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Where Economics and Strategy Intersect: A Political Economy Approach to Global Power

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About the Author

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Introduction

This essay attempts to understand the role of economic power in shaping the world since the Second World War. It focuses on the main strand of economic developments over this period, and it is important to clarify what it does not do. It does not look at subsidiary (or, at best, parallel) processes, important though they also were, processes such as the Cold War or the limited *détente* that began in the early 1970s. It also ignores the quiet struggle between the UK and the US over economic influence until about the mid-1960s.

This point may require a little elucidation. It is not that the Cold War or détente were less important. But their importance lay in the military and strategic arenas – the *détente* of the 1970s in particular was of historic significance, but that was because of the cross-recognition of the two Germanys (thus ending the uncertainty of the early 1960s when Kennedy, Khrushchev, and Erhard led the United States, Soviet Union and West Germany respectively) and of the Oder-Neisse frontier; and, of course, the limitation of nuclear arms. But from the economic point of view, these processes were put in the shade by the much bigger magnitudes of capital flows in the West and among the oil producers.

Equally, it ignores the emerging challenges to the US domination of the World Economy in recent years. It does not, thus, look at the Chinese Belt and Road Initiative (that has been done separately), or the emergence of crypto currencies, nor does it look at the Russian (and possibly Chinese) drive for a gold-backed alternative to the US dollar. All these are unquestionably important, but at the moment, their success is far from assured. There is time before these need to be the subjects of detailed study.

The First Phase: European Recovery and US External Imbalances

The study begins with the European Recovery Programme, or the Marshall Plan, as it is more commonly known, which ran from 1948 to end of 1951.

By way of backdrop, the Bretton Woods institutions – the International Monetary Fund (IMF) and the World Bank – had been established and had placed the US Dollar at the centre of the international financial system. It was the only currency that was convertible into gold at a fixed price ($35 per ounce) and all other currencies were fixed in relation to the dollar. Devaluations beyond a narrow range could only be done with IMF permission where the US had veto voting power and were only permitted in cases of "fundamental disequilibrium" which was not defined.

Marshall Aid turned out to be necessary because the European recovery after the war was slow in coming. By 1946-47, there were signs of serious unrest and the fear of Communist advances if the economies of the countries were not to show some quick and substantial improvement. Two features of Marshall Aid are worth highlighting. First, it was large. The total value over the period 1948 to 1952 was approximately $12.5 billion (in current dollars, a bit over $450 billion, using gold prices as the convertor). The US Gross Domestic Product (GDP) in 1952 was a little under $60 billion. What this did was to leave little American assistance for other countries – a point frequently made by US officials in discussions with other countries, including India.

The second feature was that it marked the line of cleavage in the Cold War. The countries that accepted the aid were: Austria, Belgium, Denmark, France, Greece, Iceland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Sweden, Switzerland, Turkey, and the United Kingdom as well as the bizone of Germany, later to become the Federal Republic of Germany (FRG). Those that rejected US assistance were the USSR, Albania, Bulgaria, Czechoslovakia, Hungary, Poland, Romania and of course, the Soviet part of Germany, later to become the German Democratic Republic (GDR). These countries formed the Warsaw Pact and the Soviet-led economic cooperation arrangement under the Council for Mutual Economic Assistance (COMECON). Finland, though a capitalist country also refused Marshall Aid. It became a byword through the Cold War for sensitivity to Soviet concerns, and gave the term 'Finlandisation' to the discourse during those years. Yugoslavia, part of the Communist International (Comintern) in 1948, rejected Marshall Aid, but in 1949 asked to be included. It did receive US assistance, but outside of Marshall Aid.

These European countries also committed to accept the "friendly advice" of the US to develop economic integration among themselves, including West Germany. This served the dual purpose of tying the FRG with the West economically, which was a major goal, because the country had not yet been taken into North Atlantic Treaty Organization (NATO) – that was to happen in 1955, after the failure of the European Defence Community. The second major objective was to find a large enough economic area to absorb the investment already made in the oil industry in West Asia including the pipelines that were to transport Saudi and other oil into Europe. The important thing in this connection is to note is how the money was used. Over 10 per cent was spent on oil imports, almost entirely from the Middle East, and a slightly smaller amount was spent on transport – also oil fired, or undergoing conversion from coal to oil.[i] This marked the beginning of a three-way economic commitment involving the US, those parts of Europe that accepted Marshall Aid, and West Asia, with Saudi Arabia at its centre. A little bit of background to this development may add clarity as regards the drivers of these changes.

As far back as December 1943, while the Second World War was still on – but after the German surrender at Stalingrad had determined the outcome, and the Teheran Conference between Roosevelt, Stalin and Churchill had just ended – the oil company California Arabian Standard Oil Co (later ARAMCO) requested the US Administration for permission and backing to supply oil from Saudi Arabia to West European markets. In short order, this request was approved and finance amounting to a maximum of $160 million was also provided to be repaid over 25 years. Certain conditions were attached, including building up a reserve, and that ARAMCO (its new name from January 1944 on) would not sell oil to any party deemed inimical to the US interests by the State Department.[ii]

By April 1944, the policy was elaborated in greater detail. The Inter-Divisional Petroleum Committee of the State Department announced its aims with regard to Middle East oil in the following terms:

> *"Facilitation, by international agreement and otherwise, of substantial and orderly expansion of production in Eastern Hemisphere sources of supply, principally in the Middle East, to meet increasing requirements of post-war markets removal, by international agreement and*

otherwise, of impediments to the exploitation of Middle Eastern concessions held by United States nationals."[iii]

The phrase "by international agreement and otherwise" catches the eye – diplomat-speak for the use of coercion if persuasion were not to work. And it was used on a regular basis – in Syria in 1949, in Iran in 1953, in the Suez in 1956, to name a few. But the more important purpose of discussing the role of oil is to bring out its importance for the US, an aspect that will feature in a bigger way in the discussion of developments in the international economy in the late 1960s and early 1970s.

It would be helpful to quantify this emerging triangular relationship. European imports of crude in the period of Marshall Aid were as follows:

Year	Imports of Crude
1947	5 million tons
1948	11million tons
1949	29 million tons
1950	31 million tons
1951	54 million tons

European refining capacity showed a similar increase. It rose from 24 million tons in 1948 to 40 million tons in 1950, and to 77 million tons by 1952.[iv] All the oil came from wells owned by US, British and British-Dutch oil companies. Most of the refining was done in refineries with the same ownership pattern, and the same went for the retail distribution.

For once, the European Recovery Programme (ERP) served its purposes as per design. It integrated Germany, it moved the European economies from coal as the primary fuel to oil, and it drew a line of cleavage between the Soviet bloc and the Western bloc. There were problems of course, most notably the Dollar shortage caused by the fact that the US was running persistent surpluses with the Europeans who were unable to make the settlements in their balance of payments. Accordingly, the US extended regular loans to the countries amounting to another roughly $9 billion over the period 1952 to 1960.

By this latter date the success of the ERP was well established and the member-states were running surpluses with the rest of the world, so that they could make their currencies convertible on current account. In 1957, six of the leading countries of the ERP – France, West Germany, Italy, Belgium, Netherlands and Luxembourg - set up the European Economic Community (EEC), and thus began a period of changing trade patterns between the US and Europe and, by extension, in the global economy.

The reason was that, as the European surpluses grew, and with it, the fear that the US dollar would face devaluation pressures, countries such as France asked to redeem their dollar holdings into gold. This was the period of fixed exchange rates, and dollar convertibility into gold at the fixed parity of $35 per ounce. This faced the US with a double dilemma – how to preserve the Bretton Woods system, with fixed exchange rates and convertibility into gold, and yet fix the persistent and growing trade deficits. At the same time, they also wanted to provide for the growing liquidity needed to finance the rapidly growing global trade – growing faster by a factor of two to three than the global output. The table below illustrates the scale of the US deficits between 1959 and 1973.

Year	Trade Balance	Current Balance	Basic Balance
1959	0.91	−2.14	−2.00
1960	4.89	1.80	−3.20
1961	5.57	3.07	−3.11
1962	4.52	2.46	−3.69
1963	5.22	3.20	−5.04
1964	6.80	5.79	−6.19
1965	4.95	4.29	−6.19
1966	3.82	1.94	−4.12
1967	3.80	1.54	−5.36
1968	0.64	0.96	−1.08
1969	0.61	−1.63	−2.27
1970	2.16	−0.32	−3.02
1971	−2.72	−3.91	−6.27
1972	−6.99	−9.81	−1.67
1973	0.62	0.67	−2.52

Source: US Department of Commerce, *Survey of Current Business.*

Table 1: The US balance of Payments, 1959 – 1973 (in $ billion)[v]

The Second Phase: The Oil-Finance Cycle and Financialization

In actual fact, as the US archives show, the problem between Europe (and, increasingly, Japan) on the one hand and the US on the other was more acute than these figures suggest, for the deficits of the US with those countries were larger. Several ideas were at this stage floating in the Nixon Administration by 1969, but the dominant theme was that a devaluation of the dollar was the way to fix the persistent trade deficit. After an initial minor adjustment, which did not yield the desired result, Nixon took the step in August 1971 of taking the dollar off gold, and imposed domestic price controls as well as import tariffs of 10 per cent across the board.

The availability of monetary gold was the obvious constraint on the issuance of dollars in the period when the dollar was linked to gold, for that was the second problem in using the dollar as the international currency for financing trade. It is revealing therefore that the South Africans were running their mines at full capacity, and, in 1970, produced the highest output in their history, as the chart below shows. This amount, 1000 tons in 1970, represented two-thirds of the world output. But even this amount was not sufficient to meet the requirement and it tapered off once the gold window closed.

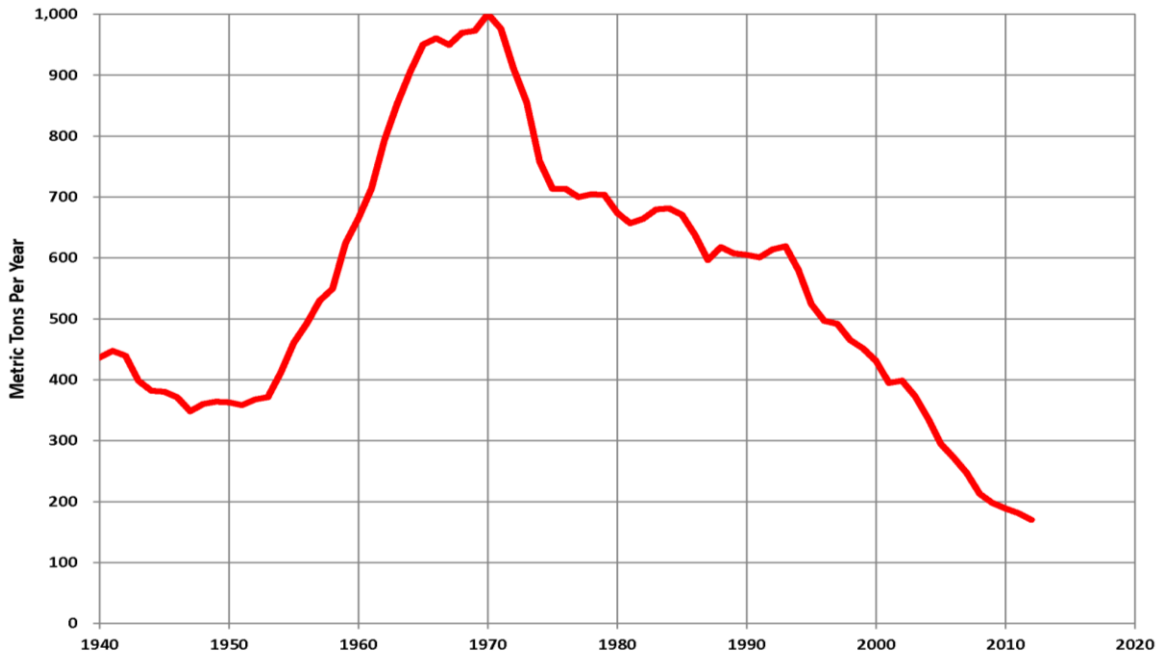


Figure 1: South African Gold Production 1940 - 2012[vi]

In the event, this did not help the external balance except for a short while, and the downward pressure on the dollar continued. Nor was the US the only major economy facing difficulties. The UK, which had already once devalued the Pound in 1967, continued to face balance of payments difficulties, and decided to let its currency float in 1972. The Japanese and the Swiss followed a few months later, and by 1973 most of the major currencies were floating, including the US Dollar, though the Europeans maintained a band within which their currencies could float against one another.

In parallel with this process, a few others were also in train, and would collectively transform the global economy, and the US role in its management. Three processes are discussed next. None of them would have been possible but for the freedom given to the dollar by the abandonment of the gold standard, and the floating of exchange rates. The three processes were:

(i) Increase in oil prices driven by Organisation of Petroleum Exporting Countries (OPEC);
(ii) Loosening of US monetary policy, with the Dollar freed from the constraints of maintaining any parity with either gold or other currencies; and
(iii) Rise in the role of the banks to deal with the flow of petrodollars into the European money markets, overwhelmingly into London.

The rise in oil prices began in the late 1960s, when Libya began its hard bargaining with Occidental Petroleum Corporation. As an independent company, it enjoyed little official support, and was heavily dependent on Libyan oil as its only major source of crude. Its leverage was further increased by the difficulties created by Nasser over the Suez Canal in 1967, leaving Libya and Algeria as the only countries that could supply oil to Europe without needing to transit the Suez Canal.

Colonel Gaddafi, who had taken over in a coup in September 1969, finally succeeded in raising the tax payments charged to Occidental on its oil. One after another, the other oil companies agreed to the higher taxes, which then fed back into arrangements in the Persian Gulf producers. This started a chain of increasing demands, which culminated in the Tehran Agreement

of 1971 that saw an increase of some 50 per cent (from 80 cents a barrel to $1.25 per barrel) in the amount of tax paid by the oil companies to the producer countries. This was accompanied by a programme of annual increases all the way to 1975.

This is what led the US State Department oil expert, James Akins, to remark:

> *"With the possible exception of Croesus, the world will never have seen anything quite like the wealth which is flowing and will continue to flow into the Persian Gulf."*[vii]

The Akins article is remarkably prescient on a subject notoriously hard to predict, and is recommended to the inquisitive reader – not only for the information it provides on oil politics, but equally for the way it leads to the other two aspects mentioned above. For he goes on to examine how the massive surpluses that OPEC was going to earn could be utilised.

And that brings in the US financial and monetary response to these developments. It would be useful to pause, though, and stress that all this was happening before the October 1973 Yom Kippur War upset even these arrangements, and led to a partial embargo and hence still higher prices for oil. This, in turn, provided even higher surpluses for the OPEC, especially Arab, countries.

Why this becomes important to note is that, after the US abandoned the gold standard in August 1971, Paul Volcker – then the Under Secretary for International Affairs at the Treasury – remarked at one of the meetings of a working group that the developing countries would have to bear the burden of adjustment, given the policies the West was following. The exact quote is in the third person in a report from a staffer from the office of the Presidential Assistant for International Economic Affairs:

> *"Paul noted that both the OECD and the US ideas of equilibrium call for the LDC's to bear a significant part of the adjustment burden!"*[viii]

And so indeed it turned out; the table below, shows the nature and magnitude of the current account deficits the least developed countries had to face throughout the 1970s and beyond.

	1973	1974	1975	1976	1977	1978	1979	1980
Industrial Countries	11.3	−9.6	19.4	−0.5	−4.6	30.8	−7.8	−44.1
OPEC	6.2	66.7	35.0	40.0	31.1	3.3	68.4	112.2
LDCs	−8.7	−42.9	−51.3	−32.9	−28.6	−37.5	−57.6	−82.1

Source: IMF Annual Reports, various issues.

Table 2: Global current account balances 1973 to 1980[ix]

The loose monetary policy that marked the 1970s has been well documented. Nixon was facing re-election in 1972 and needed positive economic results after the upheavals described above. He, therefore, appointed a new Federal Reserve Chairman, Arthur Burns, who loosened M1 from $228 billion to $249 billion between December 1971 and December 1972. The previous 12-month period under the long-serving Chairman, William McChesney Martin saw a move from $198 billion to $203 billion.

The essence of the loose monetary policy became clear towards the end of the decade, as inflation rose to 14 per cent by 1979, but allowed two large oil price hikes to be absorbed by the global economy – with the developing countries being the exception, which indeed had to bear the burden of the changing economic strategies. How they coped with the burden is the third part of the changes that followed the abandonment of the Bretton Woods arrangements in the early 1970s.

This was the role of the private commercial banks in the handling of the unprecedented funds that accrued to the oil exporters. Since the end of the war, the job of transferring capital was left to governments, as Marshall Aid itself showed, or to the World Bank and the IMF. At this stage, an informal consensus emerged among the financial managers of the world – the IMF, Organization for Economic Cooperation and Development (OECD), and the main central banks – that the handling of these large funds would be left to the private banks, as they, the governments or the international financial institutions, could not do the same job adequately. The traditional lenders, particularly the IMF, were constrained by quota limits and conditionalities. In point of fact, even the banks were uncertain about their ability to handle

and recycle such large amounts of capital. The geographic location of the recycling centre was to be the City of London, because both continental Europe and the US had fairly tight banking regulations, which would not permit the free-wheeling practices that made such recycling possible. Thus, the Eurodollar market was unleashed – though it had existed on a small scale since at least the late 1950s.

A recent book by Carlo Edoardo Altamura titled *'European Banks and the Rise of International Finance'* provides useful insights into the process. The main driver was the British financial establishment, led by the Bank of England, which recognised that the City was singularly well-placed to provide the banking services needed to undertake the task of recycling. The interesting insight the book provides is that even the banks were not quite sure they could cope with the challenge of recycling. The following quote from one of the British members of the Trilateral Commission, Sir Philip de Zulueta to the Governor of the Bank of England is illustrative:

> *"At the Brussels meeting we had among other things a discussion about the re-cycling of Arab oil money. The bankers present, of whom the most important were David Rockefeller himself and Alan Hockin (Executive Vice President of the Toronto Dominion Bank) but included some Europeans, expressed considerable worry about the capacity of the private banking system to re-cycle the extra Arab oil money into medium term credits …"*[x]

Among other issues, the bankers were concerned about the maturity mismatch, since the deposits were short-term, the loans medium- to long-term, and the straight fact that many of the countries to which loans were advanced were poor credit risks. But in a pattern that was to repeat itself in the early 2000s, there was no better option, as the surpluses kept pouring in. The only safeguard adopted was syndication – loans to developing countries were divided up among a number of banks and these syndicated loans parcelled out the credit risks among the participant banks.

To sum up, the situation that the US and the developed world faced in the early 1970s involved some tough choices. The dollar was in an unsustainable position, being both a national currency and an international one. The demands of the latter meant that the US had to run persistent

deficits on its balance of payments; in addition, because trade was rising several times faster than global GDP, the issuance of dollars had to be faster than the national growth would warrant. Inflation, and hence, depreciation, was built into this system. Moreover, the US was running consistent deficits on its balance of payments, and so there was always a downward pressure on the currency.

The only way to control the situation was to go the way Nixon chose, or to curtail the money supply and induce a recession, which is how the issue was faced down by Federal Reserve Chairman Volcker in the late 1970s, which is discussed below.

For the nonce, the decision was to accommodate the rise of the petrodollar, and its recycling through the Eurocurrency markets. This, in turn, meant the financialization of the US economy, and the empowerment of the commercial banks in a way that has not been seen since the Great Depression.

It also meant empowering Europe in a way not seen since the war. Those with long memories will recall the public and sharp airing of differences in the 1970s between the Europeans, particularly the French, on the one side and the Americans on the other. Authors like Mary Kaldor wrote 'The Disintegrating West', as a harbinger of things to come, with Europe emerging as an independent force, co-equal of the US, in international affairs. And a young economist, Fred Hirsch, spoke of the need for a "controlled disintegration" of the global economy as a legitimate aim for the 1980s.

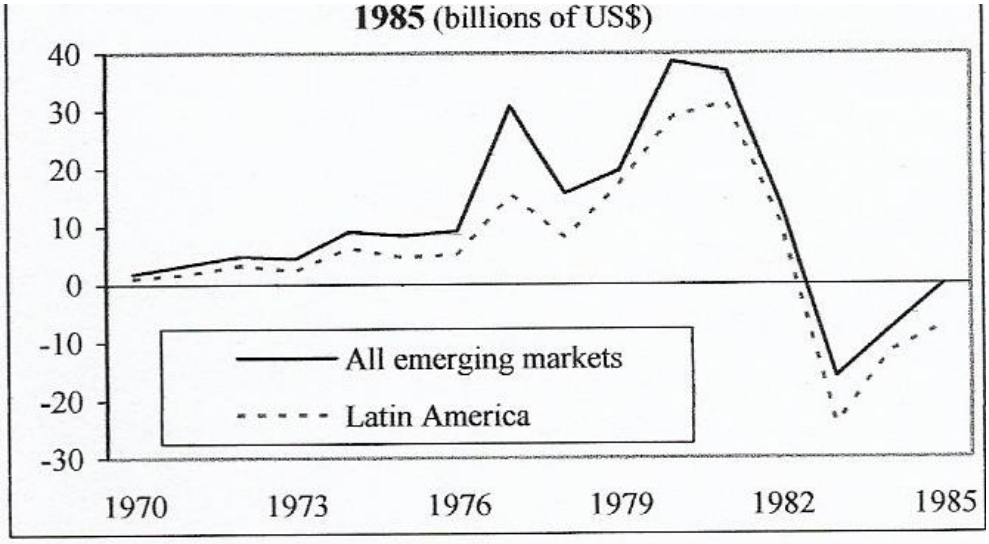
The Third Phase: Controlled Integration of the Global Economy

The riposte was not long coming, and it was Volcker again who set the stage. Fittingly or not, he delivered the first Fred Hirsch memorial lecture in 1978, Hirsch having died in January the same year aged 47. Instead of controlled disintegration, Volcker spoke of the need for a "managed integration" of the global economy. He was then the President of the New York Federal Reserve Bank, and shortly to be appointed Chairman of the Federal Reserve Board. In arguing for managed integration, he conceded that the US was no longer the dominant economic presence, but argued that a coordinated approach with Japan and Europe would best serve the

interests of the three, also making the point that such an approach would avoid currency volatility and at the same time prevent unhealthy competition between the three for advantageous positions in the developing countries. Also noteworthy is the following passage:

> *"For one thing we have learned that even large exchange rate changes have not been nearly as effective as hoped in achieving adjustment of long-standing imbalances in current account positions. Where clear improvements have been made, they can be traced to changes in relative demand pressures, or to structural changes such as North Sea oil."*[xi]

This relative demand management was the tool he was to employ to good effect upon taking over at the Fed, for that was the result of his shift towards money supply targeting, causing interest rates to rise to 20 per cent by the end of 1980. The stated aim was to end the high inflation (14 per cent at its peak in the late 1970s). It also had the effect of breaking the oil-finance recycling as many of the developing countries in Latin America and East European countries (to whom smaller amounts were extended) were unable to service the loans. The graph below, which shows what the result of this monetary tightening was, is taken from an IMF study.



Source: World Bank, Global Development Finance.
Bank flows include short-term financing.

Figure 2: Bank flows to emerging markets 1970 – 1985 (in US$ billions)[xii]

The implications of this for Europe were spelt out by an ex-President of France well-versed in the ways of high finance, Giscard d'Estaing, in an article in *Foreign Affairs,* written in 1983, at a time when the US recovery was well under way:

> *"Traditionally a US recovery has fuelled exports of developing countries, increasing their orders of equipment goods from countries such as Japan, Germany and France, and the interdependence between European countries has led to diffusion in Europe of these expansionary forces, thereby sustaining the world recovery. This time, and due to the international debt crisis, developing countries will not be in a position to benefit fully from the US recovery."*[xiii]

This passage also provides some insight into the active diplomacy then under way on the North-South Dialogue. Evidently, the European economies were at risk of an economic "decoupling" because of the policies adopted in the US. Of course, these policies also affected the US itself in a long-term way, and it would be well to spell out some of features of the new economy that was slowly taking shape. The most important feature was the decline of the traditional manufacturing industries and rise of international finance as the new driver of the economies of many of the developed countries. Here is how Altamura, already quoted above, puts it:

> *"After the end of the gilded age of Fordist capitalism, a new compact for growth had to be found. The compact that started to take place in the Western world (Europe for the purpose of our work) in the early 1970s, after the crumbling of Bretton Woods and, particularly, after the first oil shock, was a compact based on less and less regulation on financial movements and institutions. It was based on the centrality of the banking and financial sector as opposed to the public hand and industrial sector as the engines of growth, and, finally, was based on the collusion between controllers and controlled, which increased the moral hazard."*[xiv]

The result of this empowerment of the banks was that the commercial banking sector in the US grew by orders of magnitude over the period 1978 to 2007. The commercial banking sector held assets of $1.2 trillion in 1978, equivalent to 53 per cent of GDP. They rose to $11.8 trillion in 2007or 84

per cent of GDP. Over the same period, investment banks grew even faster, going from $33 billion, or 1.4 per cent of GDP to $3.1 trillion, or 22 per cent of GDP. Profitability in the sector grew significantly more rapidly than in other corporate sectors combined, as the chart below shows.

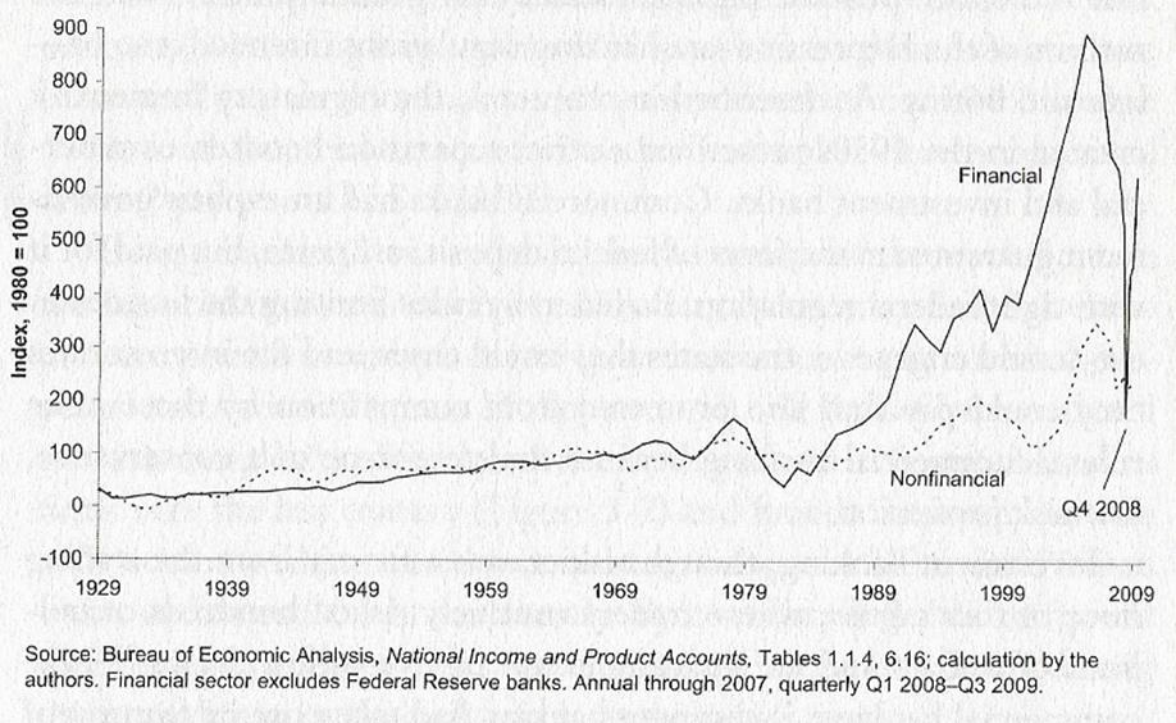


Figure 3: Real Corporate Profits, Financial vs Non-Financial Sectors[xv]

Two additional features stand out, and are worth spelling out, for they were to be repeated in aggravated form by 2008. The first was the emergence of large-scale global surpluses, which could not be productively employed in the country, or countries, originating them. These were the OPEC member-states at this time. Having no place to deposit these surpluses, such as the IMF or even the Bank for International Settlements (BIS), all the countries concerned agreed that it was best for the private banks to take in these funds and employ them where possible. In the 1970s, the focus of these deposits was the offshore commercial banks. But by the 2000s, the US financial services industry had been liberalised to an extent where they could handle the funds onshore.

The second feature was the recycling of these funds to countries, some of which were questionable credit risks. As the amount of surpluses grew, the banks were perforce looking at riskier investments. The same was to happen in the 2000s, of course, and that is what gave rise to the subprime

loans. The difference was that in 1979, Volcker could apply the brakes on the oil-finance cycle by curtailing money supply, and the US economy could take the shock because its own exposure was limited to offshore commercial banks, and the debtors were also foreign countries. Three decades later, it was a different story.

But all that was still to come. In the 1980s, the Mexican default in the summer of 1982 forced the hand of the US financial establishment to ease up on money supply, and that began a financial bull run that has continued – with occasional hiccups – to this day. For comparison, the Dow Jones Industrial Average (DJIA) ranged between 600 and 1000 from 1965 to 1982. It was a little above 700 in August 1982, when the Fed announced that it was abandoning monetary targetting. Twenty years later, it was above 10,000. In graphic form:

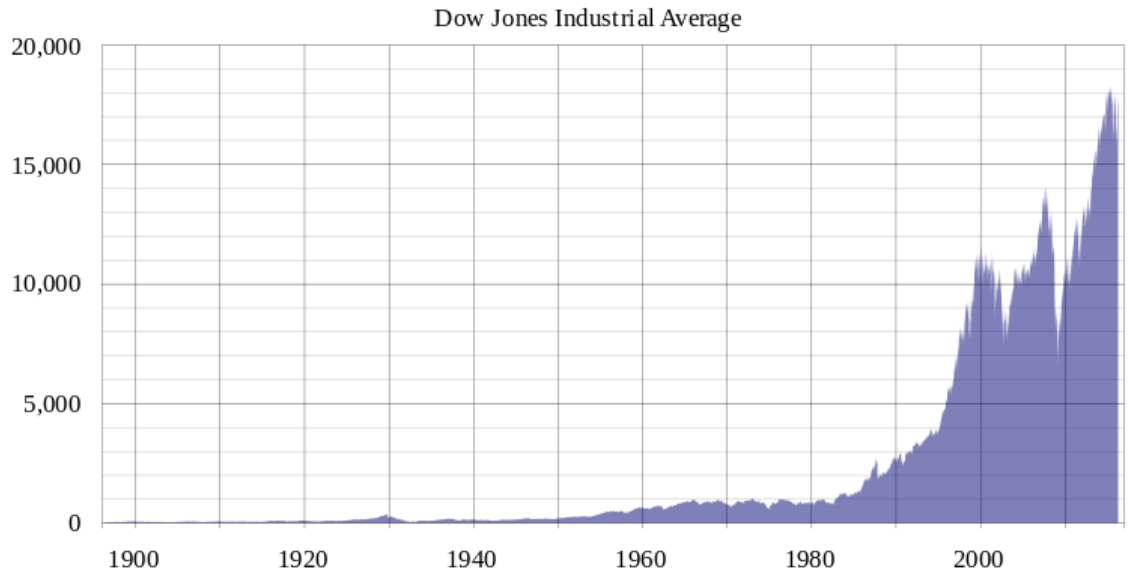


Figure 4: Dow Jones Industrial Average 1900 - 2014

This twenty-year period also saw a few significant changes in the global economy. The most important, without question, was the relative decline of Europe, and the rise of Asia, as it also became the most important trade partner of the US. And within that process, the world saw the rise of Japan in the 1980s, and its stagnation from the mid-1990s.

A second feature was the liberalisation of the US financial sector. The improbable reality of the US economy up to the 1970s was that it was heavily controlled and regulated – a result of the post-1929 experience and

the New Deal regulation. Banks were divided into commercial and investment functions under the Glass-Steagall Act of 1933. Regulation Q set limits on the interest they could pay on deposits, and they could not cross state borders. Others such as the Bank Holding Act and the Interest Equalisation Tax were further constraints. The process of removing these began in the 1980s, which gradually eroded, and finally repealed Glass-Steagall and also, along the way, permitted the growth of moral hazard. The Savings & Loans bailout in the late 1980s cost the taxpayer some $125 billion. Later, in 1998, saving Long-Term Capital Management (LTCM) was similarly helped out by the New York Federal Reserve Bank, though no public funds were used. Nonetheless, several analysts noted that the New York Fed had brokered a better deal for the LTCM shareholders than would have been possible without such intervention. And there was, of course, the bailout of Bear Stearns by the New York Federal Reserve Bank, whose role was described by Volcker as "actions that extend to the very edge of its lawful and implied powers".

The Fourth Phase: Growth Shifts to Asia

Meanwhile, the real economy was also undergoing shifts of an unprecedented magnitude. With Europe struggling after the Latin American debt crisis – several commentators described the situation as "Eurosclerosis" while Asia was gaining economic heft. In the 1980s, Japan was the fast-rising economy, and the usual spate of writing ensued describing Japan as the coming economic leader of the world.

As is well-known, that did not happen. And the reasons for that not happening are well-documented, and deserve treatment in some detail. The first point to note is that the Japanese economy did not stagnate from the late 1980s. Though it is frequently believed that the crash of the stock market at the end of December 1989, when the Nikkei was close to 40,000, marked the downturn. In actual fact, Japan's GDP continued to grow until 1995. It was $3.0 trillion in 1989, and reached $5.3 trillion in 1995.

The cause of the stalling may be found in the rise of China, and this came about in three stages - the devaluation of the Yuan and the simultaneous rise in the Yen; the Asian Financial Crisis; and the entry of China in the World Trade Organization at the end of 2001.

The devaluation of the Yuan by nearly 50 per cent (from Y5.8 to the $ to Y8.7 to the $) on 1 January 1994 had the effect of making asset prices and labour costs significantly cheaper for foreign investors. The table below, taken from ADB *Key Indicators of Developing Asian and Pacific Countries* for various years, provides an indication of how Foreign Direct Investment (FDI) behaved over the period just before, and just after the devaluation, and how the Asian Financial Crisis affected the region in terms of FDI flows. It suggests a clear movement of FDI into China in ever growing amounts, and either stagnant, or diminishing investment into other South-East Asian countries. The partial exceptions are Singapore and to a lesser extent Thailand.

Countries	1990	1995	1997	1998	2007
East Asia					
China, People's Rep. of	2657.0	33849.0	41673.7	41118.1	121418.3
Hong Kong, China	...	...	...	-2220.0	6712.0
Korea, Rep. of	-263.1	-1776.2	-1605.2	672.8	-13696.7
South Asia					
India	96.0	2143.0	3562.0	2480.0	15545.0
Sri Lanka	41.6	53.1	429.8	193.0	548.0
Southeast Asia					
Indonesia	1093.0	3742.0	4677.0	-241.0	1164.2
Malaysia	2332.0	6642.0	6787.7	2708.0	-2561.7
Philippines	528.0	1361.0	1113.0	1592.0	-514.0
Singapore	3541.0	4748.0	2849.1	5148.9	11837.0
Thailand	2402.0	1183.0	3298.0	7360.0	7819.4
Viet Nam	120.0	1780.0	2220.0	1671.0	6550.0
Developed Member Countries					
Australia	4272.4	2792.5	3819.2	1889.0	1624.7
Japan	-48968.9	-22591.0	-22767.8	-20960.2	-50999.5
New Zealand	...	4984.3	2120.1	-131.7	821.3

Table 3: Total Net Foreign Direct Investment (in US$ million)

The next table, Table 2, shows the effects of this large-scale FDI into China. It shows the growing importance of FDI in China's export performance.

Enterprises with foreign funding contributed 31 per cent to China's exports in 1995, just as the boom was starting. By 2005, when the boom was in its peak years, their contribution was 58 per cent.

Year	FDI (in $ bn)	Total Exports (in $ bn)	Exports by FFEs (in $ bn)	*Share of FFE Exports (in %)*
1995	37.52	148.78	46.88	31.51
1996	41.73	151.05	61.51	40.72
1997	45.26	182.79	74.90	40.98
1998	45.46	183.71	80.96	44.07
1999	40.32	194.93	88.63	45.47
2000	40.72	249.20	119.44	47.93
2001	46.88	266.10	133.24	50.07
2002	52.74	325.60	169.99	52.21
2003	53.51	438.23	240.31	54.84
2004	60.63	593.33	338.59	57.07
2005	60.33	761.95	444.18	58.30

Table 4: China's Inward FDI and Exports by Foreign Funded Enterprises (Nominal), 1995-2005[xvi]

But an even more striking pattern when the direction of trade flows is also taken into account. Table 3, taken again from ADB (*op. cit.*), reveals the shift between 1990 and 2007. On the export side, it shows a major shift in Chinese exports towards the US and Europe, with both doubling (or better) in percentage terms – which would also obviously in absolute terms, given the huge increase in China's export quantities. For almost all the other countries, the opposite process is under way. Exports to both the above destinations decline, while exports within Asia go up significantly, which for most countries, means to China. Only India and Indonesia provide partial exceptions, and then too, not very significant in quantitative terms. In plain language, China became the funnel through which raw materials and intermediate goods were finished and exported to the US and Europe.

Table 4 showing the changing pattern of imports is equally revealing. The imports of all countries, except China, go up from Asia, and down from the US and Europe. China's imports from all three regions decline, which indicates that it was importing ever larger amounts from other sources – mostly oil and other raw materials not covered in the three jurisdictions

included in these tables. Here, then, we have the new pattern that emerged over the period from the mid-1990s to the mid-2000s, and this brings out the nature and source of China's huge current account surpluses. To go further, the bulk of the surpluses arose from exports to two destinations, the US and EU. The US alone accounted for over 25 per cent of total exports in 2005, and for 18 per cent as late as 2016.

Country of Origin	To Asia		To Europe		To North and Central America	
	1990	2007	1990	2007	1990	2007
China, People's Rep.	67.7	40.8	14.7	23.5	10.0	22.9
Korea, Rep. of	34.0	51.4	15.5	16.1	33.4	17.5
India	21.0	32.6	47.2	23.4	16.3	17.6
Indonesia	64.3	60.8	12.8	13.3	13.9	12.5
Malaysia	58.0	57.1	16.6	13.5	18.1	17.3
Singapore	47.1	64.7	17.2	11.3	23.0	11.6
Thailand	37.8	54.1	25.3	15.5	25.3	14.5
Viet Nam	39.1	36.8	48.1	23.1	0.6	25.0
Australia	50.4	60.5	17.1	12.5	12.9	7.6
Japan	26.1	42.8	23.0	16.8	36.3	24.9
New Zealand	30.4	32.4	21.7	15.3	16.9	15.7

Table 5: Direction of Trade: Merchandise Exports (per cent of total merchandise exports)

Country of Origin	To Asia		To Europe		To North and Central America	
	1990	2007	1990	2007	1990	2007
China, People's Rep. of	48.4	40.4	24.1	14.5	15.8	9.4
Korea, Rep. of	33.5	46.7	13.1	12.6	25.3	12.0
India	17.3	29.9	41.3	21.6	12.9	9.2
Indonesia	43.4	70.7	22.5	8.4	13.7	5.1
Malaysia	50.6	60.3	17.9	13.2	18.1	11.6
Singapore	48.2	54.4	15.9	14.1	16.9	13.5
Thailand	53.3	56.4	19.7	11.0	12.1	7.6

Viet Nam	34.1	69.1	21.3	10.4	0.4	3.9
Australia	32.4	49.0	27.5	23.8	26.4	14.8
Japan	25.1	40.8	19.8	13.4	27.2	14.0
New Zealand	24.0	42.0	25.0	17.7	20.0	11.5

Table 6: Direction of Trade: Merchandise Imports (per cent of total merchandise imports)

The Fifth Phase: Unsustainable Surpluses Again

Thus, in the real economy, China was running up surpluses of a magnitude that even the Japanese – in their halcyon days – did not enjoy, leading to unprecedented surplus accumulation by China. At the same time, the OPEC countries were also enjoying a sustained rise in oil prices, which were to peak at over $140 per barrel (Brent) in 2008. Croesus was left far behind. A revealing datum is the figure for money supply in the US. M3 is the broadest measure commonly used, and it captures the newer forms of money market funds, as well as external sources. In the US Fed data, they also used to show the figures for non-M2 M3, and this figure, which captured these new sources rose from 1 per cent in 1959 to 35 per cent in 2006.

Once again, the global economy was faced with excessive surpluses and nowhere to use them. This time, the bulk of the monies were deposited in the US banks, particularly in the Wall Street banks, now freed from all constraints. They had also developed new and unregulated instruments with which to recycle these colossal amounts. Inevitably, this required dropping diligence standards for evaluating loan recipients. And this time, instead of syndicating loans, the safeguard employed was securitisation, in the form of Mortgage-Backed Securities, and other derivatives. Despite some efforts at regulating these activities, nothing was done to control them. It was in essence a repeat, with some change of technique and major actors, of the oil-finance recycling of the 1970s.

At least one person in a position of authority seemed to sense the dangers in the situation. When Fed Chair Greenspan began raising interest rates in 2004, he testified before the Senate, where he said, *inter alia*, *"We cannot be certain that this benign environment will persist and that there are not more*

deep-seated forces emerging as a consequence of prolonged monetary accommodation," (emphasis added).[xvii]

Given the elliptical way central bankers use language, it is hard to be certain as to the meaning of this sentence. His book, '*The Age of Turbulence',* also does not clear up the meaning. But it would be a reasonable assumption that this was on his mind, in the same way that the excess liquidity in the global system was in the late 1970s. In fact, in later years, Greenspan has squarely blamed the global savings glut for the financial crisis.

And Greenspan did not confine himself to statements. In the subsequent meetings of the Fed Open Market Committee, interest rates were raised 17 times on the trot, in a sequence that seems unimaginable today. What is even more striking in comparison, when the cycle of upward moves began in 2004, unemployment was at 5.6 per cent, and core inflation between 1.5 and 2 per cent - that is significantly worse in terms of unemployment, and not much different in terms of inflation as compared to the present situation. And yet, he raised rates, whereas today, there is a marked concern to hasten slowly, and then too with every mark of extreme reluctance.

Of course, there was in between the searing experience of the financial crisis, or the Great Recession, as it is coming to be called. Enough has been written about it, and this essay does not intend to go over the ground here. Some of the major post-crisis features of the global economy are worth highlighting. Arguably the most important change has been the effect on global trade. This has led global growth since the late 1940s, and has registered a growth rate of 6.8 per cent annually between 1985 and 2007. Post-crisis, it has slowed down and has barely kept pace with global GDP growth, even falling below in some years, and going negative in years such as 2015 – in both value and volume terms.

In turn, this behaviour of global trade has meant that export-dependent economies have been adversely affected. As the world's leading exporter, China has faced serious challenges in maintaining its growth rate. And that brings in the major feature, the rapid growth in Chinese debt. The open indebtedness in China is now 250 per cent of GDP, and there is more from

the shadow system. The Chinese are themselves more open about their economic problems than much of the western conventional media. Thus, for instance, the Chair of the People's Bank of China described the latent risks in the financial system as "hidden, complex, sudden, contagious and hazardous"[xviii]. This came after warnings from the IMF and the BIS, as well as downgrades by some rating agencies regarding the very same issue – Chinese debt levels. This level of debt accumulation in so short a period of time is without precedent in post-War history. In graphic form:

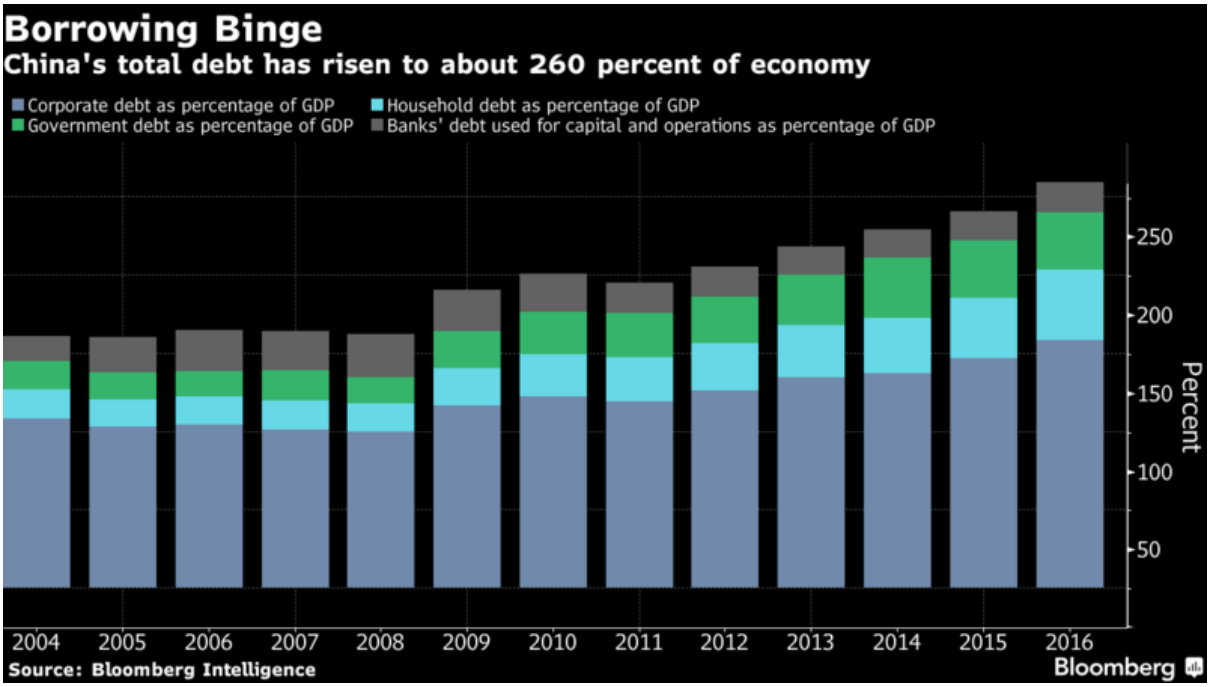


Figure 5: China's total internal debt 2004 - 2016

All of the above demonstrates not just the downside risks facing the Chinese economy in the post-crisis period; it also indicates the dependence of China on benign US policies, especially with regard to interest rates and trade. On the first count, higher interest rates will cause China also to tighten its debt issuance or risk a depreciation of the Yuan – and there are several well-known China bears who are shorting the currency. But it will also affect China's external debt, which is of the order of $1.5 trillion. This is why Fed Chair Janet Yellen finally broke her silence on the relevance of China in decision-making on interest rates in September 2015, when she decided against raising them and invoked China 16 times in her press conference. This was in stark contrast for the Fed, which barely talked about global worries before.[xix]

On the second count, China is even more dependent on the US for continued growth. In 2016, for instance, China's export surplus with the US was of the order of $350 billion. Its overall surplus was $510 billion, so the US contributed just under 70 per cent of China's trade surplus. This is in conformity with the long-term pattern of US-China trade.

There is the counter-argument that "China owns US debt", or that the "US is addicted to Chinese debt" – suggesting that there is mutual dependence so that China also has leverage over the US. In fact, China owns a little less than 6 per cent of US Government debt, which is about the same as Japan. Adding corporate debt to the numbers puts Japan well ahead of China. Plus which, the various Quantitative Easings have shown that, in the final analysis, the US does not need any outsider to buy its bonds. At its peak, the Fed was buying (and "twisting", that is, swapping maturities) a trillion dollars annually on its own. To prove the point, it may be recalled that China sold $188 billion of US Treasurys in 2016 – with little effect on yields.

To offer some final thoughts: the narrative above has been aimed at showing that the US has ensured its economic domination of the global economy essentially through financial control, after the industrial domination was irretrievably lost in the late 1960s. The financial flows, and the management of currencies enabled the US to direct its support through the process of "managed integration" described above. In turn, this brought the blessings of US effective demand to the EEC, then Japan, and finally, China. This last is being played out now, and there are vested interests in keeping it going, just as there are – especially in the new Trump Administration – forces that seek an altogether new system and pattern of international engagement.

It is early yet to discern the contours of this new pattern. But some tentative conclusions are possible. Firstly, the heavy reliance on trade-led global growth is under strain. It was breaking down anyway, even before 2017, but is now part of the strategy of the new Administration. This would have far-reaching implications for both the global value chains that emerged over the last two decades or so, and for the financialization of the US (and Western more generally) economy that took shape under the oil-finance cycle.

The role of Brexit is also worth noting. The Eurocurrency markets depended on the City in order to function, and that was among the main drivers of the British entry into the EEC, as it was then called. Now, the pull-out of the UK from the EU could very well be the harbinger of a new financial system to displace the current one.

These are huge changes, and are calling forth huge opposition. The outcome of this struggle will determine the kind of world that emerges.

Conclusion

Some winding up remarks would be in order now.

Perhaps a good starting point would be to state what should be obvious from the foregoing- the US is not in decline. Since the late 1960s, the US GDP share in the global output has been fluctuating between 22 and 24 per cent. In 2016, it was 25 per cent. One could argue about the nature and quality of the growth, but the basic fact cannot be controverted. The notion of decline has been linked to the undoubted rise of China. But China has filled the space vacated by the USSR, Europe, and Japanese stagnation. China's growth, as has been argued in this essay, is itself dependent on the US policies of loose money, and open trade, especially its imports. This is changing, if the Trump Administration follows through on its new economic approach. And so far, it gives every indication of being serious about this.

Equally, the Dollar is not under threat. Its role in international reserves remains unchanged, even enhanced. It accounted for 62 per cent of international reserve holdings in 1996, and that has gone up slightly to 63 per cent currently, as of end-2016. The Euro has increased slightly over the same period. The combined of the D-mark, the French Franc, and the ECU was a little shy of 18 per cent in 1996; it is 20 per cent now. There is also the Greek debt issue, which has not yet been finally resolved. The IMF has not joined in yet, pending a review of the repayment programme of the government for sustainability. After satisfying itself on that score, it will join the assistance package in 2018.

The Chinese Yuan is in the 1 per cent handle at present, but it entered the SDR basket only last year, so its future will need to be tracked. So far,

though, China has maintained strict – and tightening – capital controls, so it is unlikely that its share will rise significantly until capital controls are eased. Gold-backed movements are also worth monitoring, especially since China is now the largest gold producer in the world, and Russia and Uzbekistan are also among the top ten.

The foregoing analysis has also attempted to show the nature of the functioning of the global economy since the late 1940s. It has been an economy led and controlled by US power, which has been sustained by increasing financialization and dollar dominance, especially since the end of the Bretton Woods arrangements in the early 1970s. It has also been a system where trade has acquired a leading role in fostering economic growth. And once again, as the export destination of first resort, the US has had the power to direct the speed of that economic growth. It has also used its pulling power to shift growth from one jurisdiction to another – Europe initially, Japan and finally China.

All this has not been without external challenges, and internal doubt. As early as 1952, the incoming Eisenhower team posed the problem inherent in international trade, that of persistent surpluses and deficits. The point was made in the following words:

> *"How is it expected that a world system of trade and payments, free of quantitative restrictions and exchange controls and with convertible currencies, would be kept in balance? In other words, what equilibrating forces are expected to operate so as to prevent persistent surpluses and deficits (not accounted for by normal capital flow)? Under the gold standard the notion was that an inflow of payments produced by an export surplus would tend automatically to increase prices in the surplus country and reduce prices in the deficit country, thus stimulating imports into the surplus country and deterring imports into the deficit country. Whatever may have been the validity of this notion in the past it is clear that under present and foreseeable circumstances there is no direct or automatic connection between the inflow and outflow of payments and internal price levels."*[xx]

This was written at a time when the US was running surpluses with the rest of the world, and so is all the more prescient. But once the tide turned and

the US was facing the prospect of persistent deficits, the same problem was seen differently. Kissinger noted in a memo to President Nixon that "the present monetary system puts very little real pressure on surplus countries to act short of intense political pressure from the rest of the world".[xxi]

This indeed gets to the heart of the problem of international trade and finance. Surpluses are deemed good but deficits bad – and yet, you cannot have one without the other. And when the surpluses become as large as they did in the 1970s and in the early 2000s, the global economy faces the problem of how to utilise them. Both times, financial institutions found a way to put these surpluses to some use, and inevitably, they were economically unsustainable.

It appears possible that the new US Administration has understood that these are structural problems in the global economy and its management since the 1940s. The structure of the US economy itself has had perforce to change to accommodate these patterns of capital and trade flows, but this has come at a cost – frequent financial crises, poor job growth, and persistent deficits in the external balance, with corresponding volatility of the dollar. Not only have the new economic team openly rejected the long-standing commitment to free trade, they have also supported external policies – like the full-throated of candidate Trump for Brexit, when the incumbent President voiced open discouragement for it. It would be wise to prepare for a radical shake-up of the global economy.

One of the consequences that appears to be happening already, and even before the current Administration took office, is a slowdown in international trade. The period after 2012 saw stagnation, and even negative growth, especially in 2015, both in value and by volume. The situation has improved a little in recent years, but even now, the growth in trade is no faster than overall global growth. This is slow by historical standards, when trade has outstripped global growth by a factor of two or three.

This implies that domestic demand will grow in importance as a driver of growth. The Chinese leaders recognise this, and have been talking since the last ten years about the need to boost domestic demand. The results so far have fallen short. But India is in the happy situation of having one of the most buoyant domestic consumption economies in the world. The changes

described in this essay suggest that India needs to nurture this and the best way is to reduce the burden of direct taxes – on income, on corporate profits, and on property-related transactions – and to reduce the burdens of regulations and inspection. Not only will this play to our strengths, it will also provide a true free-market approach to managing the economy, something that has long been promised, but not really delivered so far. The experience of several countries is that reducing taxes does indeed raise revenues after an initial dip, through better compliance, and through higher economic growth. The times are propitious for such an approach.

There is another insight that the history of the last seven decades has to offer- depreciating one's currency is no help in fixing an external imbalance. The US example also bears this out. In terms of gold prices, the dollar has fallen from $35 per ounce, to close to $1300 per ounce today – and the US continues to run persistent deficits. And the dollar has not weakened just in terms of gold. It has been all over the place against the currencies of its main trading partners, including periods of extended weakness to no avail.

India itself offers a compelling example. A dollar bought Rs 3.21 in 1947, whereas today it is in the range of Rs 65. That is a 20-fold decline, and there has been a similar decline vis-à-vis other currencies as well. Yet, we have run deficits in our balance of trade every year, except two in the 1970s. Indian policy-makers would be well-advised not to work to weaken the Rupee since it will not help our external balance. The current US Administration has, to boot, placed India on the watch list for policies that deliberately weaken the Rupee. We have been buying over a billion dollars per month for the past few years, whether intending to weaken the currency or not. But that has been the effect. And it has not helped our trade balance.

Finally, the inquisitive mind will be struck by the close linkages between the economic and political. If Marshall Aid divided Europe along the line of cleavage of east and West, the Yom Kippur War served to raise oil prices and the launch of the oil-finance cycle. Similarly, there is fertile ground for inquiry into the gold production and its link to the dollar, to the US Interest Equalisation Tax, and perhaps even to apartheid. Similarly, the breaking of the oil-finance cycle in the early 1980s led to major pro-democracy

movements in South America. The distinction almost universally drawn between the economic and the strategic is probably a misleading one – and that is what this essay has tried to demonstrate.

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