Anton Malkin
Balsillie School of International Affairs
Wilfrid Laurier University
Waterloo, ON, Canada
amalkin@balsillieschool.ca

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Wilfrid Laurier Uiversity
Waterloo ON, Canada

Global Imbalances: a Domestic Political Economy Approach

This paper seeks to address a theme that has largely been the domain of macroeconomists: the persistence of imbalances in savings and investment among key economies across the world (commonly known as global imbalances) in the face the largest financial crisis since the Great Depression. To approach this phenomenon from a political science perspective, I examine the domestic policy roots of, and responses to, the global financial crisis, tracing the relationship between the macroeconomic causes of the crisis—the large and growing imbalances in global savings and investment. The latter refers not to the regulatory and legal aspects affecting global financial flows[1] but to the domestic politics of income distribution, consumption and social welfare.

More specifically, I focus on the symbiotic relationship between the trade surplus/capital exporting countries and the deficit countries, taking China and the United States as case studies, respectively. Given the widely held-expectation that a crisis originating in the United States would lead to a collapse in the value of the US dollar, and to the contraction in global trade and financial flows that would inevitably follow, this paper proceeds to ask the question: why do global imbalances continue to be sustained? Financial commentators, economists, and central bankers have analyzed the issue of global imbalances extensively. However, there appears to be little consensus as to why a huge glut of savings and a huge dearth thereof, continues to characterize the global financial system. In this paper I suggest a domestic political economy framework for analyzing the puzzling outcomes of the global financial crisis. I argue in the US and in China, political processes directly conditioned patterns of savings and investment. The former adopted a policy of increasing investment in the housing sector to maintain domestic demand and employment in the face of stagnant incomes among lower and middle income households; the latter opted for a policy of repressing domestic demand by subsidizing the banking and state-owned corporate sector to attain high levels of growth and investment. These processes were mutually reinforcing and created significant pressures on policymakers to sustain them; and these pressures are first and foremost political rather than economic.

To be sure, my domestic-based political economy argument is not the only possible alternative to the existing literature. In addition to the famous market-based approach to explaining the resilience of global imbalances (The Bretton Woods II hypothesis) this paper will explore other approaches in the International Political Economy literature in order to justify why a domestic political economy approach was chosen. Power-politics approaches stress the ability of the United States, as well as prominent dollar holders like China, to delay the burden of adjustment associated with an unwinding of global imbalances; constructivist approaches stress the cultural influence of domestic consumption in deficit countries and that of savings in surplus countries; and finally, radical/critical approach stress the influence of transnational elites, which link Chinese coastal exporters with US financial interests. I will, instead, take a domestic political economy approach, which stresses the salience of domestic political arrangements—electoral politics in the US and the politics of social stability in China, respectively—above international ones. To be sure, the competing explanations are not

[1] The politics of national regulation and their contribution to the crisis are a crucial subject of study but they are beyond the scope of this paper.

argued to be 'wrong', as each of them tells an important part of the story of the outcomes of the crisis. However, the domestic political economy approach is most appropriate for connecting the dots between the micro and macro picture of the crisis—between the apparent lack of change in the domestic political and economic institutions in China, the US and elsewhere[2], and the persistence of global imbalances. To put it another way, the domestic political economy approach explains why we have lived through what could be described as the wrong type of crisis: a crisis *caused by* global imbalances but not a crisis *of* global imbalances.

Global Imbalances and the global financial crisis

In the half decade leading up to the global financial crisis, the existence of large imbalances in global trade and capital allocation has been a subject of concern and intellectual interest for academics, financial journalists and policymakers alike. The global financial crisis has certainly seen an immediate shrinking of surpluses and deficits of the current accounts of key economies, as spending collapse in many parts of the world (See Obsfeld and Rogoff 2009). However, we are increasingly seeing a reversion to familiar patterns of the last decade as global recovery slowly takes hold (see IMF 2010, pp. 4-9). This paper focuses on the microeconomic factors that form the building blocks of these macro-imbalances—the individually devised yet symbiotic financial structures in the United States and China and their political underpinnings. First, a brief definition of global imbalances, as well as their contribution to the crisis is in order. Global imbalances, broadly conceived, refer to the imbalance in trade and financial flows taken together, as defined by basic accounting identities occupied by different consuming and producing countries worldwide. In other words, they refer to an imbalance, broadly conceived, of saving and investment, whereby some countries produce in excess while others consume in excess.

These imbalances are therefore in the macroeconomic realm, in that they refer to current accounts between different countries and do not include the savings and consumption differences between different income groupings within individual countries or the earnings and productions structures of global firms headquartered in particular countries. However as I will discuss, these differences are significant to the ways in which global imbalances have emerged and are sustained. The 'global' variable in the notion of macroeconomic imbalances implies the fact that there is an endemic and sustained but unsustainable glut of savings and restrained consumption by some countries and a corresponding sustained unsustainable excess of asset-based investment and excess consumption by others. The former refers to such countries as Germany, oil-exporting countries in the Middle East as well as Russia, Japan, China, and smaller East Asian states like South Korea. The latter refers to countries like East, South, and Northern European countries like Spain, Ireland, and the UK, and, of course, the global consumer of last-resort—the US.

Before proceeding with the analysis, a few caveats must be established. First, I should indicate what could be interpreted as a normative component to my argument—that global imbalances are inherently harmful to the economic health of the actors involved. This paper therefore assumes that global imbalances, in effect, have created the conditions that allowed the crisis to take place. As I will explain, there are several schools

[2] In particular, the last section of this paper broadens the analysis and applies it to Europe.

of thought that dispute this position. However, the position taken in the paper is that a growing current account deficit in the US and a growing financing of that deficit by China and other emerging economies through the purchase of private and public US debt, were ultimately responsible for allowing excessive risk to spread throughout the global financial system. This risk was based in increasing borrowing in the domestic household market, which sustained a historically high level of growth in purchasing power, despite an effective stagnation in real incomes (Kumhof and Rancière 2010). Fundamentally, then, the crisis was rooted not in the inability of foreigners to finance US deficits but in the inability of the US to absorb this debt (Wolf 2008). The most significant observation, then, is that flows of capital from emerging economies (which are characteristically "poor" on a per-capita income measure) to wealthy advanced countries are not a 'natural' or market-based phenomenon but rather a product of the differences in the types of financial systems on each side of the savings-investment divide (Austin 2011). As this paper will show, these financial systems have both political origins and consequences.

Second, for the sake of simplicity, global imbalances will be modeled on the bilateral relationship between China and the US. Because this is a theory-building endeavor, the China-US example serves as a preliminary model for understanding the domestic political economy implications of global imbalances. Lastly, it is not entirely necessary to include a wider array of actors because the globally significant savings gap in the US and consumption gap in China, along with the latter's outsized holdings of the latter's debt illustrate the micro causes sufficiently.[3]

Surveying the literature

The literature on global imbalances and the financial crisis typically portrays the issue in the macroeconomic sense of the term. That is, the literature usually examines the problem as that of a misallocation of savings and investment at the global level. Barry Eichengreen (2007) has aptly categorized the issue as a collective action problem involving core and periphery actors in the global monetary system, spanning development and trade-related interests of key emerging economies and creating discord and economic conflict at the international level. Others have prominently taken sides in the global imbalances debate, blaming either current account surplus countries, or current account deficit countries. Martin Wolf (2008), following Ben Bernanke's warnings some six years ago (see Benanke 2005) has argued that the blame for creating unsustainable global macroeconomic conditions can be placed on the repression of interest rates on US dollar equities by emerging economies. By engineering a glut in domestic savings these countries reversed the traditional flow of credit from the advanced world to the emerging world. Wolf goes further than Bernanke is deliberately labeling emerging economies, and China in particular, as practicing "mercantilist" trade policies—deliberately maintaining an undervalued currency to gain a trade-related advantage. Goldstein and Lardy (2009) make a similar case, albeit stopping short of attaching the 'mercantilist' label onto China. A competing argument holds that the US current account deficit should not be blamed on successful export-oriented economies, and that trade surpluses can happen without any deliberate distortion macroeconomic practices. Persaud (2011), for example, cites the example of Germany, which maintains a high savings rate, whilst giving up its monetary

[3] For a more global view of global imbalances, see Wolf 2008; Eichengreen 2007; Obstfeld and Rogoff 2009.

sovereignty up entirely. More recently (and probably for political reasons) Ben Bernanke tried to strike a more neutral argument, positing that "the global imbalances were the joint responsibility of the United States and our trading partners, and although the topic was a perennial one at international conferences, we collectively did not do enough to reduce those imbalances" (Bernanke 2009). This neutral stance is reflected in the present literature as well. As Obsfeld and Rogoff (2009, pp. 3-4) argue, "the United States' ability to finance macroeconomic imbalances through easy foreign borrowing allowed it to postpone tough policy choices, [and] at the same time, countries with current account surpluses faced minimal pressures to adjust. China's ability to sterilize the immense reserve purchases it placed in U.S. markets allowed it to maintain an undervalued currency and defer rebalancing its own economy."

There are also others who do not consider global imbalances to be a problem in the first place. The most famous of such critiques comes from a school of thought commonly defined by the Bretton Woods II argument, which sees the emergence of global imbalances as a natural and sustainable international economic order—an informal continuation of the Bretton Woods monetary system that was dismantled in 1971. As Michael Dooley, David Folkerts-Landau, and Peter Garber (DFG) have long argued, global imbalances are neither unsustainable, nor are they the primary cause of the global financial crisis.[4] According to the prominent argument that sees the current global monetary system as a fulfillment of mutual interests among emerging economies like China (and oddly enough Japan, which has long graduated from this label) and the United States. The former need to keep their currency deliberately undervalued to achieve rapid growth through exports in order to promote a rapid development of their economies and the latter needs external financing to substitute for its low domestic savings rate. Moreover, as DFG had predicted, because this system is mutually advantageous, the crisis will not lead to its demise. Indeed, in what seems like a prescient assessment, DFG had stated that "we will still have the same outcomes for current account relation between Asia and the US, the same low real risk free rates in the industrial countries, and eventually the same accumulation of foreign exchange reserves, just on a subdued scale" (Dooley et al 2009). And to be sure, DFG were not at all wrong in their predictions. Balance of payments in the US as well as China did contract rather rapidly at the height of the crisis, but at the present moment, prospects for rebalancing in the near future appear rather dim (Beattie 2010).

However, none of this literature presents an adequate explanation of global imbalances have developed and why they continue to be sustained. Many of the authors simply assume that the actors involved benefit from the dynamics of global savings and investment without teasing out what these benefits might be. Why are these dynamics important? It has been a long-standing cliché that all politics is local. And this is true even for a subject as seemingly borderless as international finance. Indeed, global imbalances may reflect the disparate decisions of international investors, but these incentives are inherently conditioned by the regulations and macroeconomic policies of key states. While a macro-level analysis of global imbalances aptly describes *how* the crisis came to be and how countries responded to it, a micro-level analysis is better at

[4] Others have made a similar case, albeit without relating to the Bretton Woods II logic, See, for example, Cooper 2006, 2007; Mendoza et al 2007.

explaining *why* the crisis originated and why we have seen a continuation of global imbalances thereafter.

Accordingly, the problem with the Bretton Woods II argument is not so much in its form but in its substance. While it seems yield an accurate approximation of the present situation, it only assumes that a glut of savings in China and a dearth thereof in the US (as well as in other surplus and deficit countries) are in the interests of both. Even if one accepts the argument that global imbalances have no bearing on the global financial crisis, there is no a priori reason to accept that both countries benefit from the present situation. And when one takes into account the stagnant incomes and the debt burden in the US (Kumhof and Rancière 2010, p. 22) as well as the transfer of wealth from households to the state sector in China (Aziz and Cui 2007), it becomes much more difficult to accept the benefits of global imbalances as something of a given.

Micro foundations: Financialization and Demand Repression

What are these micro-foundations and how do they feed into the macro-foundations of the global financial crisis and the responses thereto? While it is widely acknowledged that the global financial crisis is tightly connected to the economy of homeownership in the United States, the political economy of homeownership and household indebtedness is much less frequently discussed. It is indisputable that the current account deficit in the US is due to a relatively large dearth of savings among households. However, the sources of the 'spendthrift' behavior of the US consumer are as much domestic as they are international. As Kumhof and Rancière (2010) have recently found, an important correlation exists between the stagnation in income of the bottom 95% of the US population and the increased indebtedness of the US consumer. In other words, stagnant incomes require outsized consumer spending to maintain growth. Herman Schwartz (2008) has found that in the US a key macroeconomic variable—disinflation—combined with a key microeconomic variable—home ownership—to effectively assuage voter anxiety over falling real wages and non-wage benefits and to develop a strong resistance against inflationary spending and taxation. As Schwartz describes it, increasingly low inflation allowed US homeowners to increase their purchasing power as the weight of their mortgage payments fell along with low interest rates (Schwartz 2008).

This process, which took off significantly in the early 1990s but with roots in the 1980s with the mass-marketing of unsecured credit to consumers can be described as 'financialization' (See Fraud et al 2010). The main characteristic of financialization is the liberalized nature of the US financial system, with the deepest and most liquid bond markets (Cohen 2006) and a unique capacity for absorbing foreign capital (Seabrooke 2001). But more than simply financial liberalization, financialization is a conduit for shared interests among a wide array of the US electorate. It unites the interests of Wall Street with those of middle and low-income earners, who are able to access a higher degree of purchasing power through greater access to financial intermediation. Importantly, proponents of increased financialization have stressed the welfare effects of increasing reliance on consumer credit, or the 'democratization of finance.' As Alan Greenspan put it, prior to the financial crisis, "unquestionably, innovation and deregulation have vastly expanded credit availability to virtually all income classes.

Access to credit has enabled families to purchase homes, deal with emergencies, and obtain goods and services . . .” (quoted in Fraud et al 2010).

Financialization is therefore taken to indicate the gradual reliance on finance as an engine of growth by maintaining the propensity of middle and low-income earners to consume regardless of earned income. The significance of this definition is twofold. First, financialization is *not* taken to be synonymous with the predominance of the financial sector over a particular country’s economy. This can be a misleading measure of the ‘democratization of finance’ because financial sector profits, as a share of total corporate net earnings per country, are not on average higher in the US than in the rest of the world (see Bichler and Nitzan 2010).[5] Rather, financialization is best understood as a process of increased intermediation by the financial sector of a growing income gap; of “recycling of part of the additional income gained by high income households back to the rest of the population by way of loans, thereby allowing the latter to sustain consumption levels…” (Kumhof and Rancière 2010, p. 22) Second, my definition focuses more narrowly on the use of financial instruments on the consumer side, which shifts attention to what some have called a welfare tradeoff between debt and asset ownership on one hand and public sector service provision on the other (Seabrooke 2009; Schwartz 2008; Kemeny 2005).

As Jim Kemeny has argued, “in societies with low public retirement pensions and poor public welfare provision for the elderly, households are forced to make private provision for their old age. That is, they are forced to devote resources already in early adulthood to ensure levels of private savings so that personal capital can be accumulated to secure their old age” (Kemeny 2005, 62). The argument is, on the one hand, intuitive, as reliance on public sector pension payouts alone leaves few American pensioners above the poverty line (Schwartz 2008). But it is also empirically verifiable. Kemeny and other have documented the ways in which widespread homeownership, which is synonymous with rising mortgage burdens on middle and lower income voters, crowds out the tolerance for high levels of taxes in advanced industrial economies. Most significantly, increase in homeownership, which has come to be predicated on variable rate mortgages, conflates voter preferences among creditors and debtors alike for low inflation and interest rates.

In short, the engine of financialization is the increased reliance on private homeownership, which proliferated in the United States for the better part of the latter twentieth century and increased substantially with the rise of mortgage securitization in the last decade. It gives households a stake in the wellbeing of the financial system by making them asset-holders in addition to debtors. In effect, voter preferences are increasingly aligned toward tolerating stagnant incomes and consumer indebtedness because the vehicle for sustaining this indebtedness—homeownership and other forms of consumer credit—sustains the purchasing power of majority of US voters (Seabrooke 2009; Schwarz 2009; Fraud et al 2010). What impact does this domestic political and economic alignment have on the broader global pattern of savings and investment? Simply put, it allows excess savers—most significantly China—to channel their savings into the US financial system. This allowed the US to become “the equivalent of a bank that passively accepts deposits” (Austin 2011, p. 84). As Herman Schwartz points out,

[5] Besides, the growth of the financial sector in a particular economy cannot be said to be a detrimental phenomenon in itself. If the financial sector is dominant in a particular economy, this could simply imply a comparative advantage in the classical Ricardian sense.

"the US housing finance system was one of the few crucial conduits for the international capital flows that drove down the nominal cost of borrowing globally over the past 20 years" (Schwartz 2008, 262).

But naturally, these capital flows had had to come from somewhere. This turns our attention to the creditor side of the global imbalance equation: China. The economic policy framework in the US, which has relied on financialization for the provision of welfare for the broader base of American society, has been sustained in large part by availability of foreign financing from abroad. A significant portion of these savings come from East Asian economies, the most significant of which—by the volume of dollar asset reserves, which reached over three trillion this year (Bloomberg 2011)—is China. But Chinese savings have little to do with a favour granted to US debtors, or leverage gained by the Chinese state vis-à-vis the US economy (both popular portrayals of the US-China relationship). Instead, they reflect domestic policy choices that, like their US counterpart, are grounded in domestic interests, but also in political prerogatives.

Unlike the US financial system, which fuels outsized consumer demand, the financial system in China suppresses consumer demand by transferring wealth from the household sectors to the corporate, state-owned enterprise (SOE) and ultimately, to the banking sector. The latter of the three directly and indirectly finances both deficit spending by the US government and indebtedness by the US consumer through officials holdings in the People's Bank of China (the PBoC, the central bank). This processes is underpinned first and foremost by a combination of policies that repress household earnings in order to control inflation, which creeps higher as earnings by the export sector put an upward pressure on domestic prices. To prevent this from happening, Chinese policymakers restrict credit creation, through a combination of very high reserve requirements in the banking sector and artificially low interest rates and, most significantly, politicized lending practices. In effect, liquidity is sucked out of the system to control inflation and sustain investment-led growth (a large part of that investment is directed at coastal exporters). In effect, China sends its capital abroad. A large proportion of it is channeled into US debt instruments because of the depth and liquidity of US financial markets the buoyancy of US domestic demand. As a result, the PBoC is able to import demand from the US to avoid a dearth of it at home from stalling growth (Austin 2011). This policy paradigm places what some, like Nicholas Lardy (2009) for example, have called an implicit tax on households. This implicit 'tax' works in two ways: (1) through a reversed wealth effect and (2) through a policy favouring cheap credit to capital-intensive industrial production.

In the first instance Chinese households, unlike American consumers, do not benefit from low interest rates, as most of their assets remain in the form of bank deposits. This is due largely to the politicized nature of the Chinese financial system. In China, capital markets remain tied to the economic prerogatives of the central government and most households remain cut off from the financial system, and the central government maintains a firm grip on the provision of liquidity and the ways in which lending decisions are made. As Pettis (2009) describes it, "given very weak credit analysis and risk management in the banks, and the long tradition of policy-directed lending, previous forays into consumer lending have typically resulted in large amounts of nonperforming loans, thus low interest rates have had little effect in spurring consumer credit." The PBoC also maintains an artificially low ceiling on interest rates to maintain

investment-led growth, which negatively impacts households' purchasing power. Households typically benefit from an increase of interest rates simply by earning more interest on their bank deposits[6] (Pettis, 2009).

In the second instance, China's lending policies favour capital-intensive corporate enterprises and large SOEs, at the expense of smaller, labour-intensive businesses, thus reducing domestic aggregate demand through restrictive employment and wage growth (Aziz and Cui 2007; Austin 2011). This phenomenon could be attributed to the influence of party politics and the legacy of central planning (see Shih 2008) or to the difficulty of institutionalizing financial markets in general. But the underlying point remains the same: China's low level of domestic demand, and thus its high savings, is the product of financial sector politics. Many economists have categorized these policies as 'financial repression' (for example, Lardy, 2009). But due to the highly politicized and imprecise[7] nature of the term, it is best to refer to them as 'demand repression,' which more neutrally describes a process by which domestic demand has been repressed through adaptation of model for achieving rapid growth (common among East Asian economies, with Japan and South Korea as notable examples) that transfers wealth from households to the corporate/state owned sector (Pettis 2009).

To be sure, a missing element in this analysis is a discussion of causality in the equation of global imbalances—that is, whether China or the US is to blame for the skewed composition of global demand and capital flows. However, establishing causality is not the intended purpose of this paper. This is better suited to a more systematic empirical examination of capital flows. My purpose here is to highlight how the two institutionally independent political-economic developments in China and the United States contribute to sustaining global imbalances. So far, the global financial crisis has been a significant test for the resilience of global imbalances, and that pre-crisis patterns continue (See Fig. 1, Appendix) should lead us to examine the responses to the global financial crisis and why policymakers have collectively moved to reinforce pre-crisis patterns of savings and investment in their respective domains. As the last section of the paper will show, an unwinding of global imbalances is likely to require domestic political change in both countries, which will likely frame how and when rebalancing occurs. In short, the obstacles to rebalancing the current accounts between these two crucial actors are most strongly related to domestic political arrangements in both countries.

Alternative Explanations

Before rounding out the explanation given above, it is important to outline potential criticisms and responses to the theoretical framework I have proposed. In particular, the field of international political economy (IPE) has produced a vibrant and varied literature on the role of power, ideas, and interests in shaping the global financial crisis and the responses thereto (see, in particular, Helleiner and Kirshner 2009; Schwartz and Seabrooke 2009; Germain 2010; Cohen 2010). Many of these analyses deal either directly or indirectly with the phenomenon of global imbalances and it is therefore useful

[6] Most Chinese households do not owe a large stock of debt, like a mortgage or a credit card debt, both of which remain luxuries in China.

[7] Financial services are only "repressed" for some segments of the populations. Capital is in fact very cheaply available for large-scale infrastructure projects and capital-intensive export-industries (Pettis 2009a).

to categorize them in order to clearly outline the theoretical niche I intend to occupy. This section separates the literature in four categories and proceeds to outline my point of contentions with these perspectives, respectively.

Power Politics and Self-Insurance

One plausible explanation for the recalcitrance of global imbalances is related to the notion of structural power, which stresses a particular state's position in a hierarchy of economic relations as determined by its ability to control or influence an international reserve currency.[8] This perspective stresses power and self-insurance as reasons for the buildup of debt and savings, respectively. In the case of the US, a realist scholar in IPE might point out that the US had build up a large stock of fiscal debt and allowed private debt to rise sharply quite simply because it could. Because the US issues the world's predominant reserve currency other countries will continue to finance US deficits because dumping US dollars would be disastrous for the capital value of their dollar-denominated savings. Indeed, if we want to know why the crisis has not caused a widespread dumping of dollars—why global imbalances have not, in fact, unwound—we may need to examine American power (Drezner 2009; see also Cohen 2006). In the case of China, some have argued that repressive financial sector policies, which cause a buildup of currency reserves that are recycled into US debt securities, provide financial insurance against speculative attacks against the domestic currency in the event of a crisis (see Chin 2010 for an overview). This 'self-insurance' motive is ultimately related to national insulation and to the economic power of the state.

However, approaches stressing US power, vis-à-vis the dollar, fail to explain why emerging powers like China have chosen to accumulate dollars, thus making themselves vulnerable in the fist place. But more significantly, power-based explanations, just as much of the existing literature on global imbalances, describe the how global imbalances are sustained but give no systematic explanation about why these structural relationships are in the interest of the actors, if at all. Certainly, the US' ability to postpone domestic adjustment in the face of international pressure is bolstered by its ability to issue the world's predominant international reserve currency. However, it is far from clear whether US adjustment (in the form of increased savings and reduced consumption) is actually in China's interest. Nor is it clearly the case that the US benefits from China recycling its savings into American capital markets (Austin 2011, Bergsten 2009). Lastly, the self-insurance argument is not entirely incompatible with the domestic political economy argument I put forward. Indeed, a buildup of currency reserves in China prevents domestic inflation allows the government to fuel capital-intensive development at the same time.

Constructivist approaches

Various culture-based explanations have been put forward, stressing a culture of consumerism and homeownership in the United States and a culture of thriftiness in China. For example, in the US, Johnna Montgomerie has stressed the ways in which a consumerist culture has perpetuated a "historically constructed notion of the American

[8] Susan Strange pioneered the notion of structural power in IPE forty years ago (see Strange 1971). Modern applications of the concept have been especially forthcoming in recent years. See, for example, Andrews 2006; Helleiner and Kirshner 2009.

middle-class standard of living" (Montgomerie 2009, 18), which underpins the cycles of debt that the American consumer has incurred. Others stress the role of ideas as a key factor contributing to the public policy framework that sustains the dearth in savings in the US (in particular, Fraud et al 2010 and Seabrooke 2009).[9] As Seabrooke (2009) notes, constructivist, ideas-based, explanations are not at all incommensurate with more rationalist explanations—such as the one I offer here. And indeed, my own analysis draws on these constructivist explanations to develop my domestic political economy framework). However, while a cultural narrative explains the outcome of the policy framework, it does not adequately explain why a particular policy framework was institutionalized in the first place. There is no reason why a consumerist society could not go hand-in-hand with rising middle and lower income earnings (as has been the case throughout the first half of the postwar era). In other words, it gives insufficient consideration to income inequality as a precondition for increased consumerism in American culture (as per Kumhof and Rancière 2010). As such, culture-based explanations could benefit from a clearer exposition of cause and effect in explaining the US contribution to global imbalances.

In the case of China, culturally based explanations, which stress Confucian values and a lack of consumerist influences, offer particularly inadequate explanations. As I have tried to explain in this paper, China's savings are intrinsically tied to the ways in which the central government seeks to achieve growth. As an IMF working paper recently put it, "… rather than search for alternative explanations related to culture or history, a larger part of the explanation lies in more conventional economic forces such as China's rapid economic growth, declining labor share of income, the relatively low level of financial development, the relatively capital-intensive means of production, and a low level of service employment." (Guo and N'Diaye 2010, p. 6).

A radical explanation: the influence of elite interests.

A more 'radical' explanation for the persistence of global imbalances would stress the role of a transnational capitalist class in creating the conditions that allowed global capital to be recycled in such outsized proportions as we have seen in the last decade. Indeed, many analysts—Marxist or otherwise (indeed, often the scholars/commentators are far from radical in their views)—have stressed the influence of Wall Street on the one hand (See, for example, Johnson 2009) or elite interests in East Asia on the other (see, for example, Murphy 2006; Hung 2010) in sustaining the patters of global savings and investment.

In many ways, the role of rising inequality, which I had underscored above, does factor into this argument. As Herman Schwartz has highlighted, "The largest economic benefits from [China's] growth have gone to the children of the party elite, who have constituted themselves as a new economic elite" (Schwartz 2009, 168). Similarly, in the US, the top 5% of the income bracket benefited directly from the diminished bargaining power of the bottom 95%, as they found new forms of financial asset investments to park their increased savings (Kumhof and Rancière 2010). But a confluence of transnational

[9] In the case of China, scholarly analyses from this perspective have not been forthcoming. However, it has become increasingly popular to discuss China's (and more broadly East Asia's) high rate of savings as a cultural attribute stemming from deeply-embedded traditions of frugality (See Pettis 2009b for an overview).

interests—a transnational class of elites comprising of the children of CCP in China and the financial class based in Wall Street in the US—is harder to locate. While they may be close in business affiliation, their shared interests are less pronounced in policymaking. For example, major figures in the American political scene that can trace their careers from Wall Street to high levels of the Presidential cabinet and the Federal Reserves—including two recent Treasure secretaries, Timothy Geithner and Henry Paulson—have not been especially eager to sustain global imbalances. In fact, they have repeatedly pushed for China to reserve its policies of exporting capital to the US (Li 2009; Fan 2009; Branigin 2010). With respect to China, the elite-based suffers from a burden-of-proof problem. Indeed, while the influence of coastal elite might be aligned with the East Asian Growth model, it is difficult to establish the whether or not this correlation is not imply circumstantial—whether the elite variable is actually correlated with excess savings and capital recycling.

Domestic politics and the responses to the crisis

While each of the three alternative narratives explain an important part of the story of global imbalances, respectively, they ultimately fail to fully account for why a crisis caused by such global imbalances did not in fact lead to global rebalancing. My intention has not been to argue that these approaches are either wrong or misguided, but that they suffer from important analytical gaps that can be filled by adding an analysis of domestic politics. This last section draws together some stylized observations of the policy responses to the global financial crisis in the US and China. It thus provides a domestic political economy framework for understanding why global rebalancing has been so hard to achieve.

The responses to the crisis, both in China and the US, flowed directly from the symbiotic, inertia-induced policy frameworks in both countries. Institutional inertia is taken to mean reflexive political responses favouring a return to business-as-usual. These responses are symbiotic because the politics of financialization in the US depend on corresponding retrenchments of the status quo in the politics of demand repression or financial repression in China. After all, if one country saves more, another country would be required to save less, and vice versa. From a domestic political economy perspective, it is important to keep in mind the structural that policymakers face in rebalancing, given the firmly rooted political foundation of Chinese and American savings and investment patters. Leavings aside the debate about bailouts, stimulus packages and other emergency-prompt measures undertaken by all the major economies, we can see the logic of the US recovery again place emphasis on home-ownership as a source of income and the general continuation of financialization as a means of social insurance.

As Leonard Seabrooke (2009) shows, the "politics of expectation" in the United States Trouble Asset Relief Program (TARP), which aimed at rescuing the banks' balance sheets and preventing housing prices from collapsing, have flowed reactively from the institutional reliance on housing as a provision of welfare that began in the 1980s and 90s. These institutional capacities favoured the need to recapitalize existing debt—to place mortgage originators Fannie Mae and Freddie Mac under conservatorship in order to "kick start securitization". As Seabrooke puts it "discussions of financial reform must engage with housing finance systems and, where present, recognize that securitization systems are *intimately tied to the domestic welfare systems*" (Seabrooke

2009, 67, emphasis added). The politics of the welfare tradeoff in the US were palpable. And indeed, they were not even unique in their manifestation.

In the US, rebalancing is has proven illusive, in part, because policy alternatives to financialization have not been forthcoming rather than because of the high burden of public and private deb. As such, the effort to initiate a reduction of the US current account deficit would likely require far-reaching policy reorientation and predictable resistance from powerful affected domestic interests. But even more significantly, a US contribution to global rebalancing would mean changing the ways in which the US electorate understands its earning and purchasing power. It might also require, in some shape, a restoration of poor and middle-income households bargaining power (Kumhof and Rancière 2010). So long as incomes for the bottom 95% of the US population continue to stagnate, financialization will remain an attractive option for maintaining an increasing the earning power of a vast majority of US households. The US appears to be stuck between the prospect of rebalancing by means of domestic contraction and deflation (i.e. massive loans defaults, which would rapidly shrink spending and investment and increase savings as a share of GDP) or continued maintenance of debt-financed domestic consumption. Even Fed Governor Ben Bernanke were to succeed in increasing inflation expectations by purchasing long and short term debt ('QE2' in its latest phase), the negative impact on households with variable rate mortgages (see Schwartz 2009) might offset any increase in the purchasing power gained by debtors. In short, the status quo is not at all kind to the prospect of rebalancing savings and consumption in the US.

But rebalancing has also proved illusive in part because a reduction in surplus savings has also failed to occur. In China, responses to the global financial crisis followed a similarly institutionally inert pattern. The domestic 'stimulus' followed a correspondingly predictable pattern, wherein credit continued to be selectively restricted, channeling domestic stimulus funds into export-oriented capital-intensive industries, rather than into bolstering domestic demand (Pettis 2009a, p. 4). Naturally, this led to a bigger buildup of currency reserves, and a recycling of credit into US debt. Unavoidably, global rebalancing would require domestic rebalancing. In instance of China, domestic rebalancing would likely require a painful adjustment process of shifting employment towards services and away from export-oriented employment—a process that some suggest is fraught with the likelihood of domestic political instability arising from a mass closure of factories and idle industrial labour. But the problem is not one of simple economic trade-offs as political economy analyses often suggest. The financial system in China is highly centralized and politicized and has been increasingly so for the past decade (see Shih 2008). Some suggest that changing the dynamic of effective subsidies to the corporate sector would change the levers of political control entirely. Pettis (2009), for example, argues that "eliminating the mechanisms by which China's policy makers can transfer income from households to manufacturers will reduce their control over the commanding heights of the economy, and it will sharply reduce the power and leverage the ruling party has over businesses and local governments."

As such, China's side of the global imbalance equation remains institutionally inert in large part because of the political considerations that are attached to the prospect of rebalancing its growth and therefore its global economy. Among the various options for rebalancing reversing China's high savings rate, we could count a raising of interest

rates, a liberalization of the financial system, an increase in wages, and a revaluation of the domestic currency (Pettis 2009). Each of these options implies a host of economic winners and losers, including the state-owned corporate sectors and the government of China more broadly. Higher interest rates may be good for households, and therefore for rebalancing by increasing domestic consumption, but it would directly harm China's banks, capital-intensive industries (exporters and real estate developers) and indebted local governments. A liberalized financial system might remove the politicization of lending and increase the earning and spending power of depositors, but doing so might also cause significant solvency problems for the aforementioned actors, who received loans without risk or solvency considerations in mind. And, needless to say, raising the value of the renminbi, causes huge loses for China's central bank as well as for China's exporters. All these options incur sectoral political economy considerations that are, unfortunately, not discussed at length in the literature on global imbalances. They also provide a window to explicating China's continued willingness to fund the US current account deficit despite its leaders' continued criticism of US low savings and lose macroeconomic policy.

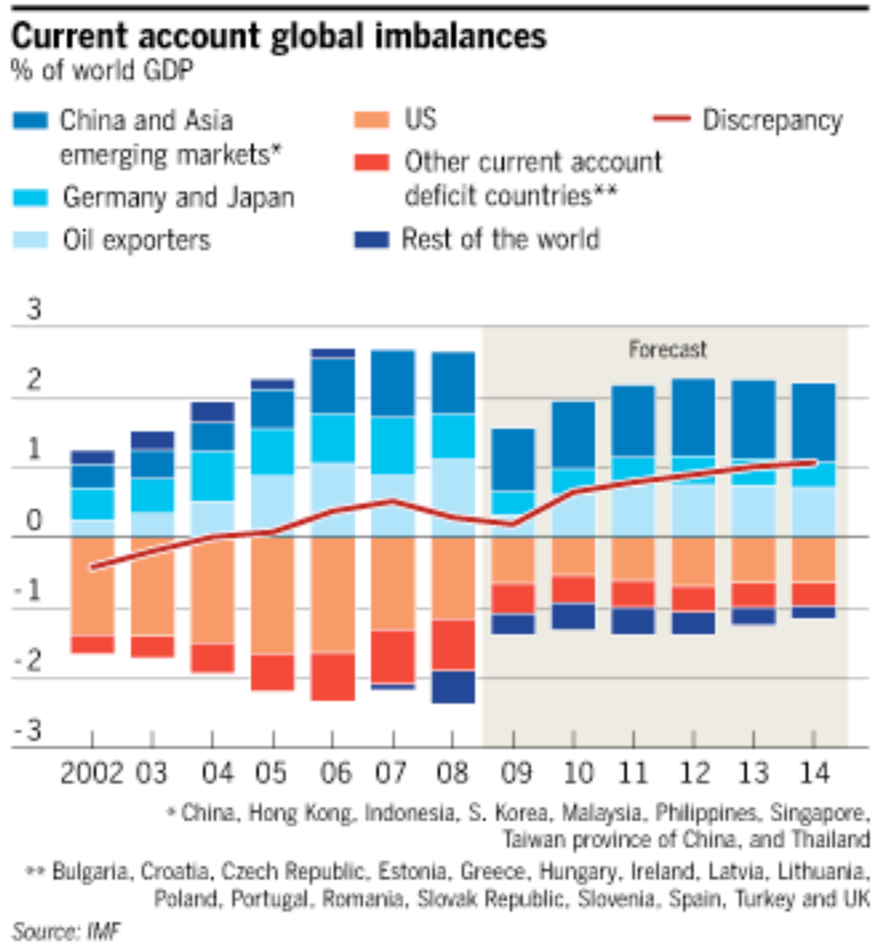
Conclusion

This paper has provided theoretical framework for a domestic political economy explanation for the persistence of global imbalances in spite of the biggest financial crisis since the Great Depression. I focused on China and the US to explain why the global financial crisis has not led to any significant policy overhaul in these countries, examining the resilience and inertia of the policy frameworks that sustain outsized patterns of domestic savings in the former and outsized domestic spending in the latter. I have stressed that it is crucial to think about not just the international but, more significantly, the domestic political dynamics which drive patterns of savings, spending and investment in key actors in the global economy.

I wish to highlight here that the process of addressing macroeconomic imbalances involves not just commonly understood tradeoffs between savings or investment, and exports or imports; it involves domestic constituents and interest groups, and how these actors impact, and are impacted by policies that structure global savings and investment. Empirical research has certainly provided use with considerable insight into the political economy of exchange rate regimes and of trade policy. What is missing is an examination of how domestic political interests, ideas and institutions impact and limit how countries save, spend, and invest. That is, rather than assuming a US preference for having other countries finance its deficit and China's preference for maintaining an export-oriented economy, we need to examine the underlying political dynamics that reinforce or even defy these preferences. In a time when emerging markets accumulate trillions in domestic savings and the United States runs persistent consistent current account deficits—in a time when countries debate reform of the international monetary system—we need to start thinking critically and systematically about the political determinants of macroeconomic processes.

Appendix

Fig. 1 (IMF 2010)



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