable and inequitable (Ocampo, 2009; Teunissen and Akkerman, 2007; Teunissen and Akkerman, 2006).

Figure 1: US Current Account Deficit and Real Effective Exchange Rate, 1975-2009



Source: WDI
Note: Real effective exchange rate here is calculated as the inverse of the real effective exchange rate estimated by the IMF.

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Policy responses will depend on the underlying causes of the problem and the constraints imposed by political reality. An understanding of these two factors is important. The analysis will define appropriate policies at the global, regional, and national level. Even if the problem is well-defined the appropriate solution may not be feasible because of *realpolitik*. For example, many experts have criticized the 'exorbitant' privilege the US enjoys because of the role of the dollar as a global currency. However, policies to curb this privilege are constrained by the dominant role of the US in global governance. This is one of the important themes of this paper.

The next section describes the international monetary system and analyzes its fundamental problems. The most significant issue in the analysis is whether these structural problems have fueled the global macroeconomic imbalances and whether the latter played a key role in the 2008 crisis. The argument has important policy implications. For example, if the structural problems of the international monetary system had a minimal role, then the 2008 crisis would be a wake-up call in terms of other aspects of the financial system, particularly the regulatory framework. Attention will then be diverted away from reforming the international monetary system.

Section 3 deals with one of the key features of the international monetary system: the role of the dollar as a global currency and reserve asset. The discussion begins with the well-known Triffin Dilemma and then focuses the debate on whether the exorbitant privilege[2] is actually a negative feature. The benefits of the deep and liquid global financial markets that resulted from this privilege may have offset the costs resulting from the unstable and inequitable features of the international monetary system.

The last part of Section 3 takes off from the premise that the 'exorbitant' privilege has resulted in problems in the international monetary system. This would include the 2008 financial crisis. The argument then proceeds to whether it is the "supply" side or "demand" side that is the primary cause of the problem. This is where the present debate regarding the role of the People's Republic of China (henceforth the PRC), particularly the undervaluation of the renminbi, can be situated.

In Section 4, the political economy of reducing the dollar's role as a global reserve currency is discussed. Measures to reduce global imbalances can be considered without having to involve the role of the US dollar. However, these also have implications for global governance. The likely situation is dominance of the dollar for the foreseeable future. Possible policy prescriptions are put forward in Section 5.

In the latter part of the paper, the implications for East Asian economies will be discussed. *Realpolitik* may deem policy responses at the regional level more feasible than global initiatives. However, *realpolitik* may also affect the viability of implementing these policy recommendations.

2. THE INTERNATIONAL MONETARY SYSTEM

2.1 Is it a Non-system?

After the breakdown of the Bretton Woods dollar-gold exchange standard, the international monetary system evolved into what can best be described as a fiduciary dollar standard (Ocampo, 2009). The dollar remained as the dominant international currency largely by default (Padoa-Schioppa, 2009). There has been no real anchor for the global reserve currency and support for the dollar has been largely based on "confidence" in the economic power and capital

[2] The "exorbitant" privilege afforded to the US by the international role of the dollar is a term attributed to President Charles de Gaulle of France but actually coined by his then finance minister, Valery Giscard d' Estaing.

markets of the US (Teunissen, 2006). The result has been described as a “non-system’” since there are no standard rules governing currency and monetary regimes of economies and the manner in which interventions are applied in case of problems or crises (Gilpin, 1987; D’Arista and Griffith-Jones, 2006; Mateos, Duttagupta, and Goyal, 2009; Visco, 2009).

The fiduciary dollar standard has been weighed down by market failure. The main reason is that exchange rate adjustments and the implementation of policies designed to manage aggregate demand have failed to correct economic imbalances, while international capital markets have proved to be an unreliable source of payments financing (Bird, 2010). The latter is considered the primary weakness of the “non-system” as financial globalization has resulted in volatile capital flows which tend to be pro-cyclical, thus making greater international capital mobility part of the problem rather than a possible solution.

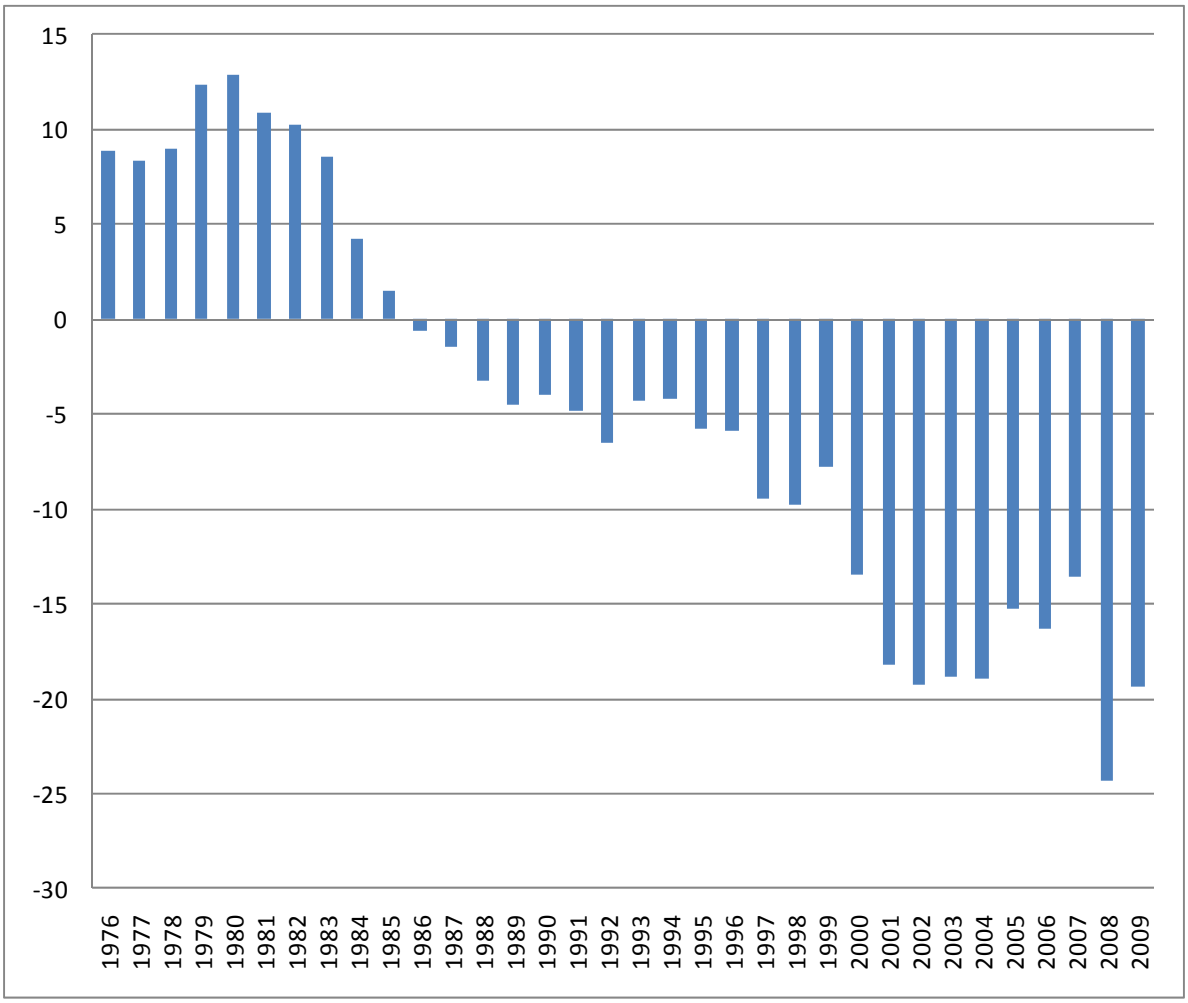
Market failure is the flip side of the fundamental flaws of the system which are described succinctly by Ocampo (2009). The first is that there is a deflationary bias in the global economy since there is no built-in mechanism to assist countries with current account deficits in their adjustment. Meanwhile, economies with surpluses only have an internal reason to adjust and this is related to inflationary pressure. They do not have an “external” source of pressure—the equivalent of creditors for deficit countries—to move towards balance. The second feature is that the system is unstable, which is an outcome of the Triffin Dilemma. This aspect, which relates to the dominant role of the dollar, will be discussed in more detail in Section 3. Finally, the system is inequitable because under the fiduciary dollar standard resources are transferred from economies accumulating foreign exchange reserves to the major economies that issue the global reserve currencies.

The more important issue is whether or not the fiduciary dollar standard is sustainable. The way this issue is addressed in this paper is to determine whether the fiduciary dollar standard contributed significantly to the 2008 global financial and economic crisis. This topic is discussed more extensively in Section 2.2 with reference to the global macroeconomic imbalances. If the fiduciary dollar standard did not contribute to the 2008 crisis—or the relation is weak—then the debate about the former’s sustainability can be resolved based on the arguments that have been made prior to the crisis.

2.2 Explaining Global Macroeconomic Imbalances

Global macroeconomic imbalances have been a perennial feature of the international economy. However, it is only in the past decade that they have reached staggering levels. The net international liabilities of the US have increased sharply since 2000 (Figure 2) and reached a peak of 24% of US gross domestic product (GDP) in 2008, before declining slightly to 19% in 2009. This was mirrored by a surge in international reserves, particularly those held by the PRC (Table 1).

Figure 2: US Net Foreign Asset Position (% of GDP)



Source: Bureau of Economic Analysis

Table 1: Foreign Exchange Reserves of Industrial and Emerging Countries *(In US Million Dollars)*

	INDUSTRIAL			EMERGING							
	US	Japan	EU	China		India	Russia	Indonesia	South Africa	TOTAL	Growth
	Current	Current	Current	Current	Share to Total	Current	Current	Current	Current	Current	(%)
1990	52,193	69,487	-	28,594	4.7	1,205	-	7,353	-	611,739	-
1991	45,934	61,758	-	42,664	6.6	3,580	-	9,151	-	647,372	5.8
1992	40,005	61,888	-	19,443	2.9	5,461	-	10,181	-	674,564	4.2
1993	41,532	88,720	-	21,199	2.8	9,807	5,829	10,988	-	752,362	11.5
1994	41,215	115,146	-	51,620	6.4	19,386	3,976	11,820	-	812,894	8.0
1995	49,096	172,443	-	73,579	7.9	17,467	14,265	13,306	-	934,955	15.0
1996	38,294	207,335	-	105,029	9.6	19,742	11,271	17,820	-	1,089,230	16.5
1997	30,809	207,866	-	139,890	11.7	24,324	12,771	16,088	-	1,197,890	10.0
1998	36,001	203,215	-	144,959	12.4	26,958	7,800	22,401	-	1,167,450	-2.5
1999	32,182	277,708	227,989	154,675	11.9	31,992	8,455	26,245	6,065	1,298,310	11.2
2000	31,238	347,212	218,633	165,574	11.1	37,264	24,263	28,280	5,793	1,486,120	14.5
2001	28,981	387,727	207,817	212,165	13.0	45,251	32,538	27,048	5,765	1,630,880	9.7
2002	33,818	451,458	215,812	286,407	16.2	66,994	44,051	30,754	5,601	1,771,200	8.6
2003	39,722	652,790	188,173	403,251	19.8	97,617	73,172	34,742	6,164	2,035,750	14.9
2004	42,718	824,264	181,196	609,932	25.3	125,164	120,805	34,724	12,794	2,413,610	18.6
2005	37,838	828,813	167,150	818,872	27.1	131,018	175,690	32,926	18,260	3,022,610	25.2
2006	40,944	874,936	184,034	1,066,340	30.5	170,187	295,277	40,866	22,720	3,490,680	15.5
2007	45,804	948,356	203,189	1,528,250	36.0	266,553	466,376	54,737	29,234	4,239,370	21.4
2008	49,584	1,003,670	201,969	1,946,030	40.9	246,603	410,695	49,339	30,238	4,763,730	12.4
2009	50,520	996,955	194,411	2,399,150	46.1	258,583	405,825	60,572	32,432	5,208,370	9.3
2010 QI	48,885	990,926	197,244	2,447,080	44.8	254,685	412,834	66,326	34,779	5,458,700	4.8
2010 Q2	47,557	996,096	194,820	2,454,280	43.1	249,628	422,778	70,609	34,556	5,694,640	4.3
2010 Q3	51,709	1,051,920	206,500	2,648,300	45.9	265,231	447,567	80,520	35,980	5,774,510	1.4
2010 Q4	-	-	-	-	-	-	-	-	-	-	-

Source: IFS

Note: 9.3% growth rate of total reserves in 2010.Q2 is compared to 2009 figure

This section describes how the imbalances are a manifestation of the key features of the fiduciary dollar system. The main issue then becomes whether the global imbalances are sustainable. There are essentially two contending views, labeled either as orthodox vs. heterodox (White, 2007) or equilibrium vs. disequilibrium (Serven and Nguyen, 2010). These categories correspond with each other.

The equilibrium approach emphasizes structural factors and domestic policies that have resulted in the steady accumulation of assets in the US by the rest of the world. This outcome has also been labeled as the ”new Bretton Woods” or Bretton Woods II. Structural factors focus on the capital account and international asymmetries in the supply of and demand for financial assets. The rise in income and wealth of emerging economies leads to an increase in their demand for assets in economies with more advanced financial markets, particularly the US. This is largely because most emerging economies have underdeveloped financial sectors and therefore limited options for portfolio diversification. The increase in demand for US assets is met by widening US current account deficits that raise the supply of these assets for international investors. According to the “equilibrium approach” this situation is sustainable as long as emerging economies continue to grow. If in the future their financial systems become more sophisticated, the global imbalances will narrow.

The other version of the equilibrium approach elaborates on the policy of emerging economies to accumulate external assets. One variant characterizes emerging economies as “new mercantilists”, wherein the desire to maintain export competitiveness leads to an obsession with undervalued currencies. The most straightforward mechanism is to compress domestic spending, particularly consumption, and allocate resources to the export industry. The outcome will be persistent current account surpluses and an accumulation of foreign exchange reserves.

Meanwhile, the rapid accumulation of reserves by emerging economies in the past decade has brought up the possibility that this is a form of self-insurance against the periodic financial crises that have global repercussions. Economies have a precautionary motive to maintain a large pool of reserves. In order to mitigate this need, various economies can practice reserve-pooling. A related proposal will be mentioned in Section 4.3.

The ‘orthodox’ interpretation of the widening of global imbalances follows the equilibrium approach described earlier.[3] The global imbalances are linked to improved relative growth prospects in deficit countries and inflows of foreign capital driven by higher expected rates of return. The more prominent explanation is that the increase in productivity growth in the US attracted capital inflows that strengthened the dollar and resulted in a current account deficit. Meanwhile, the high saving propensities in emerging economies, particularly in Asia, have led to a large savings-investment imbalance. The highly liberalized and more sophisticated financial markets of deficit countries then provided investment opportunities for these surplus funds.

The “disequilibrium approach” posits that the global macroeconomic imbalances reflect a violation of the inter-temporal budget constraint. The latter implies that an economy’s net liability position vis-à-vis the rest of the world at any given time cannot exceed the present value of its future current account surpluses. Analysts point to the steep decline in net foreign assets of the US as an indication that the global imbalances are unsustainable (Figure 2). Rather than being an indication of inter-temporal optimization, the decline reflects excessive private and public spending—i.e., the US has been living beyond its means (D’Arista and Griffith-Jones, 2006). Eventually the imbalances have to be corrected and this can happen in either an orderly or disorderly fashion.

[3] The description of the orthodox vs. less orthodox view is derived from White (2007:63–64;69–71).

The ”less orthodox” view expounded by White (2007) view is an extension of the “disequilibrium” approach. The analysis combines the phenomenon of asymmetric monetary policy and the liberalization of the global financial system. These two factors explain the period of easy credit and low interest rates during most of the 1990s and 2000s.

An anti-inflationary bias has characterized monetary policy in industrialized economies since 1980. Some analysts are puzzled, therefore, by the distinct trend towards easing of monetary policy as reflected in the decline in real interest rates in major industrial countries (White, 2007). The possible reason is an asymmetry in monetary policy wherein the process of easing is more pronounced during times of economic slowdowns than is the process of tightening during economic upturns. The low-interest rate regimes in industrialized countries sparked a surge in capital flows to developing countries (Table 2). The subsequent recycling by official reserve managers of these inflows back into the industrial economies particularly the US has likely pushed down long-term interest rates further.

Table 2: Net Resource flows to Developing Countries and China, 1960-2009 (in current US Billion Dollars)

	Aggregate net resource flows[1]		Total FDI and Portfolio Equity	
	Total	China	Total	China
1982	117	1	11	0
1983	75	3	10	1
1984	72	5	9	1
1985	70	7	12	2
1986	73	8	9	2
1987	87	12	10	2
1988	97	12	18	3
1989	99	10	24	3
1990	139	14	25	3
1991	151	12	36	4
1992	207	28	53	11
1993	253	45	94	28
1994	240	49	113	34
1995	313	57	109	36
1996	316	57	144	40
1997	347	70	185	50
1998	276	33	159	45
1999	237	40	173	39
2000	211	42	163	45
2001	269	88	166	45
2002	218	57	163	52
2003	321	74	179	55
2004	424	103	244	66
2005	592	142	343	99
2006	721	156	454	121
2007	1,262	204	649	157
2008	882	155	544	157
2009	603	148	467	106

Source: World Bank, Global Development Finance

Note: 1 - Net flows on external debt + Net official development assistance and official aid received + Foreign direct investment, net inflows + Portfolio equity, net inflows

The asymmetry in monetary policy was compounded by the liberalization of the global financial system. The latter is epitomized by the passage of the Gramm-Leach-Bliley Act in 1999, which deregulated the financial sector in the US. This Act allowed commercial and investment banks to consolidate, and opened up competition among banks, securities companies, and insurance companies. The sharp deterioration in the net foreign assets position of the US happened in the wake of deregulation of the financial sector.

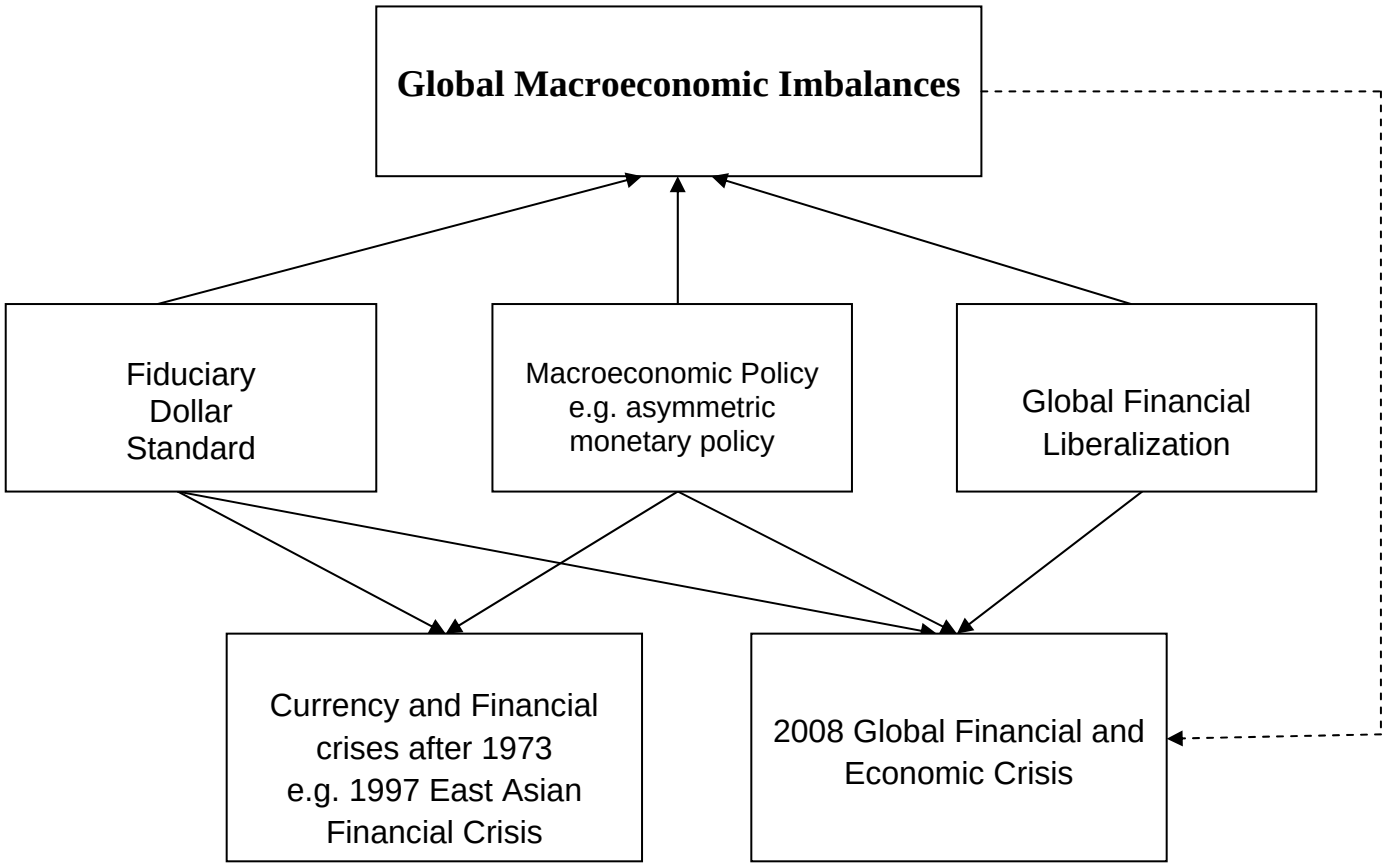
Asymmetric monetary policy and a liberalized global financial system fueled a surge in asset prices in industrialized economies, especially in the Anglo-Saxon countries (White, 2007). Rising asset prices—particularly in the housing sector—led to a positive wealth effect and, combined with easier access to credit, led to increased domestic spending. Greater consumption spending eventually led to a sharp fall in savings. Internal imbalances therefore emerged and led to a widening of existing external imbalances. The recycling of surpluses from emerging economies further contributed to the increase in domestic spending and deterioration in the external imbalances.

To summarize, the fiduciary dollar system has built-in weaknesses that lead to market failure. This was compounded by the liberalization of the global financial system. The result was a widening of the external deficits of many industrialized economies, particularly the US. There are two interpretations of the global imbalances. The “equilibrium” and “orthodox” views tend to treat the global imbalances as a consequence of imperfections in emerging market economies. On the other hand, the “disequilibrium” and “less orthodox” views acknowledge the importance of policies in industrialized economies, including the deregulation of their financial systems. The role of global imbalances in the 2008 crisis will shed light on which view is more credible.

2.3 Global Imbalances and the 2008 Crisis

The framework for analysis is depicted in Figure 3. Perhaps the best way to synthesize the various strands is to acknowledge that the global macroeconomic imbalances and the 2008 crisis have common roots (Obstfeld and Rogoff, 2009; Visco, 2009). The fundamental weaknesses of the fiduciary dollar standard and specific macroeconomic policies contributed to both global macroeconomic imbalances and the 2008 crisis. The vulnerability was exacerbated by the liberalization of the global financial system.

Figure 3: Global Imbalances, Financial Liberalization and the 2008 Crisis



Source: Author

It remains an empirical issue which of these factors—the fiduciary dollar standard, macroeconomic policy, and liberalization of the financial system—and which particular elements of each factor, e.g., different exchange rate regimes, was more influential in driving the global imbalances and triggering various financial crises. A sample of related empirical work is presented in Box1.

An issue that has not been resolved is the possible direct relationship between the global imbalances and the 2008 financial crisis (the dotted line in Figure 3). Perhaps the more appropriate description is of imbalances as a ”handmaiden” to the crisis, i.e., as a more or less central contributor to the crisis (Suominen, 2010). The conventional wisdom is that imbalances relaxed the credit constraint in the US. The accompanying low real interest rates in turn fueled borrowing and the housing bubble.

This is related to the view that the proximate causes of the 2008 crisis were financial in nature and emanated from specific segments of US financial markets. Existing imbalances at that time exacerbated the impact of the crisis, primarily by providing a conduit for rapid propagation worldwide (Visco, 2009). Economic agents had to consolidate their balance sheets and the degree of imbalance made the adjustment process difficult.

The previous discussion refutes two major arguments. One is that the global imbalances are the underlying cause of crisis. Another is that the global imbalances were an essentially benign phenomenon (e.g. Cooper, 2007), reflecting the underdeveloped financial sectors in emerging economies. Both assertions fail to take into account various other factors that have made the international monetary system vulnerable.[4]

3. THE ROLE OF THE US DOLLAR

A recurring theme throughout the post-war evolution of the international monetary system is the role of the dollar as both a global currency and an international reserve asset. This is an issue that cuts across the major areas shown in Figure 3. The major contention is that an international reserve system that is based on a national currency is inherently unstable. This is the famous Triffin Dilemma, which dealt with the primacy of the dollar. The shift to a fiduciary dollar standard exacerbated the situation, which is reflected in the global macroeconomic imbalances. Meanwhile, liberalization of the global financial system encouraged more risk taking, particularly by US investors. The role of the dollar allowed the risk to be spread easily outside the United States.

Parallel to the equilibrium versus disequilibrium approach, there are also conflicting views about the impact of the dollar’s dominance. The discussion also includes the possibility and consequences of a decline in the role of the dollar. The debate spans a generation (see for example Triffin, 1978 and Eichengreen, 2009) and recently gained prominence after the critique of the Governor of the People’s Bank of China (Zhou, 2009). Governor Zhou proposed to “create an international reserve currency that is disconnected from individual nations and is able to remain stable in the long-run, thus removing the inherent deficiencies caused by using credit-based national currencies.”

[4] Frankel (2007) summarizes the nine distinct arguments in favor of the view that the US current account deficit—and by affiliation, global macroeconomic imbalances— is sustainable and not a cause for worry: 1) The siblings are not twins; 2) Alleged investment boom; 3) Low US private savings; 4) Global savings glut; 5) It’s a big world; 6) Valuation effects will pay for it; 7) US as the World’s Banker; 8) “Dark Matter”; and 9) Bretton Woods II. Frankel refutes all these arguments.

3.1 The Triffin Dilemma

The original Triffin Dilemma under the dollar-gold exchange standard can be summarized as follows (Triffin, 1978): a) If the US corrected its persistent deficits, the growth of world reserves could not be fed adequately by gold production at $35 an ounce; but if b) the US deficits continued, its foreign liabilities would far exceed its ability to convert them into gold upon demand, and bring about a dollar and gold crisis.

Under the fiduciary dollar standard, the Triffin Dilemma has different characteristics (Ocampo, 2009; Mateos, et al. 2009; Padoa-Schioppa, 2009). With global capital flows and more flexible exchange rates, US monetary policy has become more independent. The US does not have to deal with the constraint imposed by dollar-gold convertibility as flexible exchange rates in theory should take care of adjusting the demand and supply of dollars. Global liquidity could be provided with the US running persistent current account deficits and/or investing in assets abroad.

Instability in the international monetary system has come about because many economies have chosen to stabilize their currencies in relation to the dollar and hold dollars for that purpose (Padoa-Schioppa, 2010). US monetary policy has therefore been transmitted almost automatically to the rest of the world. More importantly, the system has exempted the US from the discipline with which the other countries have to comply. Triffin's Dilemma could therefore be generalized as follows:

"…the stability requirements for the system as a whole are inconsistent with the pursuit of economic and monetary policy forged solely on the basis of domestic rationales in all monetary regimes devoid of some form of supranationality."[5]

3.2 System Maker and Privilege Taker

The role of the dollar allowed the US to be a "system maker and privilege taker" (Mastanduno, 2009). This is consistent with the primary role of the US in global governance, particularly with regard to security matters. It will be useful to summarize the political-economic factors that led to this state of affairs. The interplay between economics and politics will determine the feasibility of the current proposals to reform the international monetary system.

The term "system maker and privilege taker" suggests a dual role that the US has played in international economic relations over the past 60 years. On the one hand, the US was the primary driver behind the establishment of the liberal economic order. This was highlighted in later years by the Washington Consensus. Subsequently, in the second phase the US "defended that order in the face of internal and external challenges, and in the third phase they enlarged the order geographically and functionally. In each phase, the United States took advantage of its privileged position and was forced to confront systemic imbalances and adjustment struggles."[6]

The relationship to the role of the dollar, particularly during the period of the dollar-gold exchange standard, is explained as follows:[7]

"The U.S. dollar was the lynchpin of the transatlantic and transpacific deal. Freer trade depended on monetary stability, which, in turn, depended on the special role of the dollar. While governments in Western Europe and Japan committed to defending the value of their currencies relative to the dollar, the U.S. government took on the more formidable obligations of

[5] Padoa-Schioppa (2010:11)
[6] Mastanduno (2009:123).
[7] Mastanduno (2009:129–130).

maintaining a fixed value for the dollar in terms of gold and of agreeing to accept dollars from other central banks in exchange for gold at that fixed rate. By upholding a pledge that the dollar was 'good as gold,' U.S. officials provided the confidence that public and private actors needed to embrace the special reserve and liquidity functions of the dollar in the world economy.

This critical role for the dollar granted a well-understood privilege to U.S. policymakers. As long as other governments proved willing to hold dollars, U.S. external deficits could be financed essentially by printing money and lending it abroad, enabling the United States to pursue a variety of foreign and domestic policy objectives without necessarily confronting difficult trade-offs in the short term. Allied governments in Western Europe and Japan were willing collaborators. The dollars held by their central banks financed the U.S. commitment to guarantee their security, including the most tangible manifestation of that commitment, the stationing of U.S. troops on their territories. Equally important, as allied economies recovered during the 1950s and 1960s, their central banks purchased and accumulated dollars in order to prevent local currencies from appreciating beyond the acceptable range of their fixed exchange rates. By meeting their obligations they maintained undervalued currencies, which in turn enabled them to maintain a competitive export position in the large U.S. market.

Robert Triffin famously recognized that this elegant monetary system was based on an inherent contradiction. The United States needed to run balance of payments deficits to supply liquidity to the world economy. But the United States also needed to maintain confidence in the dollar as a store of value—confidence that would be undermined by large and persistent external deficits. The success of the arrangement required U.S. policymakers to strike a delicate balance. They needed to run payments deficits large enough to provide adequate dollar flows to the world economy, yet not so large as to trigger an international crisis of confidence in the dollar.

The U.S. balance of payments needed to be responsive to this precise requirement of system management. American officials were aware of this obligation throughout the 1960s yet ultimately chose to give priority to U.S. policy autonomy. The U.S. balance of payments position was more a function of U.S. domestic and foreign policy choices than a response to the stringent demands of the liquidity-confidence paradox. This became most apparent during the escalation of the Viet Nam War, when the Johnson administration opted for guns and butter—an activist military policy abroad and an ambitious expansion of the welfare state at home—and financed both not by raising taxes but by allowing the expansion of dollar holdings by foreign central banks."

The practical consequences of the dominance of the dollar is that it allowed the US government to dispense with the traditional choice between guns, butter, and economic growth (Mastanduno, 2009; D'Arista and Griffith-Jones, 2006). The deficits of the US were automatically financed by the rest of the world. As mentioned earlier, some analysts have quipped that the US has been "living beyond its means".

3.3 Support from Major Allies

One critical aspect is that this dual role of the US has to be supported by its major global partners. This support is the primary source of "confidence" in the dollar as a global currency and international reserve asset. This was evident in the 1960s when Germany—West Germany in that era—did not join France in criticizing the exorbitant privilege enjoyed by the US. Mastanduno (2009) explains that at that time it was widely recognized on both sides of the Atlantic that the most obvious solution to the US balance-of-payments problem was the withdrawal of US troops from Europe. However, because of its security implications, West Germany made the necessary economic adjustments to accommodate the US deficit.

Teunissen (2009) narrated Triffin's acknowledgement that "Americans and most Europeans saw the maintenance of the dollar as the reserve currency as a way of financing their joint defense".

An interesting issue is how the analysis applies in the context of a fiduciary dollar standard. It has been argued that the "exorbitant privilege" grew stronger under the fiduciary dollar standard because of capital and exchange rate gains on the net liability position of the US. Since a large portion of the US investment position is composed of dollar denominated liabilities and US assets are mostly denominated in foreign currency, there is a built-in protection against the depreciation of the dollar. In addition, data show that, on average, the US enjoys higher returns on its assets than it pays on its liabilities (Norrlof, 2010).

This is related to the argument that the fiduciary dollar standard allowed the US to incur larger current account deficits. Not surprisingly the US current account balance has been in a deficit position since 1981 with a relatively sharp deterioration between 1982 and 1987 (Figure 1). This was the time that there was an immense flow of Japanese capital into the US economy.

Japanese finance came after West Germany's unwillingness in October 1979 to support the dollar and import American inflation (Gilpin, 1987). The latter caused the US to change its domestic economic policy and to shift to a tighter monetary policy. By the mid-1980s, Japan had replaced West Germany as America's principal economic ally. Japanese capital allowed the Reagan administration to simultaneously stimulate US domestic consumption and commence the largest military expansion in peacetime US history (Gilpin, 1987). The issues that were emerging at that time bear a striking resemblance to those that presently confront the PRC and the US (see Box 2).

One of the issues then was whether Japan should establish itself as the financial hegemon of East Asia and not merely subsidize American hegemony. The issue was essentially resolved by the 1986 Baker-Miyazawa deal, which was described as another example of the ability of the US to shift the burden of adjustment onto other countries (Norrlof, 2010). "Not only was Japan persuaded to cut interest rates and stimulate demand through fiscal packages, but the United States used the settlement reached with Miyazawa to extract macro-economic concessions from a recalcitrant Germany."[8] Specifically, West Germany agreed to greater tax cuts than it had budgeted. The Baker-Miyazawa deal came in the midst of the Plaza-Louvre accords in 1985 and 1987, which resulted in a sharp appreciation of the yen vis-à-vis the dollar. The US was therefore able to engineer a strong economic recovery and a soft landing of the dollar.

There is a debate about whether the sharp yen appreciation caused the subsequent stagnation of the Japanese economy for nearly two decades. For example, Corbett and Ito (2010:5) argue that "refusing to accept yen appreciation (not caving in to yen appreciation) was one of the causes of the bubble economy toward the end of the 1980s in Japan." This argument disproves the notion that US pressure was a factor in Japan's economic stagnation. However, Corbett and Ito (2010:3) do admit that "what caused the bubble to expand and become more dangerous was the low interest rate policy of 1987–1989." The latter was part of the Baker-Miyazawa deal. Moreover, the sharp yen appreciation caused the hollowing out of Japan's domestic industry which is an integral part of the economic stagnation. The unemployment rate in Japan increased from 2% in 1980 to 4.8% in 2000. It reached 5.1% in 2009.

Like West Germany, Japan's accommodation can also be traced to America's "security card". As Norrlof argues: "The formal defense commitments that go out to Japan and South Korea also give two of the five largest reserve holders a powerful incentive to prevent American decline."[9] Gilpin was less sympathetic when he stated: "One political and psychological problem is that

[8] Norrlof (2010:153).
[9] Norrlof (2010:186).

such relationship converts the American military into a mercenary force defending Japan in return for Japanese capital."[10] In this context, the imbalance in global governance—which is narrowly defined as the provision of a security umbrella—is the primary source of the global macroeconomic imbalances.

3.4 Does a Problem Really Exist?

The argument made so far is that one of the root causes of the imbalances and instability in the international monetary system is the role of the dollar. However, some analysts tend to overlook this particular problem. After all, the major industrialized and emerging economies benefited from the dollar-based system. They have gained access to the large open market of the US which aided their export-led development strategies. The projection of US military power protected the flow of vital raw materials. The security umbrella provided political stability, which is crucial to investment decisions. It also enabled these economies to allocate more resources to improving their productivity. In other words, these economies should consider the instability of the international monetary system as a quid pro quo for their overall development.

Some analysts have argued that dollar dominance is a reflection of the US economy's large size, credible monetary policy, and the dollar's high liquidity, rather than a symptom of an unfair international monetary system (Brouwer, 2007). This is echoed by Mateos, Duttagupta, and Goyal, (2009:7) when they state:

"That said, while in the early decades of the Bretton Woods system the dollar's primacy was rooted in law, this has not been the case for the past 30 years: dollar reserves have been accumulated as a matter of choice and the track record of U.S. policies over decades has, in the main, helped preserve macroeconomic and financial stability. Its open capital account and deep financial markets have contributed to growth in global trade in goods and assets, as scale economies in the use of the dollar have materialized. In that sense, the relative return on assets could be seen as payment for world banking services, and what privilege the dollar enjoys is an earned one."

These views are reflected in various proposals related to the imbalances. For example, Kregel (2009) points out that the deflationary bias of the fiduciary dollar standard implies that the most fundamental problem of any international monetary arrangement is the operation of the adjustment mechanism in the face of global imbalances, rather than the specific asset that serves as the international currency.

The credibility of the dollar based on liquid markets and a highly sophisticated financial system is a self-reinforcing feature (Eichengreen, 2009). Foreign investors undertake their transactions and concentrate their holdings in US markets because these markets are liquid, and that activity, in turn, makes them more liquid.[11] This can be described as the "first-mover advantage" which was echoed by Triffin when he lamented the large role played by "routine and fear of change" when it comes to reform of the international monetary system (Teunissen, 2009).

In other words, the use of the dollar is driven primarily by sheer inertia. Another perspective is that monetary privilege facilitates commercial expansion and, at the same time, commercial strength reinforces the monetary privilege (Norrlof, 2010).

That the status quo is not sustainable should be evident from the discussion in Section 2. The fiduciary dollar standard is prone to generating macroeconomic imbalances and periodic financial and currency crises. While many economies have benefited from the liberal economic

[10] Gilpin (1987:338).
[11] Eichengreen (2009:57)

order that was supported either directly or indirectly by the fiduciary dollar standard, many emerging and low income countries can develop faster with a more stable international monetary system.

3.5 Demand Side versus Supply Side

Addressing the shortcomings of the fiduciary dollar system has a similar dimension to the issue of global macroeconomic imbalances. Should the focus of adjustment be on the demand side or the supply side? The latter postulates that the US exploits its exorbitant privilege and spends too much. On the other hand, emerging economies, particularly the PRC, take advantage of the deep and liquid US financial markets and channel their surpluses into US treasury bills.

The previous discussion emphasized the supply side based on the role of the US as a system maker and privilege taker. However, some analysts are critical of the single-minded pursuit of an export oriented strategy by certain economies (e.g., Jones, 2009). The current account surpluses generated by this strategy created a savings glut which found its way into dollar denominated assets. Because of the surge in investible funds "US financial institutions quite literally did not know what to do with the vast pool of liquidity at their disposal and so they switched from investing in the real economy to speculating in financial instruments."[12]

The demand side of the debate does not quite jibe with the empirical results described in Box 1. However, even a cursory look at the data indicates that the surge in imbalances emanated primarily from the supply side. The faster deterioration of the net international investment position of the US (Figure 2) occurred after financial markets were deregulated in 1999. This has been accompanied by a steady climb of the PRC's share in international reserves beginning in 2001.

While it can be argued that the PRC's current account surpluses have risen sharply since 2005 (Table 3), this was actually accompanied by an increase in the net international liabilities of the US after 2005. The PRC's current account surplus at its peak, moreover, was only half of the US current account deficit.

[12] Jones (2009:69).

Table 3: Current Account Balance of China

	% of China GDP	% of US GDP
1995	0.22	0.02
1996	0.85	0.09
1997	3.88	0.45
1998	3.09	0.36
1999	1.95	0.23
2000	1.71	0.21
2001	1.31	0.17
2002	2.44	0.33
2003	2.80	0.41
2004	3.55	0.58
2005	7.13	1.28
2006	9.34	1.90
2007	10.64	2.64
2008	9.64	3.04
2009	5.96	2.10

Source: WDI, ADBKI

4. POLITICAL ECONOMY OF REFORM

Reforming the international monetary system has two related dimensions. The first would be to implement measures intended to directly narrow macroeconomic imbalances. This would limit opportunities to exploit the exorbitant privilege of the US. The only way for these imbalances to be efficiently narrowed would be through a significant increase in US net exports (Grenville, 2010). The second approach would be to dilute or even eliminate the exorbitant privilege by reducing the role of the dollar as a global currency and international reserve asset. The various proposals and their prospects are discussed in this section.

4.1 Narrowing Global Imbalances

Global macroeconomic imbalances actually narrowed in the aftermath of the crisis. The US current account deficit fell to 2.7% of GDP in 2009, the lowest level since 1998 (Figure 1). Meanwhile, total international reserves grew by only 9.4% in 2009 after recording double digit growth rates between 2004 and 2008 (Table 2). Admittedly, this was a direct consequence of the crisis. Economic agents had to adjust their balance sheets and spending in response to the bad debts that materialized.

The key question is whether this trend can be sustained. The International Monetary Fund (IMF) projects that the US current account deficit will be 3.2% and 2.6% of GDP in 2010 and 2011, respectively.[13] This is partly in response to the depreciation of the dollar. Nevertheless, it is difficult to imagine further consolidation given the unemployment problem in the US. Moreover, no long-term change in the investment-saving balance can be expected, unless appropriate

[13] Forecasts of current account balances of the US and the PRC are obtained from the October 2010 IMF World Economic Outlook. http://www.imf.org/external/pubs/ft/weo/2010/02/pdf/c2.pdf

fiscal measures are put in place. Given the lack of political will in the US with regard to raising taxes[14], global macroeconomic imbalances from the supply side are expected to persist.

Meanwhile, the PRC's current account surplus fell to 6% of GDP in 2009 (Table 3) and the IMF projects a further drop, to 4.7%, in 2010, before a slight recovery, to 5.1% of GDP. In this context, the analysis should focus on whether the PRC will allow the renminbi to appreciate significantly. There are several reasons why this is unlikely.

One, there are sound theoretical reasons why an appreciation of the renminbi will not generate the desired effects (McKinnon, 2010). These reasons are related to the fact that imbalances are both reflected in the current account and the disparity in savings and investment levels. An exchange rate adjustment may be coursed through the difference between savings and investment, thus negating changes in exports and imports due to price movements.

Two, the PRC is aware of the adverse effects on the Japanese economy of the sharp appreciation of the yen between 1985 and 1987. Hence, it is adopting a more cautious policy.

Three, which is closely related to the second aspect, the level of development of the PRC in 2010 is much lower compared with Japan and Europe at the time there were major adjustments in the international monetary system in which they were involved. The data are shown in Table 4. It can be argued that Europe bore the brunt of the adjustment in the 1970s, while Japan absorbed the largest impact in the 1980s (Mastanduno, 2009; Norloff, 2010). The data show the importance of Europe, Japan, and the PRC to the US at various stages. In 1970, Europe—as represented by the European Union 15—had a relatively large share of US securities (32.8% based on 1978 data), but the US accounted for a relatively small share of its export market, namely 7.9%. Japan in 1985 accounted for 10.5% of US securities, but the US market share of its exports was 37.6%. The PRC in 2009 held 15.2% of US securities and 18.4% of its exports went to the US.

Table 4: Comparison of Macroeconomic Indicators

	GDP per capita (constant 2000 USD)	US share in exports (percent)	Unemployment rate (percent)	Holdings of US treasuries (share in %)*
EU 15 (1970)	10,983	7.9	2.3	32.8
Japan (1985)	27,012	37.6	2.6	10.5
China (2009)	2,206	18.4	4.3	15.2

**Data are 1978 for EU 15, 1984 for Japan*
Sources: WDI, WITS, ADBKI, BLS, IFS, ILO, US Department of Treasury

While all three economic power blocs were fairly important to US in the periods cited—albeit at varying degrees—Europe in 1970 and Japan in 1985 had much higher per capita incomes than the PRC in 2009. Both also had lower unemployment rates than the PRC in the same years.

[14] Evidence of this lack of political will to deal with fiscal consolidation was the signing of a bill containing a package that retained Bush-era tax rates for all taxpayers, including the wealthiest Americans, by President Obama in December 2010. This is a provision Mr. Obama himself and congressional liberals opposed.

Therefore, it will be more difficult for the PRC to perform the roles that Europe and Japan did in terms of economic adjustment.

Four, the PRC does not share the same security concerns as Japan and Europe. Hence it does not have the same incentive to bear an inequitable share of the burden in consolidating the global macroeconomic imbalances. As a matter of fact, the PRC is usually on the "opposite side" with regard to regional conflicts and disputes. These include, among others: i) the North Korea issue where the PRC is perceived to support the former; ii) the dispute over the Spratly Islands, wherein the PRC has a claim along with the Philippines; Viet Nam; Taipei,China; and Malaysia[15]; iii) the lingering issue with regard to Taipei,China, with the US being bound by the Taipei,China Relations Act of 1979[16]; and iv) border disputes with Japan, India, and Viet Nam.

Lastly, the PRC has apparently taken steps to reduce its holdings of US Treasuries. During the first seven months of 2010, the PRC not only refrained from buying any more US government paper, but even began to sell its holdings. At least one analyst has pointed out that this is the primary reason the US has been criticizing the PRC more heavily about the undervaluation of the renminbi.[17]

Given these considerations, it is highly unlikely that concrete measures will be taken by either the US or the PRC to narrow the global imbalances in the near future. An impasse between the two countries is likely to ensue.[18] Attention, therefore, will be on international and regional efforts to reduce the role of the dollar as a global currency and international reserve asset.

4.2 Reform of the International Financial Architecture

Proposals for reform of the international financial architecture range from the ambitious—a single global currency as proposed by noted economists such as John Maynard Keynes and Robert Mundell—to more practical measures, e.g., expanding the use of Special Drawing Rights (Ocampo, 2009; Zhou, 2009; Padoa-Schioppa, 2010; Eichengreen, 2009). Exchange rate arrangements have also been proposed, like the recommendation of a common currency between the US and Europe accompanied by monetary unions among countries with similar economic structures—which would result in regional currencies (Campanella, 2010).

Reducing the role of the dollar would also require replacing the liquid and highly sophisticated financial systems that are anchored on the dollar. For example, financial markets where the Special Drawing Rights can be traded should be created.

All these proposals, however, require collective action, particularly among the major industrialized economies. Given the dominant role of the dollar, the US is unlikely to support any

[15] (In the middle of 2010, the US raised the stakes in this controversy by rejecting outright the claim of the PRC on the Spratly Islands.)

[16] See HR 2479(http://thomas.loc.gov/cgi-bin/bdquery/z?d096:H.R.2479:).

[17] This paragraph is based on the op-ed column of Hans-Werner Sinn entitled "Fair-weather Friends" that appeared on page 4 of the Business World, October 28, 2010, Volume XXIV, Issue 68.

[18] It remains to be seen whether the state visit of President Hu Jintao to the US in January, 2011 will break the impasse. The Joint Statement released by the Office of the Press Secretary (2011) contains an encouraging reference to "using the full range of policies to strengthen the global recovery and to reduce excessive imbalances and maintain current account imbalances at sustainable levels." With regard to specific economic policies, "the United States will focus on reducing its medium-term federal deficit and ensuring long-term fiscal sustainability, and will maintain vigilance against excess volatility in exchange rates" while "China will intensify efforts to expand domestic demand, to promote private investment in the service sector, and to give greater play to the fundamental role of the market in resource allocation. China will continue to promote yuan exchange rate reform and enhance yuan exchange rate flexibility, and promote the transformation of its economic development model."

drastic change in the current international monetary system. With the ”exorbitant” privilege, the US has more of an incentive to maintain the status quo.

Moreover, the US still bears a disproportionate share of responsibility with regard to global governance. Table 5 shows that the US is by far the largest military spender in the world. In 2009 defense spending in the US accounted for 4.6% of GDP[19] and 17.9% of central government expenditure. Reducing the US dollar’s role (and fiscal consolidation) is likely to be accompanied by a diminished global presence of American security. Since both Europe and East Asia rely on the US economically and militarily, collective action to dislodge the dollar as a primary global reserve currency is unlikely.

Table 5: Cross-country comparison of military expenditures

Share of world military expenditures (%)	1988	2007	2008
US	41	44	45
Euro-16	NA	15	15
EU-12/EU-27	16	22	21
PRC*	1	5	5
Japan	3	4	3
Soviet Union/Russia	18	3	3
India	1	2	2

Source: Table 2.1 of Norrlof (2010), Data from Stockholm International Peace Research Institute (SIPRI)
*Note: *1989 figure for the PRC*

4.3 Reform at the Regional Level

Given the grim prospects for narrowing global imbalances and reforming the international financial architecture, the best chance for meaningful change in the international monetary system seems to lie in regional efforts. Asia has made great strides in the area of regional cooperation and integration (e.g., ADB, 2008). Financial and monetary cooperation has figured prominently, as epitomized by the Chiang Mai Initiative and its multilateralization.

Financial and monetary cooperation has also explored means to reduce dependence on the dollar for international transactions. For example, extensive work has already been done on the Asian Bond Markets Initiative (ABMI) and the Asian Bond Fund (ABF). This is part of a concerted effort to develop capital markets in the region and reduce dependence on US financial markets.[20]

Proposals have also been made for closer exchange rate coordination, the establishment of an Asian Currency Unit, and eventually a regional currency. Rising intra-regional trade in East Asia provides a basis for increased exchange rate coordination. The establishment of a regional currency will allow members to reduce their reserves significantly, as was the experience in the Eurozone.[21] This will reduce dependence on the use of the dollar.

[19] In comparison Russia spent 4.3% of GDP, the PRC spent 2%, and India spent 3%.
[20] Development of the financial market should also include the short-term capital market. In addition, efficient forward markets as well as other foreign exchange derivatives should be developed to allow firms to hedge the exchange rate risk. The author is grateful to Professor Shin-ichi Fukuda of the University of Tokyo for these recommendations.
[21] The last two points were shared by Professor Fukuda.

However, similar to reforms to reduce the dominance of the dollar at the international level, these initiatives are constrained by the collective action problem. In the case of East Asia cooperation between Japan and the PRC is a *sine qua non* for regional monetary cooperation to succeed. Certainly both countries have to overcome their political differences, particularly on security issues.

After a rather lengthy discussion on the role of the dollar and the need to reduce global imbalances, prospects at the regional level have come down to a very well known fact: Japan and the PRC need to cooperate more closely, both politically and economically, for East Asian economic cooperation and integration to progress, and for the region to be significantly insulated from the vagaries of the global economy.

5. POLICY IMPLICATIONS

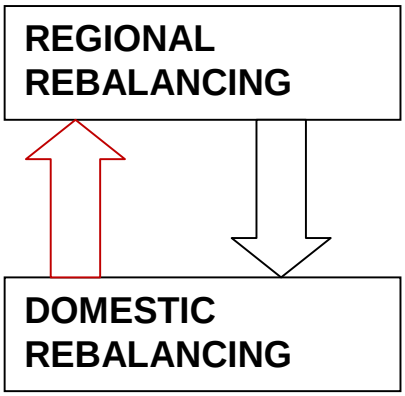
Since fundamental reform will take some time, East Asia has to contend with the fiduciary dollar standard for the foreseeable future. In the short-term the more crucial aspect is dealing with capital inflows. The latest source of these inflows is the US policy of looser monetary policy implemented through quantitative easing. Adjustment will be difficult for developing countries which are experiencing relatively strong economic growth and inflationary rather than deflationary pressures. Three macro policy alternatives are available for developing countries (Brahmbhatt, et al. 2010). Which of the three options is most suited for a particular economy is a topic beyond the scope of this paper.

The first option is to pursue independent monetary policies that target their own inflation and activity levels, combined with relatively flexible exchange rates and open capital accounts. The second would be to maintain a fixed exchange rate peg and open capital account while ceding control of monetary policy as an independent policy instrument.

Another option is implementing capital controls, which have proven be effective in several economies (see for example Epstein, Grabel, and Jomo, 2004). However, with the advent of greater financial integration, capital controls, particularly on inflows, have to be endorsed at the international level to be effective (Grenville, 2007). Given that this would require IMF endorsement, international backing of any form of capital controls is unlikely. Hence, endorsement at the regional level would be a second best solution.

In the longer term, the region should pursue rebalancing. Since a favorable external environment is crucial for achieving sustainable economic growth and the timing of recovery of industrialized economies is uncertain, rebalancing the sources toward greater domestic and regional demand is important. In this context, it is important to distinguish between rebalancing at the regional level and rebalancing at the national level (or domestic level) and to assess how these two processes relate to each other. A framework as shown in Figure 4 should be developed and be the basis for appropriate policies.

Figure 4: Linking Regional and Domestic Rebalancing



Source: Author

Some experts have noted that Asia's outward-oriented development model does not need to be overhauled. What will be required is adjustment in net exports and some shift toward production for Asian demand. In other words, the main thrust of regional rebalancing should be an increase in intra-regional trade and investment among East Asian economies, but with more of the final exports going to economies in the region instead of the US and Western Europe. In order to facilitate this transition, some economies have to import more from their neighbors, which implies increasing their domestic spending, i.e., consumption and investment. The strategy of coordinating regional and domestic rebalancing will allow the economies of East Asia to retain their outward orientation and overcome the threat of protectionism.

Box 1: Empirical Evidence Related to Global Macroeconomic Imbalances

The study of Obstfeld and Rogoff (2009) contains a footnote—number 5— listing various empirical studies that can help shed light on various issues related to the debate between the equilibrium and disequilibrium views. The relevant quote is as follows:

"Gruber and Kamin (2008) argue that as an empirical matter, conventional measures of financial development explain neither the size of the net capital flows from emerging to mature economies, nor their concentration on U.S. assets. Gruber and Kamin also argue that U.S. bond yields have been comparable to those of other industrial countries, contrary to the view that American liabilities have been especially attractive to foreign portfolio investors. Acharya and Schnabl (2010) show that banks in industrial surplus and deficit countries alike set up extensive asset backed commercial paper conduits to issue purportedly risk-free short-term liabilities and purchase risky longer-term assets from industrial deficit countries, mostly denominated in dollars. This finding also throws doubt on the hypothesis that emerging-market demand for risk-free assets that only the U.S. could provide was the underlying cause of the U.S. current account deficit."

Serven and Nguyen (2010) briefly look at the studies that determine whether accumulation of foreign international reserves was prompted by a precautionary saving motive or by a desire to prevent currencies from appreciating,**

“Even if we accept the view that the accumulation of international reserves, or external assets more broadly, was a deliberate policy choice of emerging economies, the question remains whether it was driven by caution against the volatility of international capital flows, or by the pursuance of competitive exchange rates. Assessing the relative weight of these two factors is not an easy task. Moreover, their respective roles likely differ across countries and over time. Aizenman and Lee (2007) examine the question empirically using data from 49 countries in the 1980 - 2000 period, and conclude that both motives were at work, but the precautionary saving motive was more important. Jeanne and Ranciere (2009), in turn, conclude that the accumulation of external assets after 2000 has been too large, particularly in Asia, to be justified by the precaution motive alone.

“On the other hand, if deliberate policy choices of the economic authorities had been the main force behind the accumulation of assets on the United States, capital inflows to the U.S. should reflect a dominant role of official flows over private flows. Data show that the picture is more mixed. Net purchases of U.S. assets by official entities (central banks and other government bodies) from emerging markets in Latin America, Asia and the Middle East have grown increasingly large in the 2000s. After the onset of the crisis in 2007, they became the sole source of inflows from these countries. However, over the decade as a whole the total volume of emerging - market official inflows to the U.S. was roughly on par with that of private inflows.

Thus, the big role played by private capital in the total flows from emerging markets in the run up to the crisis seems to lend some support also to the first version of the equilibrium approach summarized earlier, which explains global imbalances primarily on the basis of asymmetries in the supply and/or investors’ demand for international assets. Forbes (2010) offers some corroborating evidence, based on an analysis of the geographic origin of private capital flows to the U.S. She finds that investors from countries with less developed financial markets tend to hold greater shares of their investment portfolios in the U.S. This fact in accordance with the equilibrium approach views of Caballero, Fahri and Gourinchas (2008a,b) and Mendoza, Quadrini and Ríos - Rull (2009) discussed above.”

The relevant references can be found in the studies. There is an apparent contradiction in the findings.

**Serven and Nguyen (2010:10).

Box 2: International Finance Issues Centering on US-Japan, mid-1980s

One of the seminal works in international political economy, The Political Economy of International Relations by Robert Gilpin (1987), provides a section on the Nichbei Economy and its Prospects. He was referring to the increased integration of the US and Japanese economies. The issues he raised bear striking resemblance to the discussion of the political and economic relations of the US and the PRC after the first decade of the 21st century. Some excerpts:**

"…The United States therefore finds itself caught in a vicious cycle. On the one hand, it requires foreign capital to finance its budget deficit. On the other hand, the availability of foreign capital causes a greatly overvalued dollar and weakens its industrial base. A weakened economy in turn increases the need for foreign capital, and the drain of interest payments further undermines the competitiveness of the economy.

"…Doubts have also arisen on the Japanese side…A number of political and economic leaders have begun to ask whether it is in the long-term interest of Japan to finance American prosperity and the international hegemony whose primary concerns are different from Japan's. The view that Japan could make better use of its newly granted financial power and emergent role as a financial center was expressed in a report by the influential Nomura Research Institute…In brief, Japan should establish itself as the financial hegemon of the fastest growing region in the world and not merely subsidize American hegemony."

"…Would Japan continue to support the dollar, or would it ally itself with Western Europe?..Whatever decisions the Japanese make regarding the use of their growing financial power will have profound significance for the future of the international economic and political system."

**Gilpin (1987:337–338)

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