

“TROUBLE AHEAD—TROUBLE BEHIND”

Restructuring the Global Economy—A New Marshall Plan

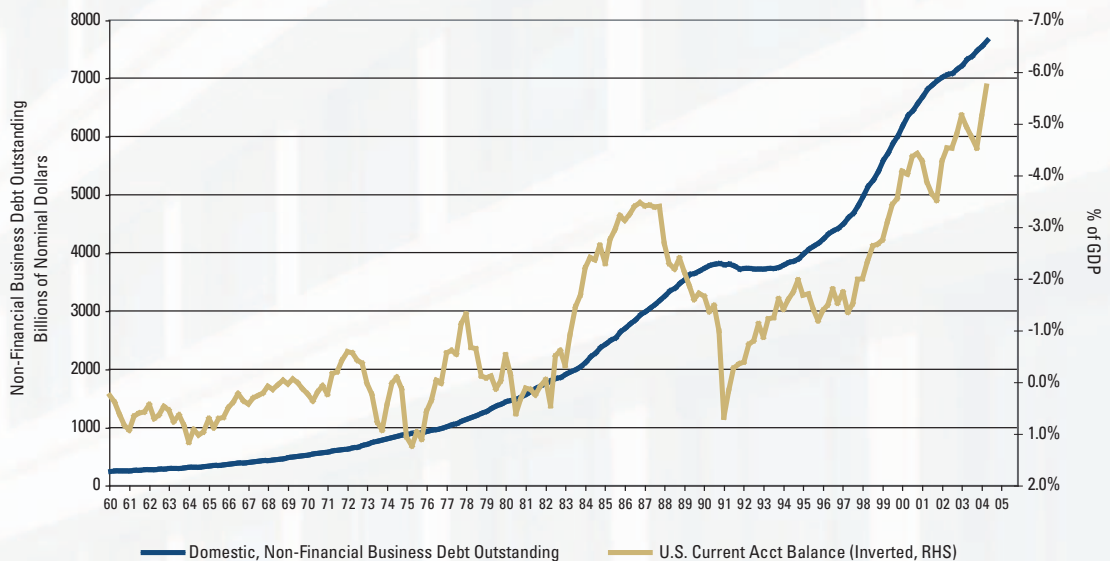
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Executive Summary

Today, the global economy is on the threshold of upheaval. The U.S. has borne the majority of the costs associated with the substantial structural change in the global economic architecture of the past ten years. Severe trade and financial imbalances pose grave risks to international stability. Keynesian spending policies and monetary stimulus predicated upon by Adam Smith’s free trade dogma, and the importance of global growth have produced the vulgar externalities of unsustainable indebtedness in the U.S. and Japan and excessive reliance on foreign capital in the U.S. As shown in Charts I and II below, domestic, non-financial business debt outstanding in the U.S. roughly doubled from approximately \$3.8 trillion in 1994 to approximately \$7.6 trillion today. Over the same period, the U.S. current account deficit soared from approximately 2 percent of U.S. GDP to nearly 6 percent, or by about \$3 trillion, accounting for 75 percent of the increase in U.S. debt formation. Absent a long overdue global restructuring, status quo policies yield to these imbalances. The U.S. current account deficit is forecast to grow to 8 percent of GDP in a few years.

Chart I

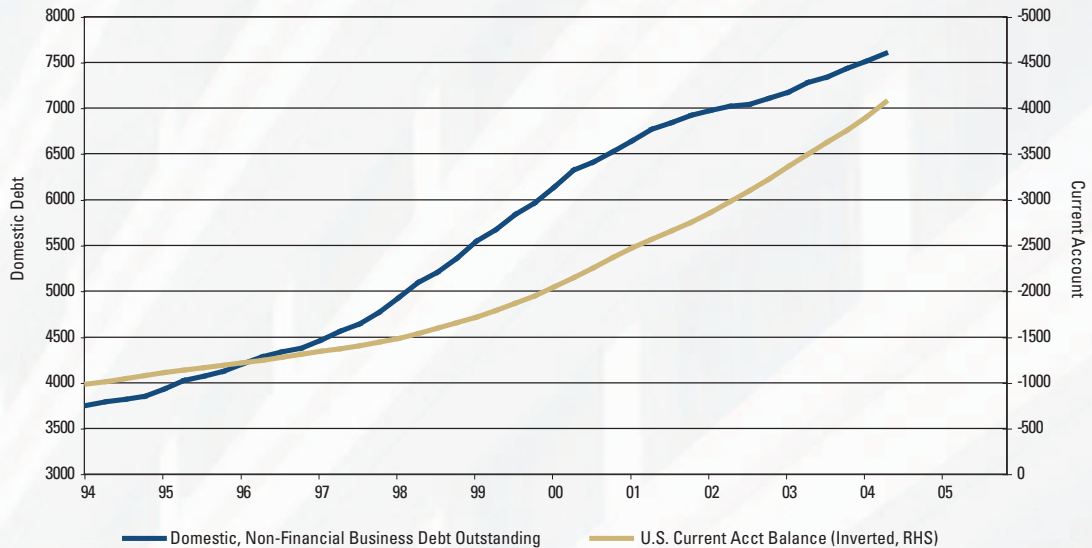
Increases In Current Account Deficit Create Increased Domestic Debt



Source: The Federal Reserve

Chart II

Growth In Current Account Debt Mirrors Growth In Domestic Debt



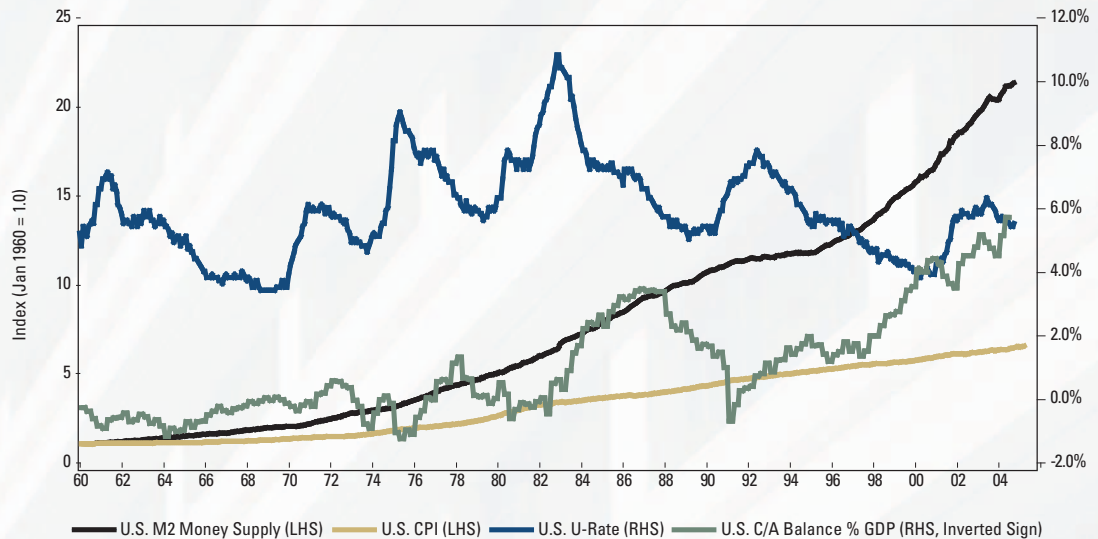
Source: The Federal Reserve

The potential for a dangerous financial crisis exists wherein the burdens of increased debt in the U.S. are transferred from the suppliers of leverage, mainly Asian central banks, back to the leveraged, namely U.S. citizens. Capital inflows into the U.S. have provided for debt formation, which has in turn resulted in an even greater U.S. dependency on foreign capital. Misguided Federal Reserve policy based on a flawed understanding of the natural rate of unemployment is at the heart of the problem. During time of war, such as today, full employment must prevail at all times, so Fed policy is constructed around a variable, theoretical rate of unemployment that is itself a fiction. Current and past Fed policies have promoted consumption, encouraged debt formation and contributed substantially to the trade and global imbalances of today. The objective function for the Fed therefore requires immediate Congressional amendment. Congress needs to impose trade and financial balances as critical variables in central bank policymaking.

The links between an accommodative Fed, consumption, debt accumulation and the explosion in the U.S. current account deficit are captured in Chart III below. Note first in Chart III that the money supply, a measure of the liquidity injected into the economy by the Fed, has expanded substantially from 1994 to 2004. To complete the link, note the explosion in domestic, non-financial business debt outstanding during the period and the surge in the current account deficit as a share of the economy.

Chart III

The Fed's Policy Objectives (Inflation, Employment) and Its Policy Variable (Money Supply)



Source: The Federal Reserve

What might motivate some members of the cartel of Asian central banks that hold massive dollar reserves to sell these assets? Perhaps it is their belief that U.S. policy makers will be foolish enough to take them out of their positions. Perhaps they will decide that their industrial development is well enough advanced that they no longer need to support the U.S. dollar as the cost for growing market share, importing technology, and expanding production becomes too great. Alternatively, perhaps they will realize that U.S. policy makers have changed their trade agenda such that their products are not welcome.

Ultimately, it does not really matter what motivates the change in behavior. Today, the potential exists for policy makers in a few Asian countries to immediately direct a sale of the holdings of their U.S. assets, and re-direct the proceeds to other countries or to domestic uses. Such a policy shift would produce a very hard landing in the U.S. which could include: a rapid increase in U.S. interest rates; sharp depreciation of the dollar; a fall in the stock market; a contraction of global trade; a reconfiguration of political/military alliances away from the U.S.; and, at the extreme, even military confrontation as the U.S. moved to sever its excessive reliance on foreign capital.

The scope of the global imbalances and the potential for crisis makes piecemeal, orthodox solutions to the global imbalance problem unworkable and far too slow. The U.S. service-based economy, with more limited economies of scale than those of newly industrializing economies such as China, will not be able to export its way out of the problem. The greatest demand for U.S. goods will be in industries such as aerospace and high technology. These are industries where exports pose national security risks. U.S. dollar devaluation by itself, especially if it is progressively slow, will increase inflation, interest rates and currency volatility without substantially improving the trade deficit. Tariffs would also work slowly and eventually invite counter-tariffs that could cripple global economies.

What then, is the solution? I believe that nothing less than an immediate comprehensive reordering of the global economic architecture will suffice. The scope of the problem is too large, time is too short, and the eventual dangers associated with global economic imbalance are too great for anything less. In effect, I am calling for a new "Marshall Plan" for the global economy: A plan to be led by the U.S. It will include a broad mix of domestic policy initiatives in the U.S. designed to boost saving, cut the federal budget deficit and shift the Federal Reserve's objective function away from promoting

consumption and toward a current account readjustment. The U.S. standard of living must decline substantially if these initiatives are to be achieved.

Change is not confined to the U.S. in the new regime. For global rebalancing to work, costs must be broadly shared. The new Marshall Plan would call for a 40 percent revaluation of the Chinese yuan, Indian rupee, and Russian ruble vs. the U.S. dollar and the renegotiation or even forgiveness of U.S. debt held by countries with large trade surpluses with America. Such external changes would create a system that measures and adjusts outcomes relative to the objective of trade/financial balance and provides a rebate to the U.S. for the prior currency readjustment bridge financing provided by the U.S., and rebates to the U.S. a portion of the cost in the fight against terrorists.

A list of policy ideas to be included in the new Marshall Plan is included as the final section of this paper. These recommendations are serious and real, yet few people will agree with all of them and fewer still will believe that any, let alone all of them are achievable. I disagree with the former group. Moreover, I do not agree with the bleak prospects of achieving at least some of these initiatives if an effort were actually undertaken to do so. Status quo despair takes us down the common path, the path to ruin and global conflict.

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I. Introduction

The change in the geopolitical economic architecture during the past twenty-five years has been historic. In January 1980, Europe was divided between East and West. The East was part of the Soviet Communist block. The West consisted of 25 countries, 21 central banks and 20 different currencies. China was an isolated Communist country whose trade with the U.S. totaled \$1.1 billion. Russia, the controlling portion of the Soviet Empire, existed independently of the Western World. Total domestic non-financial U.S. debt was \$3.7 trillion; U.S. dollar/yen was 250; U.S. dollar/deutschmark was 1.78; the hypothetical euro/U.S. dollar rate was 110; gold sold for \$500 an ounce and a barrel of oil cost \$40. The change to date 2004 has been profound. Russia and China have opened their borders to the world. The bilateral trade balance between China and the U.S. is now approximately \$140 billion. Russia's trade surplus with the world approximates \$80 billion. Eastern Europe was freed of its Soviet dependency and is again part of Europe. "Old Europe" is "united" by the Maastricht Treaty with one currency and one central bank.

Global economic changes during the past decade have been dramatic. Change is usually hard to come by. It occurs accidentally and through planning. Change springs from within, but is also imposed from without, though the forces that drive change are difficult to identify. National identities and national pride lead to biases in the analysis. Did the Soviet Union change because it was about to go bust or because its leaders determined it was strategically a good time to change? Did the changes in China occur because of external pressures or internal desires? These questions are hard to answer but important to ponder.

Today, the global economy is on the threshold of more change. Severe global trade and financial imbalances pose grave risks to international stability. While the costs of restructuring these imbalances will be substantial, the most pressing issue will be the global distribution of the costs. The underwriter of the existing restructuring, the United States, will face a tremendous challenge in arranging a revision of the current global economic regime, which requires the cooperation of other important countries and regions to bear a portion of the cost.

Changes in the global economic architecture will be proposed in this paper. The changes will be especially difficult to achieve in the face of deeply entrenched assumptions and interests. These assumptions constitute a "null set" built around Adam Smith's fallacious ideas of free trade, comparative advantage, fixed/pegged exchange rates and globalization. Adam Smith's vision seems so compelling in theory that it is hard for policymakers and investors to accept that the world described in *The Wealth of Nations* bears little actual resemblance to today's economic landscape. As I will

describe in more detail below, Smith envisioned a community of like-minded trading nations that enter into treaties of commerce based on reciprocal advantages. In today's world, international trade is often conducted between countries with very different economic systems and the advantages turn out to be far from reciprocal. Take for example the opening to China by the U.S. in the early 1970s. In that case, a relatively open and dominant U.S. economy sought to build markets in a less developed agricultural economy. This strategy has backfired, as the agricultural economy, China, has been able to industrialize, taking advantage of huge economies of scale that put the former U.S. economy at a permanent competitive disadvantage in terms of labor costs.

In 1993, I authored a paper within which I addressed many important geopolitical topics. The paper in its entirety is available on the PIMCO website under Dialynas Policy 1993 (unpublished, unedited). At that time, the global restructuring was in its infancy. The paper was distributed to a select group of about 25 people. The opinions were honest but controversial. The paper advocated protection of domestic markets among other important economic issues. Even today, the opinions are controversial, especially amongst my PIMCO colleagues. The intent of the research phase of the original paper was to generate a policy piece for a second Bush Senior presidency. The evolution of the paper from a public to a private one occurred with the Clinton victory.

In this updated paper, I maintain the 1993 paper positions and comment about the present situation as it pertains to each topic. The 1993 paper was very secular and many of its insights proved to be on the mark. The following concerns I raised in 1993 were confirmed by subsequent events:

1. Mexican Crisis of 1994
2. Japanese Deflation
3. Russian Default
4. Emerging Market/Asian Crisis of 1997
5. Long-Term Capital Management Crisis
6. Capital Controls
7. Corporate Fraud/Option Programs
8. Pension System Bust—Underfunded—Improper Asset Allocation
9. Pension Benefit Guaranty Deficit
10. Massive U.S. Current Account Crisis
11. U.S. Federal Debt Explosion
12. Currency/Trade Problems with China
13. Isolationist Global Policies
14. Appointment of Homeland Policy Czar
15. Institutional Asset Allocations to Commodity Assets
16. Very Low Nominal Interest Rates
17. Transfer of U.S. National Security Interests to the Chinese
18. Growth in State-Sponsored Gambling
19. Hedge Fund Proliferation

Many of the episodes of the past ten years are the result of massive U.S. government spending and a Federal Reserve Bank that can only be characterized as pre-emptive. The Fed has transformed itself from Lender of Last Resort to Lender of First Resort wherein global capital is misallocated and asset bubbles predominate. The notion that a Central Bank can serve as “risk manager” to the global political/economic system is ludicrous. The Fed has surrendered its capacity to effectively regulate the economy to foreign investors and governments. Contrary to the rhetoric of Fed officials today, the cumulative balance of the negative externalities arising from their past policies are today constraints that bind current and future policy alternatives.

What are the future policy alternatives? The next section of the paper provides answers to this question and also describes the geopolitical environment that has shaped the severely imbalanced global economy.

II. The Geopolitical and Policy Environment

The formal unification of Europe and the informal integration of an Asian block, led by China, substantially altered the ability of the U.S. to impose policy solutions upon the world. The conflicts that will occur among EU member countries will substitute for the prior subordination of the geopolitical/economic interests of European countries to the U.S. German unification in 1989 was the start of Europe's independence.

China and Japan are the economic/political powers in Asia. China's regional military advantage provides it with leverage that other Asian countries, and presumably Japan, cannot match. Therefore, the Asian cartel relies on China to promote its interests, viewing the Chinese as their broker with the West. The Asian countries' currencies are effectively pegged to China's currency, the renminbi (RMB) and, therefore, by virtue of the RMB/dollar peg, pegged to the dollar. The whole of Asia is hiding behind the mighty shield of China. Trade surpluses that Asian countries previously ran with the U.S. are now run through China, so that the trade between China and the U.S. is both direct and indirect. Japan's trade with the U.S., for example is both direct and cycled through China. The Chinese act as a trade broker for the Asian region, representing the cumulative economic effort of Asia. The region runs an enormous \$270 billion trade surplus with the U.S.


Resolution of the current global trade imbalance is not possible within the present economic architecture. In fact, the present trading structures will result in greater global imbalances in the U.S. citizens absorbing the costs. Policy deliberations based on misconceptions about free trade and comparative advantage offer little chance of redressing the imbalance. The inability of the U.S. to form a united consensus within its "bloc" regarding global terrorism and Iraq is indicative of a cartel-dominated world within which the traditional Western Cartel is eroding. Moreover, restructuring the global economy will require a dramatic reduction in American living standards. Americans have rarely, if ever, experienced a reduction and are likely to resist.

The U.S., Russia and China are unique in that all three invested tremendous sums in military technology during the post-WWII years. The U.S., for example, spent over \$20 trillion on defense since World War II. While it is assumed that the U.S. enjoys global military dominance today, it is difficult to know with domestic/political certainty. One must wonder why the U.S. spends imponderable sums on military power if the resolve to use this capability is absent. The threat of military engagement by America will be required to re-establish global economic/political balance. The economic restructuring costs associated with positive change in China, Russia, India, Brazil, Asia, etc. have been disproportionately borne by Americans because U.S. Keynesian spending policies and monetary stimulus dictated by Adam Smith's free trade dogma and the imperative of global growth, have the horrible, vulgar externality of unsustainable indebtedness in the U.S. Trapped by debt in a weakened state, the U.S. is now impelled to pursue unorthodox policies to relieve its burden, including military confrontation.

The policies of the status quo in the U.S. will ensure the transfer of military superiority elsewhere. The rapid industrialization of other countries naturally results in a tendency to increase resources dedicated to the protection of the newly created industries. The tendency is to protect access to markets and the property rights of the new industries. These property rights are both 1) private and 2) public. In either case, substantial increases in defense spending are warranted in areas where industrial expansion has occurred.

The scale and scope of the Chinese industrial revolution is so large and so important that a global adjustment needs to start immediately if the U.S. is to avoid a catastrophic outcome of a severe global recession/depression. The remainder of this section of the paper outlines the policies needed to spur the adjustment.

A reduction in U.S. debt is a necessary ingredient to the adjustment. Debt forgiveness by foreign holders is an important first step. Simultaneously, the U.S. must curtail government borrowing and substantially increase savings. A deficiency in U.S. national savings, represented in large part by the U.S. government's deficits (which amount to dis-saving) is an important contributor to the global



imbalances. Thus, an absolute reduction in government spending (as distinguished from a mere change in the distribution of spending) and increased taxation are critical. Moreover, the distribution of government spending must also shift, toward national defense and away from supernumerary social programs. The government's investment in older people requires re-examination. To put it bluntly: does it make much sense to spend tremendous resources to extend the life of an elderly person a few years? These policies are the most vulgar of U.S. consumption habits. Certainly, the monies are better invested in the health and education of the youth. Modest reduction in the U.S. federal deficit could be achieved by dramatic reductions in Federal social programs—particularly Social Security. Social Security should be a means based program in which an individual's assets (including real estate) are marked to market and treated as savings.

To gain perspective on the U.S. Social Security system, consider the following remark by U.S. President Franklin Roosevelt, creator of the system, to Frances Perkins as quoted in the book *The Roosevelt I Knew*, by Frances Perkins, 1946.


"I see no reason why every child, from the day he is born, shouldn't be a member of the social security system. When he begins to grow up, he should know he will have old-age benefits direct from the insurance system to which he will belong all his life. If he is out of work, he gets a benefit. If he is sick or crippled, he gets a benefit."

The initial construction of the Social Security system was based on a social insurance concept. Participants would contribute to the plan and have a contingent right to participate in it. In a Fireside Chat radio address, Roosevelt said he intended to provide "sound and adequate protection against the vicissitudes of modern life—in other words, social insurance." The basic purpose behind the enactment of Social Security, including old age benefits, was establishment of a social net that helped people avoid hardship. In other words, it was an insurance system to provide for those who have been unable to provide for themselves. Title I of the Economic Security Act authorized federal payments to the states for U.S. citizens over 65 years old whose income was "inadequate to provide reasonable subsistence compatible with decency and health." Ironically, because the system originated during the Great Depression, the economy could not afford to construct a fully funded program and instead devised a pay-as-you-go benefit system.

The Social Security system has been amended many times since its inception. Today, the pay-as-you-go system remains in place and the system is virtually bankrupt. Revisions to the system are required. The current Bush administration is seriously considering partial privatization of the system. Essentially, this involves the government borrowing to provide a lump sum to individuals now to invest as they choose, relying on the specious assumption that over the long run equity returns will exceed the government's cost of debt, so presumably smaller government payouts would be required to meet the anticipated system liability.

There are at least two serious problems with this idea. First, equities do not always do better than bonds, particularly within a world of global competition. Second, Social Security, on its most basic level, is supposed to serve as a safety net—one that prevents hardship when times are difficult. Presumably, bad times strike the less prepared and less fortunate most often. Thus, under the Bush Administration's plan the government will transfer funds "for investment" into the hands of the less skilled, so they may undertake high-risk investments about which they know very little. When they lose the investment, they will then qualify for the means test of public assistance. The bottom line is an outcome in which the government will make not one, but two payouts for retirement benefits. The cost of the plan will increase—not decrease!

The reduction of America's debt requires an extreme reversal of personal privileges. The time for extreme sacrifice in the U.S. is upon us. The re-examination of "rights" is required as debt accrues in the U.S. Debtors hold very few rights, let alone personal liberty, albeit one important one—the right to default. They can default and, fortunately for them, avoid debtors' prison. As noted in my 1993 paper, the form of default is important, because default is a form of taxation. The simplest, most effective method of default is via cessation of payment. Because the U.S. needs relief from abroad by virtue of the trade deficit, it needs to start the adjustment. The U.S. default would be directed at the foreign



holders of its debt. The side effects associated with outright default would be enormous. Foreign investment in U.S. bonds might stop. The U.S. dollar could plummet. The adjustment would be off to a fine start as long as U.S. interest rates did not rise substantially. Other methods of indirect debt default include inflation and currency depreciation. Employing inflation and currency depreciation to make the adjustment will take time and will not work. Unfortunately, an inflation tax is not a viable alternative for U.S. policy makers because the average maturity of government debt is only four years, the majority of entitlements are indexed to inflation and an increasing proportion of U.S. government debt is itself indexed to inflation. In any case, these policies promote only a gradual adjustment of global imbalances, if any, but more dramatic and immediate changes are needed. We are out of time. More time with the status quo will result in a more severe adjustment, less flexibility and, ultimately, a much harsher outcome.

Rational investors who lack a “common label” will anticipate the outcome of debt default and act to protect themselves via capital flight. This risk is particularly pronounced in an open economy with a multi-label society such as the U.S. Thus, “gradual” policy programs suffer the tax of anticipation, represented by flight capital, which disrupts gradual programs and makes implementation costlier. The policy prescription to combat this flight risk is simple. You can flee the country but you cannot flee freely. In fact, the exit tax needs to be huge. A common interest must be established such that all know “we are in this mess together.” Free riders and chiselers are unwelcome and will be punished. Establishment of common interest when debt is high is paramount. America’s private capital base cannot diminish as the industrial base has. So, domestic capital controls are required and perhaps even a dual currency system to prohibit capital flight. Establishment of complex capital controls requires careful, thorough construction such that all forms of capital flight are prohibited and discouraged.

Outsourcing and investment in plants and equipment abroad are examples of capital flight in action. These activities would be strictly controlled under the new regulatory regime. The exportation of capital by a great debtor nation is irreconcilable with its national interest. Capital flight can, in the extreme, produce a dollar or interest rate crisis. As I will describe below, the Federal Reserve Bank might react to a perceived “dollar crisis” or “interest rate crisis” by purchasing U.S. bonds in the market. The purchase of bonds by the Fed alleviates these crises in the short run, but is the wrong thing to do. The Fed risk management policy provides an exit for the foreign holders of bonds even as U.S. citizens are trapped with debt. If the Fed saves the system and purchases the U.S. debt held by foreigners, then U.S. holdings of domestic debt are actually increasing as the government issues more bonds. A “risk managing” Fed thus subsidizes foreigners as it takes the currency and interest rate risk associated with the massive U.S. debt build-up off their books of foreigners. The costs of the debt are thereby transferred back to the domestic “multi-labeled” citizenry who must then decide how that substantially increased debt burden is distributed. In this world, the U.S. bears even more of the cost of global restructuring. The Fed must not act to prevent the market adjustments required for global rebalancing. The depreciation of U.S. assets held by foreigners is the tax that they must pay for the benefit of a restructured system. The Fed must acknowledge this truth.

Alternatively, the U.S. could impose a tariff of, say 25 percent on all imported goods from surplus countries to re-establish global trade adjustment. The tariff is across the board and would not discriminate between goods for which the U.S. has domestic production capabilities and those that it does not. The policies would not require approval or action by other countries. However, establishment of tariffs will not be effective. They will be too little, too late. Such policies can be expected to invite counter-tariffs. More broadly, tariffs will result in a depressionary inflation. An environment of counter-tariffs will severely restrict trade, causing a sharp global economic slowdown, while at the same time pushing up prices of goods that compete with imports in the U.S. The result will be an abrupt downward adjustment in U.S. living standards in chaotic ways and, absent capital controls, with the total burden ultimately borne by those patriots whose capital remained at home.

To accept the urgent need for the policies described above, it is important to grasp that the scope of the global imbalances defies traditional solutions such as currency adjustments or even tariffs. A much more broad based shared sacrifice rearrangement of the global economic architecture is essential. The

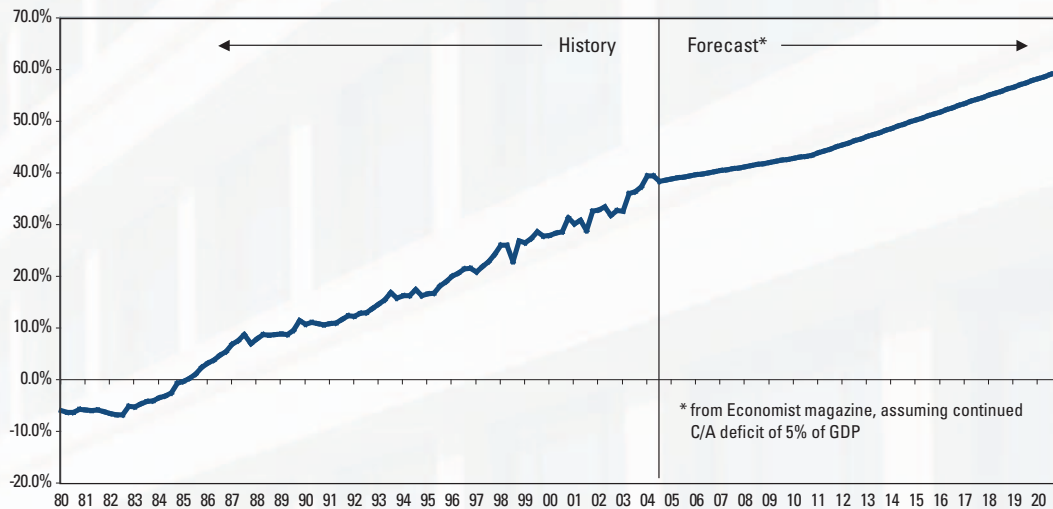
remainder of the paper will deal with impediments to the resolution of the global imbalances, the fallacies that gave rise to the imbalances and how the end game might unfold.

III. The Scope of the Problem

The adjustment problem is enormously difficult now. Deleveraging was the primary 1993 paper policy recommendation. The global financial system has experienced great changes and tremendous volatility since then. On average, the U.S., Japan and the U.K. have increased leverage. The U.S. and the U.K. are in fiscal deficit and trade deficit. Domestic and non-financial debt in the U.S. rose from \$12.4 trillion in 1993, to \$23.6 trillion in 2004. In the U.S., federal debt increased from \$3.3 trillion in 1993, to \$4.3 trillion in 2004 and trade debt from \$1.1 trillion in 1993 to \$4.1 trillion in 2004. Most emerging market countries have reduced leverage and devalued their currencies during the late 1990s. Europe remained more or less constant; some countries increased their budget deficits, but some saw a moderate increase in their trade surplus. China, Russia and India have experienced massive trade surpluses and reductions in debt—the winners! Japan’s fiscal debt increased substantially but their trade surplus also increased substantially. The big loser in the race to balance on surplus has been the U.S.

The current phase of U.S. current account deficit (CAD) deterioration began in 1994. The deterioration of the CAD has continued such that it approximates 6 percent of GDP, approximately \$550 billion for 2004, and is projected to grow to 8 percent of GDP within a few years. There is no solution in sight to the continued deterioration. The net investment position (the broadest measure of U.S. global indebtedness) was -\$1.2 trillion in 1994. At year-end 2003, it was a -\$4.2 trillion and is expected to reach -\$4.6 trillion by year-end 2004. So, the cumulative debt rose from 17 percent of GDP in 1994 to 33 percent of GDP at year-end 2003 and is projected to increase to 50 percent of GDP by 2008; representing 500 percent of expected export revenue. As seen in Chart IV, U.S. net foreign liabilities as a share on the total economy are sharply on the rise and now total some 20 percent of GDP. Assuming a U.S. current account deficit of 5 percent of GDP going forward, U.S. net foreign liabilities could surge to a staggering level of more than 60 percent of GDP by 2020.

Chart IV
Debtor's Prison



Source: The Federal Reserve

— U.S. Net Foreign Liabilities as % of GDP

A good deal of the productive capacity of the U.S.A. was transferred to other countries as result of the trade deficit of the past ten years. The loss of productive capacity means that the base upon which the U.S. relies to produce goods is smaller and, consequently, the ability to rebalance through export is reduced. Moreover, the newly established production facilities elsewhere are technologically advanced, garnering great economies of scale. In a country like China, where the establishment of public capital (roads, bridges, waterways, schools, etc.) has been very significant and continues on a massive scale, the marginal economic cost of the establishment of the next factory is reduced. Similarly, the necessity of continued operation of the factories in the newly industrialized countries is required to support the larger stock of public capital. The expected return on investment in these other countries and the economic uncertainties associated with a change of momentum inhibit global readjustments. In fact, this and other impediments to rebalancing are substantial enough to defy traditional solutions to the problem. In the next section, I will describe the impediments in more detail, setting the stage for the recommended revisions in the global economic architecture outlined later in the paper.

IV. Impediments to Global Rebalancing

A. Service-Based vs. Newly Industrializing Economies

During the past 15 years consumption of oil as a percent of U.S. GDP has declined by approximately 20 percent. This decline, as shown in Chart V below, is indicative of a decline in the U.S. manufacturing base and an increase in the contribution of the service and finance sector to U.S. GDP. This point is noteworthy since we must consider export capability as a potential solution to the trade imbalance crisis.

Chart V
Petroleum Consumption (Private+Government)
as a % of GDP (Quantity)
Crude+Gasoline+Other Distillates



Source: Bureau of Economic Analysis

The transformation of the U.S. economy from industrial to service-based reduces the capacity of the U.S. economy to rebalance. A service economy is dominated by investment in human capital—a short-lived asset with few economies of scale. Investment in new plants and equipment is required for a country to gain industrial production and to maintain production capability. The new investment renders old plants inefficient and eventually obsolete. The expected productive life of the new plant is long. The life of investment in the human capital of the service economy is brief and requires constant

reinvestment each generation. Increasing the gearing, or leverage of a service-dominated economy is limited relative to an industrial economy. The U.S. economy reached its gearing limit with the massive debt build-up and historically low short-term interest rates.

Newly created industrial economies such as China enjoy increasing economies of scale. Such economies are greater when labor supply is plentiful and, therefore, cheap on a global basis. The construction of infrastructure (roads, bridges, airports, railroads, etc.) serves to promote more investment. The marginal cost and risk of investment decrease as the infrastructure development progresses. To appreciate how these advantages can propel industrial development, consider that China's manufactured exports totaled only about \$50 billion in 1990. By 2003, the volume had grown eight-fold to approximately \$400 billion, and by more than \$150 billion since 2000.

The momentum of industrial development and competitive advantage in countries like China will only increase, to the detriment of de-industrializing nations such as the U.S. Cheap labor supply is an insurmountable competitive global advantage. Foreign producers like U.S. manufacturers, in an effort to compete, attempt to establish factories in the cheap labor country. The host, newly industrialized country welcomes such investment on a limited basis because it promotes the development of the host country, encourages technology transfer and provides a geopolitical prophylactic. The cumulative volume of flight investment calls into question the national loyalty and motivation of the home investor/producer. The greater the investment abroad, the greater the private need to protect the foreign investment and encourage public actions adverse to the home country and in favor of the newly industrialized country.

The fixed investment in the newly industrialized country is a very valuable resource; increasing in size. The new plant creates local job opportunities, products and tax revenues and foreign reserves for the government. The foreign investment facilitates technology transfer to the newly industrialized country. The sale of consumer products by the newly industrialized country to other countries provides cash flow for the import of technology and industrial inputs. The profits provide for reinvestment in more plants and equipment. The process continues until the imbalance between the newly industrialized country and the de-industrialized country is great. It is not difficult to foresee the process. The newly industrialized country, recognizing the value of its new resources, undertakes activities to prepare for the defense of its investments. Investment in military technologies increases at a faster rate in the newly industrialized area. Domestic discord grows in the newly de-industrialized country as jobs are displaced. The intensity and speed of the process increases as debt accumulates in the de-industrialized country. The gearing of the service economy results in a need for more and more gearing as productive capacity diminishes. The funding of military capacity becomes increasingly difficult.

The establishment of industrial and military capacity in the newly industrialized country provides greater independence of action and policy. In geopolitical terms, the change in status attracts new friends to the newly industrialized country. The opposite holds true for the de-industrialized country. The increase in liabilities and reduction in industrial and military capacity reduce the attraction of the de-industrialized country to its allies.

The reduction in the global prestige of the de-industrialized country results in a reduction in negotiating leverage. Diplomatic solutions to problems become more difficult. The reduced capacity to negotiate increases global frictions and the probability of conflict and confrontation. An immediate global political-economic rebalancing is required to avoid such a conflict.

The global rebalancing requires the participation and sacrifice of all countries. Otherwise, "free trade" will once again be, as Keynes noted: "A desperate expedient to maintain employment at home by forcing sales on foreign markets and restricting purchases which, if successful, will merely shift the problem of unemployment to the neighbor which is worsted in the struggle."

B. Limits to Foreign Demand for U.S. Goods

The foreign purchase of goods produced in the U.S. is a potentially partial solution to the trade deficit. However, I find it difficult to understand why foreigners would prefer American goods when

Americans prefer foreign goods. The only American goods foreigners will consume are those that are uniquely American. At the extreme, foreigners will desire goods that are off limits—high technology, aerospace and defense goods. Recent statements by Chinese government officials have confirmed China's interest in these types of goods. It would be a monumental error for the U.S. to permit sale of strategic items. The U.S. military is one of America's most important advantages relative to the rest of the world. This advantage must be maintained.

The large amounts of debt in the U.S. will make it more difficult to maintain the military advantage. Strong trade-generated cash flows to foreigners will fund new military spending outside the U.S. It is imperative that U.S. policies not yield irresponsibly to trade deficit hysteria. High tech and sensitive defense goods are a national good and should not be sold. Quite the contrary, as the U.S. ought to maintain and even increase defense spending.

C. The Perils of a General Currency Devaluation

As we have seen, the vast majority of capital inflow to the U.S. is from Japan and China. The dependency upon Asian capital is quite risky; just as dependency upon OPEC oil is quite risky. The reason, described in detail later in the paper, is a potential loss of control by the U.S. in the event the foreign holders of the debt decide to liquidate. There is a need to curtail this dependency via devaluation of the dollar, with the greatest magnitude of the devaluation aimed at currencies of countries with the largest bilateral trade surpluses, China, Russia, India and Japan. However, it would be a mistake to assume that general currency devaluation by itself is an answer to global economic imbalances. A large devaluation in and of itself would have an adverse impact on the global economy and on major asset classes in the home country, the U.S.

A progressively devalued currency is a very bad policy for the bonds of the home country. The devaluation, especially if it is progressively slow, will tend to increase the home country's inflation and interest rates and also the volatility of its currency as further devaluations are anticipated. It is very possible that the interest rate effect is muted temporarily by a currency cartel that chooses to maintain currency value through the purchase of dollar denominated bonds—a phenomenon that presently dominates in the U.S./China, U.S./Japan relationships. However, this non-economic behavior is not sustainable and only delays and magnifies the pain of the eventual readjustment.

Currency devaluation, an inflationary event, will tend to result in an appreciation of real assets. Equities, a claim on real assets of production, will increase in value as a devaluation progresses. U.S. companies with assets abroad valued in appreciating currencies will likely outperform the market. In fact, equities may increase in value at a greater rate than the devaluation. The real replacement value of the assets is assumed to exceed the devaluation because the replacement value of the asset itself (Tobin's Q) needs to remain constant and because it is assumed that the devaluation will increase the cash flow associated with the devaluation; the equity kicker. Therefore, in the initial speculative phase of a devaluation, performance of equities should exceed the rate of the devaluation. If, however, the devaluation is economically ineffective, the expected cash flows will not materialize. For example, due to a nearly infinite Chinese labor supply, the initial benefit of a devaluation could be swamped over the long run by competitive pressures that result in a decrease in equity cash flow and a diminution in nominal equity value. The bottom line is that U.S. stocks might increase in value following a devaluation but the increase is likely to be much less than expected in a static analysis.

D. Little Appetite for Change in Global Economic Regime

There is little appetite for a change in the current economic regime because the whole world has benefited from U.S. policies. Leveraged U.S. consumption has transferred wealth from the debt laden U.S. to other countries in both direct and derivative ways. In this regime, the U.S. pays and everyone else plays. Consider the following examples:

The Japanese and German economies have been greatly advantaged by the U.S. led development of China. Excessive demand policies in the U.S. have sustained strong consumption. Consumption of Chinese products by America amounts to \$152 billion in 2003. The U.S. trade deficit with China

totaled \$135 billion in 2003, and is running at a \$145 billion annual rate in 2004. This massive U.S. consumption demand created a derived Chinese demand for industrial products from Japan and Germany as well as commodity demand from Brazil and Russia. In 2003, Japan exported \$74 billion of products to China and Germany exported \$24 billion of products.

To be sure, the appreciation of the euro and the pound sterling relative to the U.S. dollar imposes a particular strain on the economies of Europe and, especially, Germany, as long as the currency of China is pegged to the U.S. dollar. The euro's appreciation vs. the renminbi has matched its gains vs. the dollar. European goods become relatively more expensive to the Chinese relative to American goods and relative to the goods produced by the many countries, including Japan, Russia and India, who have also pegged themselves to the renminbi. Being the greatest beneficiary of Chinese demand in the unpegged world, the Germany economy is the most sensitive to exchange rate changes. As the global imbalance progresses in a quasi-fixed U.S.-Asian exchange rate regime, the freely floating exchange rates of non-interventionist governments such as those in Europe will tend to appreciate relative to the dollar as they absorb a portion of the cost of the restructured global economy. Social strains will continue to increase in Europe.

The U.S. global war on terror has also contributed to the growth of the U.S. federal debt. The global capital markets have benefited from the anti-terrorism campaign. Wealth has accrued across the world and, particularly, in the newly industrialized countries. The entire world has enjoyed economic benefits from the fight on terror.

While Europe has borne some of the costs of restructuring, it has nevertheless obtained significant derived benefits from a global economy dominated by leveraged U.S. consumption. These derivative effects are very powerful. Take Russian debt for example. Russia defaulted on its domestic debt in 1998. The market value of that debt plunged to five cents on the dollar. Most of the Russian debt is held by French and German banks. U.S.-stimulated demand for foreign industrial goods and commodities by the Chinese in conjunction with the U.S. invasion of Iraq has contributed to a doubling of the price of oil. Russia is the world's largest supplier of oil. The Russians now run a huge trade surplus and are accumulating about \$10 billion in reserves per month in addition to the \$120 billion they presently hold. The credit quality of Russia has increased substantially as the reserve accumulation progressed. Accordingly, the value of the debt of Russia, including the GKO's held by the Germans and the French, has increased tremendously. It is now worth more than twenty times what it was worth in 1998.

Iraqi debt, owned primarily by the Europeans and Russians, is another example. It was illegal for American citizens to own Iraqi debt. Before the 2003 invasion of Iraq, the Iraqi debt was trading at ten cents on the dollar. As the invasion of Iraq progressed, so did the value of Iraqi debt. As of October 2004, the debt of Iraq was trading at 30 cents on the dollar. The wealth of the Iraqi debt holders has increased by approximately three times at the expense of the U.S. federal deficit.

How did the existing global economic regime, with its inflexibility and misdistribution of benefits and costs, arise? What are its intellectual underpinnings? The next section of the paper attempts to answer these questions.

V. How Did Global Imbalances Arise? A Tale of Two Fallacies

A. Friedrich List and the Free Trade Illusion

Friedrich List, a 19th Century German political economist, formulated controversial trade cycle theories. Of particular importance to me was List's opposition to the use of Adam Smith's laissez-faire global welfare ideas. Specifically, List distinguished between national and global welfare. He emphasized the fallacy of Smith's assumption of a friendly global union of national states. This assumption was historically invalid and a prospective dream. Consequently, the notion of comparative advantage, while compelling in a utopian sense, was practically flawed. List was a severe critic of the Cosmopolitical School of Economics, which is a label that he gave to the Adam Smith school of thinking.

List's ideas are of great importance today. The global trade imbalances and wealth transfers that concerned List are most prevalent today. Subsequent to List's writings, there have been numerous large-scale military conflicts. Military conflict and war is the political state today. So, the post-Adam Smith world has continuously violated one of Smith's most basic assumptions—a peaceful globe. Yet,

today, just as was the case during List's life, economists adopt their thinking and economic theories based upon the flawed theoretical foundations espoused by Adam Smith.

List provides a detailed financial/trade history of the commercial ascent and decline of many countries. He notes that the desire of dominant industrial nations to expand market share in less developed countries has generally led to loss of their world dominance. The bartering of trading rules between industrialized and agricultural countries results in treaties where low cost industrial goods and agricultural products are imported by the industrialized country in exchange for market access and production facilities in the less developed agricultural country. List theorizes that there is at all times an oversupply of production and that all countries are natural exporters. Further, he argues that the ability of an economy to transition from agriculture to industry is a great benefit. Industrial production has great economies of scale and leads to more invention and innovation in the developing country. Benefits of trade agreements between industrialized and developing countries are thus skewed in favor of the latter, an arrangement unacceptable to List, who argued that "treaties of commerce are legitimate and durable only when the advantages are reciprocal. They are fatal and illegitimate when they sacrifice one country for another."

Exogenous interruptions in industrial countries, such as wars, help facilitate industrial development in less developed countries. The dependence of Great Britain on the U.S. during World War I is such an example. In fact, in 1837 List forecast the decline of Britain and the ascent of the U. S. He advised Britain to ally with Europe. Against List's advice, Britain adhered to its "special Anglo-American relationship" and tried to copy the Greek strategy of "Roman muscles, Greek brains." We know how these two episodes turned out.

In fact, List provides a detailed account of the decay of many great industrial countries. His account begins with the Italians, progresses to the Hansards, the Netherlands, the Spanish and Portuguese, the French and finally the British. He discusses the importance of treaties, industrial development, and exogenous events in conjunction with an internal desire to expand global production as the mechanisms leading to national shifts of industrial power.

List believed in the importance of national self-sufficiency, which was necessary for a country to protect itself against military or trade wars. Self-sufficiency was most assured by maintaining industrial capacity, which led List to view instruments such as tariffs in a different light than the proponents of laissez-faire. According to List, "the system of import duties is consequently not, as has been said, an invention of speculative minds; it is a natural consequence of the tendency of nations to seek guarantees of their existence and prosperity, and to establish their weight in the scale of national influence."

For List there is a natural clash between those engaged in international commerce and the national interest. He believed that regulations were required to provide a balance between the demands of merchants and public welfare. The laissez faire world of Adam Smith neglected the national interest.

List maintained correctly that global trade required regulation to avoid imbalances that result when the industrial capacity of developed countries is hollowed out. I will go one step further and advance the politically incorrect argument that continuation of the current severe imbalances in international trade and finance must, in fact, lead to war. "Free trade is the fantasy of the merchants engaged in foreign commerce," said List. Today, we observe as List observed in 1827, "Every nation has its particular economy." Today's global trade imbalances are a manifestation of a competitive struggle for markets by "particular economies" in a time of war. The less controversial Lord Keynes noted in Chapter 24 of the General Theory, that "the competitive struggle for markets" was one of the predominant factors in the "economic causes of war." I will describe how crises brought on by economic imbalances can degenerate into military conflict later in the paper.

B. The Fallacy of the Natural Rate of Unemployment

Policy makers in the United States and especially those at the Federal Reserve Bank believe in the concept of the “natural rate of unemployment.” The natural rate of unemployment is an old economic concept formally constructed by Milton Friedman and Edmund Phelps in 1968. The non-accelerating inflation rate of unemployment (NAIRU) is considered the natural rate. The two formal policy goals of the U.S. Federal Reserve Bank are price stability and full employment. The Fed adjusts its policy to achieve a balance between these two objectives. Fed officials believe that they can estimate the natural rate and that it is 4 percent.

However, Milton Friedman, elaborating on the concept of the natural rate of unemployment stated, “The standard definition of the natural rate is as depending on the actual structural characteristics of the labor and commodity markets, including market imperfections, stochastic variability in demands and supplies, the cost of gathering information about job vacancies and labor availabilities, the costs of mobility, and so on.” (Friedman, 1968)

Full employment was the cornerstone of Keynes’ General Theory. “For we have seen that, up to the point where full employment prevails, the growth of capital depends not at all on a low propensity to consume but is, on the contrary, held back by it, and only in conditions of full employment is a low propensity to consume conducive to the growth of capital.” (Keynes, Chapter 24)

“Full employment” is used by Keynes at least nine times in Chapter 24 alone. Full employment and the natural rate of unemployment have been controversial for quite a while. So, Fed policy is constructed around a variable that is itself unquantifiable and, therefore, a fiction. The objective function for the Fed requires immediate amendment.

During a period of war, such as today, full employment must prevail at all times. The military is the employer of last resort with a large need for personnel of all kinds: doctors, lawyers, cooks, teachers, engineers, accountants, janitors, etc. Jobs are plentiful for anyone and everyone who wants a job. For anyone who wants to work there is an employer. The inflation rate is stable to upward trending today. The present unemployment rate is at least 5.5 percent or higher. Therefore, the natural rate of unemployment today must be no lower than 5.5 percent; not the 4 percent rate the Fed officials postulate.

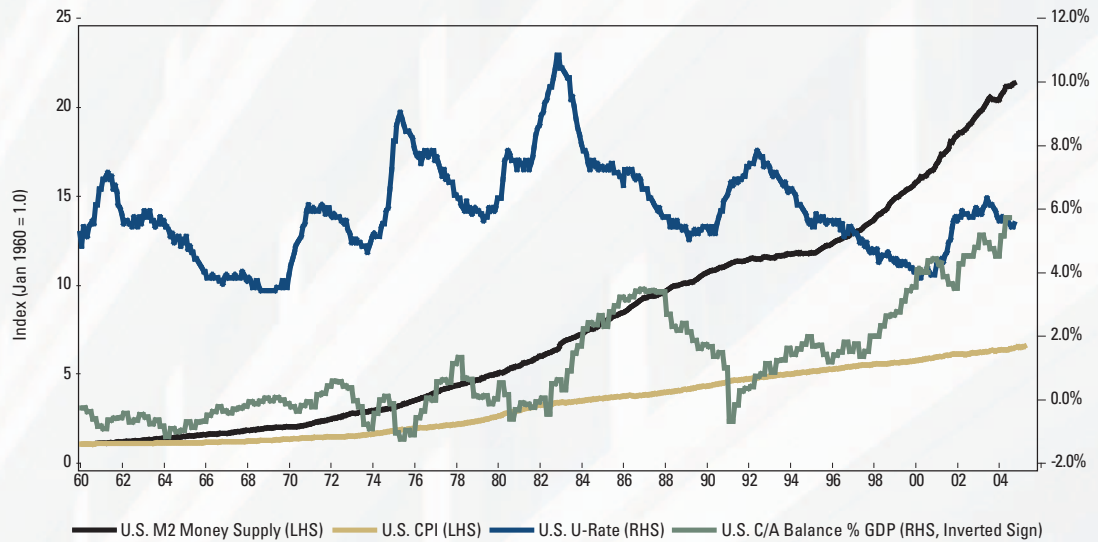
Keynes cautions at least eight times in Chapter 24 that his comments about full employment and the propensity to consume are specific to times like “present conditions.” If we were to invoke Keynesian policies today, in a time of war, we would invoke policies that reduce consumption and promote the growth of capital. Such policies, which would include reduced government spending, higher taxes and tighter money, would slow the growth of imports and expand the pool of U.S. savings, thereby making the U.S. less dependent on unreliable foreign sources of capital.

The mis-specification of the natural rate of unemployment is the norm. The natural rate of unemployment is a dynamic variable that changes every moment. The natural rate of unemployment concept is a fallacy. Prescriptive policies directed at a mis-specified variable can produce adverse externalities. Current and past Fed policies have promoted consumption, encouraged debt formation and contributed substantially to the horrible trade and global imbalances of today. To see how this is so, we need to examine the so-called Keynes Effect.

Monetary policy that accommodates excessive consumption produces low or declining interest rates. The increase in the present value of assets associated with lower rates causes an increase in wealth to holders of the assets. The increased consumption and reduction in savings associated with the wealth change is known as the Keynes Effect. A drop in interest rates engineered by the Central Bank results in an increase in wealth that stimulates the economy via increases in consumption. In an open global architecture, the increase in consumption accrues to the benefit of the newly industrialized economy. In Chart IV below, we see that the desire to reduce unemployment to the NAIRU resulted in a rapid increase in the supply of money. The production of goods in the low cost, newly industrialized countries suppressed inflation. The low inflation rate sends the Fed a false positive signal. A reversal

of the Keynes Effect may be difficult to engineer because of its severe effect on the value of assets, the consequent need to increase savings and the impact on debt service.

Chart VI
The Fed's Policy Objectives (Inflation, Employment)
and Its Policy Variable (Money Supply)



Source: The Federal Reserve

The Fed needs a new mandate with a different objective function. Existing Fed policy is antiquated since it is based on a closed model of the economy that does not take account of the horrible externalities in the global economy that fuel a relentless buildup of debt. Specifically, the Fed needs to formally include trade and financial balances as a critical variable in policymaking. In the next section, we will attempt to describe where the global imbalances will lead if they are not addressed.

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VI. The End Game: A New Economic Architecture or Military Confrontation?

The historically low Federal Funds rate in the U.S. is indicative of the attempt to “gear” the finance-dominated U.S. service sector. Further productive gearing is difficult to achieve. Status quo policy makers will attempt to further increase gearing as the global imbalances continue to grow and more employment is transferred from the U.S. to the newly industrialized areas. The increase in gearing will lead to greater imbalances and to the eventual end game. How exactly does this gearing contribute to the problem?

A. Gearing and the Average Maturity of U.S. Government Debt

The Clinton Administration was able to increase the average maturity of outstanding government debt while reducing the budget deficit. The Bush Administration has led us in the opposite direction and into risky territory. The average maturity of outstanding debt is 55 months today, down from an average of 90 months in 2000. The increased leverage of the U.S. economy increased the sensitivity of the economy to interest rate changes. Very stimulative Fed policy has induced an increase in short-term borrowing. The Federal borrowing agenda has been one of the greatest beneficiaries of the Fed policy.

The reduction in debt maturity provides two benefits and no immediate cost. The first benefit is that borrowing costs are minimized in a low Fed Funds rate environment. The second benefit is that short-term debt fits nicely into a foreign central bank's portfolio and then becomes a convenient vehicle within which to extend credit. The asset/liability mismatch masks the true cost of government operations. The risk that debt may not be rolled forward by investors is the potential cost associated with a low average maturity debt structure.

Increasing leverage while simultaneously reducing interest costs is of course a great arrangement for any borrower, whether the U.S. government or a corporation. The lower the cost of money, the greater the amount that can be borrowed for any budgeted interest cost. Gearing has therefore helped fuel growth in a service-dominated U.S. economy with a high proportion of finance-driven companies. Unfortunately, the process can also work powerfully in reverse. Interest rate increases would require deleveraging and thus slower growth for the corporate borrower to stay within budget. The alternative would be to borrow more to fund higher interest costs. A creditor's strike will tend to force the Fed into action. The Fed will need to reduce rates and extend credit directly to the government. The subsequent inflation and currency devaluation will reduce domestic living standards—the natural cost of imprudent gearing strategies.

Federal receipts grew by approximately \$500 billion in real dollar terms during the forty-year period from 1950 to 1990. Federal receipts soared by another \$500 billion real dollars during the eight years of the Clinton Administration. The increase in tax receipts resulted from higher tax rates as well as revenues generated by taxes on bull stock market capital gains. Real government spending remained constant during this period. Therefore the federal budget deficit reduction was not achieved through spending cuts but rather through revenue generation. Real defense spending fell from \$500 billion in 1992 to about \$360 billion in 2002; a 30 percent decline. So, social spending directed to people with high marginal propensities to consume increased substantially. The federally subsidized consumption increases in the 1990s, in combination with the transfer of technology to Asia, established the base from which Chinese production would begin to accelerate.

The links between an accommodative Fed, consumption, debt accumulation and the explosion in the U.S. current account deficit are captured in the attached Charts. Note first in Chart VI that the money supply, a measure of the liquidity injected into the economy by the Fed, has expanded substantially from 1994 to 2004. To complete the link, note further in Chart VI that domestic, non-financial business debt outstanding in the U.S. ballooned during the same period, from just under \$4 trillion in 1994 to more than \$7 trillion ten years later. Lastly, it should come as no surprise that the U.S. current account deficit surged during the same time from around 2 percent of GDP to almost 6 percent.

By 2003, Federal tax receipts fell by \$200 billion from the 2000 peak. Real government spending rose by about \$400 billion since 2000. Real defense spending increased by about \$130 billion since 2000, accounting for approximately 32 percent of the increased spending. In spite of a constructive redirection of federal spending to defense, the Bush Administration also transferred additional real funds to consumption, further perpetuating the trade deficit. The marginal division between consumption subsidies and defense spending has been declining, yet the trade deficit continues to increase. The further deterioration of the trade deficit is indicative of a less competitive, more dependent U.S. economy. Reducing the federal deficit may not be an effective trade deficit reduction policy unless real spending is reduced and real defense spending's share is increased. Defense spending is more U.S.-centric than consumer spending, much of which leaks out in the form of imports.

If we are to escape from this vicious cycle, what principles will need to govern the new economic architecture? The next section attempts to answer that question.

B. The Model for a New Economic Regime

Global trade dynamics are a function of the rules embedded within the trading countries. Comparative advantage can only be Pareto optimal when all rules are alike.

The greater the divergences in the economic framework of the trading countries, the less applicable are the tenets of free trade and comparable advantage theories. Radically divergent political/economic/philosophical economies should not engage in trade without surgically constructed treaties constructed prior to trade. The treaties should be flexible such that predetermined, well-specified objectives are achieved. Otherwise, the treaties should be abandoned. The purpose of the treaties should be to place the participants on equal terms given the structural elements and constraints of each. Violation of the spirit of the arrangement's objectives should result in treaty nullification and either revision or cessation of trade.

Consider an option on a basketball game where every player on your team is 5'-10" tall and you are offered the opportunity to play a team of 6'-5" players. Knowing that the basket is set at 10 feet, it would naturally be wise to decline the opportunity absent any exceptional information—particularly if the stakes are high. Now, suppose the coach of the 6'5"ers suggests a "treaty" with the objective of a ten point game. The rule specification of the treaty would issue the objective. The no greater than ten point difference is the true objective. A half-time score differential of twenty points leads to a radical restructuring of the "treaty." The "revised treaty" would be constructed such that the team in deficit is able to achieve the preordained objective of a ten-point game.

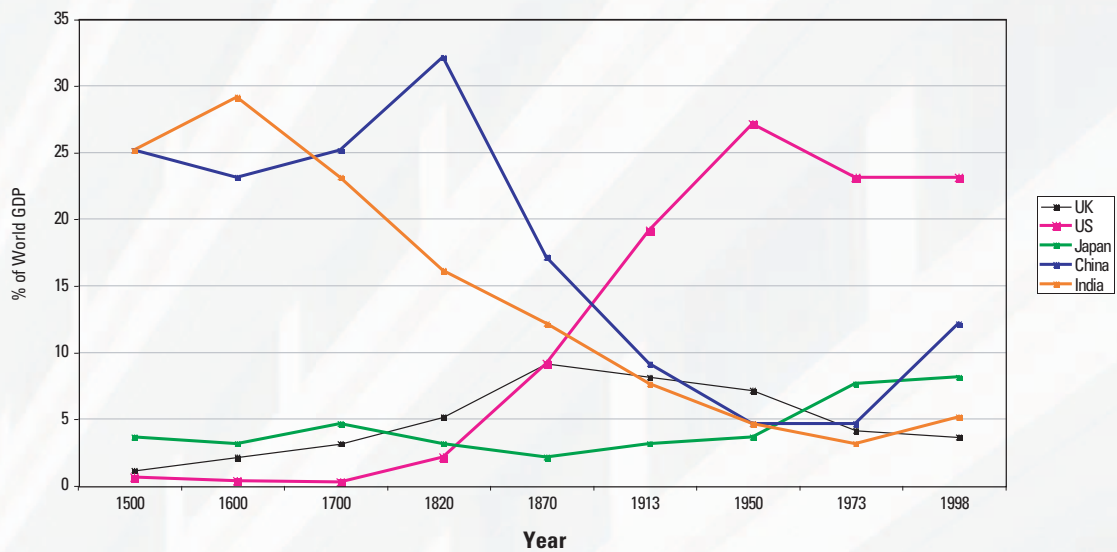
Let's review the situation. We have one participant structurally advantaged relative to its opponent in an ordeal where the predetermined result is a rule-adjusted ten point differential objective. As the game progresses, we learn that the pre-specified conditions were insufficient to secure the objective. A radical rule revision is specified such that the a priori objective function may be realized for each and every game. The objective function is the most important element; the rule specification is variable subject to constraints. Binding constraints result in the termination of the game very early. There are no excuses, no "trust me's." It is now or never to enable the next higher level of completion.

The game is analogous to the present game theoretic with China, in which a flexible U.S. economy trades with a structurally rigid, centrally planned Chinese economy where capital controls dominate. Trade balance, or near trade balance, is the objective function. Debtor nations have an obligation to get back to balance and creditor nations have a obligation to help them. The Chinese revaluation would have occurred more than a year ago had the long held rule of global trade been respected.

The notion that the Chinese will ultimately become substantial consumers of U.S. products, thereby helping to close the trade imbalance, is ludicrous. We have observed that U.S. manufacturers in China represent flight capital and are permitted to operate there only marginally in order to create a Western private vested interest in support of Chinese policies. The goal of these policies is to reverse China's historic decline relative to the West, and the policies are succeeding. As Chart VII shows, China and India held commanding shares of world GDP 200 years ago, only to see their respective shares fall precipitously. However, China's rapid industrialization over the last 20-30 years has allowed it to reverse this decline and garner an increasing share of global GDP. There is ample reason to think that this significant trend will continue. China's Communist leader Mao Tse -Tung recognized his country's potential, particularly as an exporter, when he proclaimed: "Our millions of people, once really emancipated, with their great latent productive possibilities freed for creative activity in every field, can improve the economy as well as raise the cultural level of the whole world."

Chart VII

History of World GDP Share



Source: Angus Maddison, *The World Economy: A Millennial Perspective*

Under existing rules the trade imbalance between the U.S. and China that is giving rise to this historic shift in global power will continue. A revision of the rules of engagement is required, with the threat that trade will end if such revision is not forthcoming. The global trade balance rule requires satisfaction. Pre-specified WTO trade rules are irrelevant and require amendment to satisfy the original objectives. A huge U.S. current account deficit is certainly not a pre-specified WTO objective.

The French have been criticized by many in the West for the subsidization of domestic industries whose preservation is deemed to be in the vital interest of France—most notably agriculture. These subsidies are designed to avoid dependence, based on the assumption that relying on other countries for strategic goods is dangerous. The dependent country ultimately relinquishes power and becomes subservient. It has sacrificed its national interest to others during good times, having assumed that loyalties and all allegiances are everlasting, a naïve assumption in List’s cosmopolitical critique of Adam Smith’s global harmony. True global harmony should be measured by outcome relative to objective, not outcome relative to rule. Outcome relative to objective is the most compelling argument for the long overdue global architectural adjustment.

C. The Debt Trap and Risk of Global Confrontation

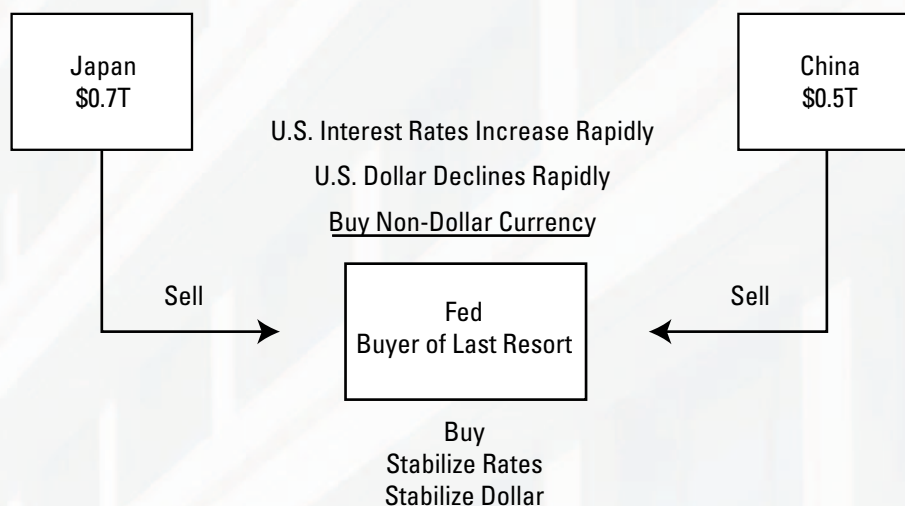
Unfortunately, it seems unlikely that such a new economic architecture could be arranged, given that U.S. negotiating power has dissipated with the reduction in U.S. wealth, and given the need for foreigners to produce in the newly established factories. Confrontation may ultimately result.

The potential for a dangerous financial crisis exists wherein the costs of the increased debt in the U.S. are transferred from the suppliers of leverage to the leveraged. More specifically, capital inflows into the U.S. have provided for increased debt in the U.S. The debt accumulation has resulted in an even greater dependency on foreign capital in the U.S. The U.S. is in a debt trap.

The debt trap is the “cost” borne because of the global restructuring. The risk of outstanding debt is continually increasing as the imbalances progress. At some point, the process of increased gearing (the Federal Reserve’s increasing the money supply) causes the U.S. dollar to decline and U.S. interest rates to increase. The “risk managing” Fed responds to the financial crisis by purchasing the bonds offered in the market; further increasing the money supply. The Greenspan/Bernanke helicopter

solution is precisely what the foreign debt holders are hoping for—a bid to take them out of their position. They have reason to think such a bid will be forthcoming. The U.S.-engineered bailout of Southeast Asian economies in 1997-1998 was an indication that America will act to stabilize markets without regard for “moral hazard.” Therefore, in the eyes of foreign holders of U.S. debt, America is even more likely to take them out of their positions when the goal is to save itself; even though doing so is actually suicidal.

The crisis policy response by the Fed provides the mechanism to further transfer burdens of global restructuring cost back to the U.S. citizens. The Fed, as buyer of last resort, attempts to fund the cumulative foreign holdings of U.S. debt so as to mitigate the rise in interest rates and the fall in the dollar. The emergency textbook policy response, requiring such an enormous creation of money, destroys the very currency the policy was attempting to correct. The full cost of the debt creation is borne by U.S. citizens via the Fed. Foreign losses associated with the debt build-up are minimized. Inflating away the debt is not feasible with a “risk management” Fed philosophy. The fish in the game is the U.S. Fed! The buyer of last resort!



As shown in the schematic above, the Fed would need to absorb more than \$1.0 trillion of securities held by foreigners, representing a 20 percent expansion of the total supply of money presently outstanding. The consolidation of trade into a few Asian countries has increased the risk that a global rebalancing will not occur and that policy shifts outside the U.S. will force Fed’s hand. The policy shift in one or both of these countries will result in a very hard landing here. Thus, the likely outcome to the “bid wanted” by foreign holders of debt would be the following:

1. Rapid increase in U.S. interest rates
2. Rapid depreciation of the U.S. dollar
3. Fall in the stock market
4. Rapid reduction in global trade
5. Probable global reconfiguration of alliances away from the U.S.

D. Musical Chairs and Dollar Liquidation

What might motivate some members of the cartel of Asian central banks that hold massive dollar reserves to sell these assets, or buy fewer of them? Perhaps it is their belief that U.S. policy makers will be foolish enough to take them out of their positions as they choose to protect themselves. Perhaps they will determine that their industrial development is well enough advanced that they no longer need to support the U.S. dollar to maintain their exports. The analogy of a game of musical chairs is appropriate.

The holding of dollar reserves by the Asian cartel approximates \$1.9 trillion. As with most cartels, adherence to the rules by individual members enables monopoly behavior by the whole cartel. Typical cartel dynamics imply a cheater's temptation. Smaller producers have a chiseler's temptation to modify behavior early prior to behavior modification by the big participant. The big participant is the agent who suffers most when monopoly power breaks down.

As the Asian cartel accumulates more and more dollar reserves, it will become increasingly difficult to maintain the behavior of the members. As the cartel's decision to change strategy approaches, it will be in each member's interest to exit first. The behavioral dynamic is very similar to the game of Musical Chairs. The initial liquidation of reserves begets greater and greater liquidation.

Ultimately, it does not really matter what motivates the change in policy. Today, the potential exists that policy makers in a very few countries in the world wake up tomorrow and direct a sale of the holdings of their U.S. assets and re-direct the proceeds to the assets of other countries. Not only do they sell and redirect their existing stock of assets, but they also decide to direct no future cash flow to the U.S. Meanwhile, day by day, the size of the potential "bid wanted" increases by the \$2 billion in daily cash needs of the U.S. economy. The U.S. has lost control of its destiny, which now resides in foreigners' hands, absent the well overdue global restructuring.

The following is a summary of policy proposals that could serve as the basis for such a restructuring.

VII. Summary of Policy Recommendations

There is a need to immediately implement a number of important structural measures affecting the global participants. Included in this Category I list of critical adjustments to increase savings, reduce debt and improve current account deficit are:

1. Cut by 15% across the board all U.S. social spending programs.
2. Increase U.S. tax rates.
3. Increase incentives to save in U.S. – consumption taxes.
4. Devise capital controls such that capital cannot be exported out of the U.S.
5. Debt renegotiation/forgiveness by countries with cumulative high trade surplus with the U.S.
6. Change the Federal Reserve Bank objective function to include a constraint on the size of the trade deficit.
7. Prohibit sale of highly sensitive technology and defense to any and all foreign countries.
8. Revalue Chinese currency to U.S. dollar by 40 percent.
9. Targeted protective tariffs if needed.
10. Renegotiate WTO.
11. Prohibit the Fed from purchasing bonds from foreign holders of U.S. debt.

All of the above measures are of great and equal importance and need to be implemented as a package. Piecemeal implementation violates the requirement that all participants must contribute to the readjustment of the global economy.

Category I initiatives need to be followed by a second set of policy measures that we will call Category. These initiatives are crucial to the long run political-economic stability of the U.S. economy.

1. Increase U.S. defense spending.
2. Develop incentive-based programs for youth, education and health. Take funds from programs for elderly.
3. Reduce minimum wage in U.S. by 50%.
4. Repeal regressive Prop 13 in California.
5. Tax prosperous countries that have benefited from prior IMF bailout recipient
6. Proceeds disbursed to IMF "equity" holders.

7. Tax holders of Iraqi debt for invasion “appreciation” and ultimate “occupation” appreciation value.
8. U.S. Treasury needs to extend average maturity of the debt issued.

Finally, a few additional measures are necessary to help safeguard U.S. national interests. These measures include:

1. Conflict of interest disclosure by any person providing policy advice.
2. Prohibit consulting contracts for any public official leaving office for two-year period.

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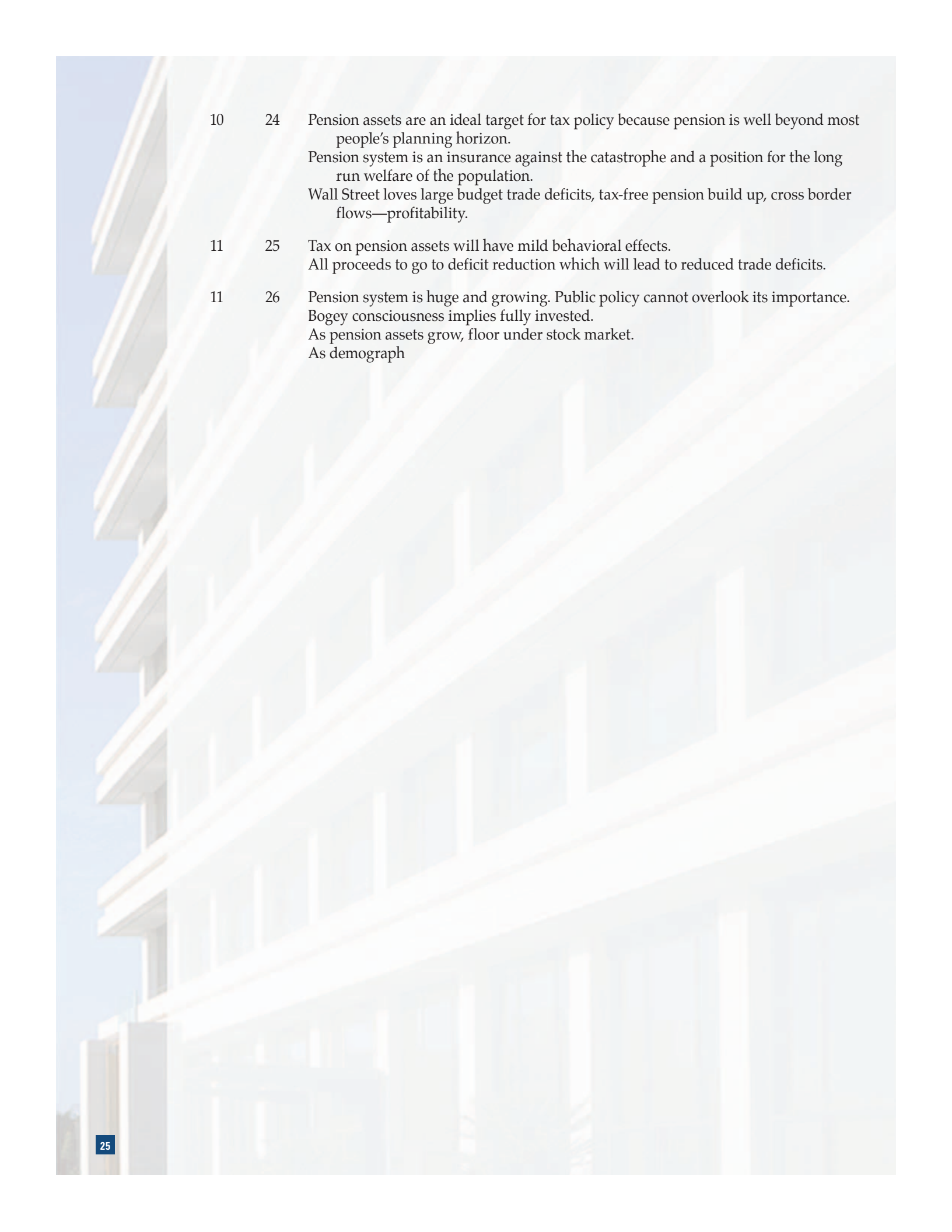
Appendix

Dialynas Policy, 1993

Page Paragraph

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|---|----|--|
| 1 | 1 | Urgent need to reduce leverage
Weak currency policy won't work
Trade deficit linked to Fed deficit
Empirical analysis bad—structural changes in global economy
Incompatibility of budget deficit—Laissez Faire |
| 1 | 2 | Ultimate outcome—debt liquidation global shrinkage
Default or repudiation of debt by U.S. |
| 1 | 3 | Standard of living too high in U.S
Artificial—no regard for cost
Leverage has enabled U.S. to go beyond production possibility frontier
Fixed social contracts, demographics, liberal immigration policy need for capital |
| 2 | 4 | Inter-country, inter-generational wealth transfers from debt build-up
Debt incurred to provide present benefits
Therefore politically difficult to reduce |
| 2 | 5 | In globalized world, deficit financing implies transfer of wealth from tomorrow's generation to foreigners
Public spending should not be undertaken to stimulate consumption in an open world economy |
| 3 | 5 | The more we import, the more wealth we transfer abroad
We do not control the policies of other countries |
| 3 | 6 | Deficit spending and simultaneous consumption of foreign product is lethal
In the past we could rely on a strong defense policy
Defense spending easy to cut
Defense spending is inner directed—domestic investment and production
Strong national defense enables us to better influence international policy |
| 3 | 7 | Orthodox economic prescription to fiscal trade deficit is to increase taxes and devalue currency
Both are a form of taxation
Difference is that one is contractionary, the other stimulative |
| 3 | 8 | Currency devaluation is the subtle form of taxation and therefore politically popular
Currency depreciation reduces global value of real wages,
Increases production, increases tax base
The real living standard is reversed |
| 4 | 9 | Dollar devaluation began in 1985. Has not worked well.
Worked better with Europe who engaged in fiscal expansion than with Japan
Argument that greater U.S. production is good thing even if trade deficit is growing is flawed
Need to deal with cumulative debt accumulation |
| 4 | 10 | Post WWII period small biased sample—period of worldwide fiscal expansions
Soviet Union paying for fiscal abuse now.
Split released Eastern Europe
Massive price adjustment in Russia to Western World standards
Future will most likely experience great fiscal contractions |

- 9 11 Fiscal deficits need to be eliminated in the U.S. and trade surpluses established
Both spending reductions and tax increases required
Defense spending presently being slashed
State gambling sanctioned
Those countries who balance first and balance best will
Emerge as the power of the 21st century
- 5 12 In 20th century, ratio of capital to labor has increased
Subletting of labor in foreign countries with low labor costs peculiar today relative to
post WWII experience
Japanese, as well as others, establishing production facilities in low cost Asian
countries
Many of these countries have pegged to the dollar
These phenomena interfere with currency devaluation prescriptive policy
- 6 13 Commodities trade in world markets. If do not change in dollar terms during
dollar devaluation then implies the cost of production input is lower for other
countries.
Supplies of world commodity production have increased to service debt burdens.
CRB spot in yen @: 1980-\$288.8, 70342.42 yen; 1993-\$238.4 and 28832.7 yen
A strong currency policy is the desired policy in a world
Of fiscal contraction and deflation—a world unknown to
Post WWII economic vigor.
- 7 14 Budget deficit leaks abroad to create trade deficit
Means greater proportion of future production must be
Directed to exports
- 7 15 “Need to import capital” arguments.
Implies capital in-flows create trade deficit
- 8 17 Currency devaluation scheme provides potential for “cheap” purchase of domestic
assets by foreigners
Fed deficit related to CAD. Balance budget—impact on imports.
- 8 18 Reduction in defense spending results in three possibilities lower currency capital
flight increase in foreign purchase of U.S. assets
- 8 19 Large federal deficit led to shift to short maturity funding to reduce interest costs
Need to keep short rates low—Fed monetization
Only offset is reduced federal deficit
- 9 20 Depreciation strategy promotes consumption, retards saving
The reduced saving implies more capital inflow, greater trade deficit.
- 9 21 Pension asset earnings not taxed.
Control over investment policy limited.
Importance of behavioral differences between money managers and owners.
- 10 22 Capital flight will occur with pension assets.
GM pensioner “unknowingly” financing Toyota.
Results in more jobs abroad, larger trade deficit.
- 10 23 U.S. government should not unknowingly subsidize foreign
corporations and governments.
U.S. should impose a tax on all pension assets invested abroad.

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- 10 24 Pension assets are an ideal target for tax policy because pension is well beyond most people's planning horizon.
Pension system is an insurance against the catastrophe and a position for the long run welfare of the population.
Wall Street loves large budget trade deficits, tax-free pension build up, cross border flows—profitability.
- 11 25 Tax on pension assets will have mild behavioral effects.
All proceeds to go to deficit reduction which will lead to reduced trade deficits.
- 11 26 Pension system is huge and growing. Public policy cannot overlook its importance.
Bogey consciousness implies fully invested.
As pension assets grow, floor under stock market.
As demograph

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