# 1 Introduction

Short on cash before his ship comes in, Antonio seals a bond with Shylock to sustain the profligacy of loyal, dear Bassanio. Cunningly, Shylock extends the credit with the proviso that, should Antonio fail to honor the bond, Shylock is entitled to a pound of Antonio's flesh. Predictably, Antonio's fortune is not homeward bound. With unmitigated glee, Shylock claims the bond. But enforcing the bond proves difficult. The rules of the game are interpreted in such a way that Shylock must forego his bond unless he claims it in a way which spills no Christian blood – a way which is clearly impossible. All ends well except for Shylock. Antonio is richer by Shylock's misfortune and so, indirectly, is Bassanio, having used the loan to conquer princess Portia, who is as good a catch as anyone ever was.

The main themes of Shakespeare's play, *The Merchant of Venice*, are familiar. Friendship juxtaposed to love, greed to sacrifice. But it is literally a story of debt, and figuratively an account of the possibility of taking advantage of debt when being in debt is as fluid and deceptive as the Seas of Venice.

In sixteenth-century Venice, Christian rules favored Christian borrowers over Jewish lenders. Shylock tried to bring that order down by funding the untenable spending habits of Bassanio, whom Antonio felt obliged to protect. Much by way of commercial and financial interactions has changed in the course of half a millennium yet there are striking parallels to mull over. This book argues that American liabilities are strategic because the prevailing order in trade, money, and security makes it possible for the American people – the Bassanios of this world – to enjoy a cornucopia of foreign goods. Alarmist bells notwithstanding, if, by financing American consumption, China is banking on the demise of American hegemony, it is betting on the same terrible odds that sealed the fate of poor Shylock.

The United States has been the most powerful country in the world for more than sixty years. Throughout this period, it has had the world's largest economy and the world's most important currency. For most of this time, it had the world's most powerful military as well – and its military supremacy today is beyond question. We are truly in an era of US hegemony, a unipolar moment, a Pax Americana, which has enabled Americans to enjoy the highest standard of living in human history.

Is this privileged position being undercut by serial trade deficits? The pessimists are growing more numerous by the day. They see the country's spendthrift ways as a disaster waiting to happen. They warn that the cavernous gap in merchandise trade, well above 6 percent in 2006, is an ominous sign of competitive slippage. In 2008, the liabilities acquired to finance the shortfall in exports reached an amazing 29 percent of GDP. A falling dollar, military overstretch, the rise of the euro, the rise of China, and progressively deeper integration in East Asia are among the factors that many believe herald the imminent decline of American hegemony.

In my view, the doomsayers are mistaken. I argue that American hegemony is stable and sustainable. While the United States certainly does face a number of challenges, an analysis of the linkages between trade, money, and security shows that American power is robust.

This book is a story about why and how American hegemony works, and what other states would have to do to emulate or, on other grounds, thwart, America's power base. As I will show, the United States benefits from running persistent trade deficits as a result of its special position in the international system. I will argue that any comparably situated country would choose to pursue the same cyclical deficit policy as the one encouraged by the US government. A series of size advantages cut across trade, money, and security: the size of the American market, the role of the dollar, and American military power interact to make a trade deficit policy rewarding and buffer the United States from the extreme consequences that a sustained deficit policy would otherwise have.

Based on new research in economics on valuation adjustments (i.e., capital and exchange rate gains), and data analysis of my own, this study draws attention to the economic advantages for the United States of having the key currency. In addition to benefits in the form of seignorage, the United States gains substantially from valuation adjustments, reinforcing policy autonomy and the gains derived from the asymmetry in the structure of borrowing and lending. I also lean on new economic research on valuation adjustments to supplement the conventional view of why military preeminence is necessary for key currency status. Military power has been seen as important in enforcing debt repayments, but there is clearly a need to rethink the connection between reserve status and military power in the present systemic context where the reserve currency country has the world's largest external liablities.

We have seen erroneous predictions of American decline before. In the 1970s, the combination of high inflation, high interest rates, high unemployment, the Vietnam War, political and military challenges from China and the Soviet Union, and the economic rise of Japan led to eerily similar forecasts. Pessimists then, as today, underestimated the longevity of American power. The main reason the United States has continued to occupy a unique place in the international system is because a sufficient number of major and lesser powers have a strong interest in maintaining America at the top of the hierarchy. To bring America down would take a deliberate, coordinated strategy on the part of others and this is simply not plausible. As much as the United States benefits from the space it has carved out for itself in the current world order, its ability to reap unequal gains will remain unless and until allies start to incur heavy losses under American dominance. Even that, by itself, will not be sufficient to sink American hegemony. A strong alternative to American rule will have to come into view for things to fundamentally change. At present, no credible alternative is in sight. The United States is not invincible but its dominance is currently steady.

Those who are inclined to think that American hegemony will persist – at least for a while – tend to dwell on the claim that the United States is providing a range of public goods to the benefit of all at its own expense. This is a chimera. The United States is self-interested, not altruistic. The illusion of benevolence has meant that very little attention has been given to uncovering the mechanism through which the United States gains disproportionately from supplying a large open market, the world's reserve currency, and a military machine capable of stoking or foiling deadly disputes. This book exposes the mechanism through which the United States reaps unequal gains and shows that the current world system, and the distribution of power that supports it, has built-in stabilizers that strengthen American power following bouts of decline. Although all dominant powers must eventually decline, I will show that the downward progression need not be linear when mutually reinforcing tendencies across various power dimensions are at play. Specifically, I will demonstrate how the United States' reserve currency status produces disproportionate commercial gains; how commercial power gives added flexibility in monetary affairs; and, finally, how military preponderance creates advantages in both monetary and trade affairs.

## The puzzle

This book grows out of my attempt to understand a particular puzzle in international political economy, the ongoing American trade deficit. In absolute terms, the American deficit, which in 2006 amounted to $753 billion, is the largest ever.[1] Net external liabilities also exploded, starting in the middle of the 1990s, and peaked at $4.2 trillion in 2008. Even as a share of GDP, these figures (5.7 percent and 23 percent respectively) are high in comparison with other industrialized countries. Is it a coincidence that the country with the most potent military force and the largest capital and consumer market is able to get away with accumulating deficits and debt? If not, why is the American experience a coup instead of the usual curse?

Large sustained trade deficits are usually seen as a liability and a sign of weakness in an increasingly competitive international economy. When countries in Africa, Southeast Asia, South and Central America run deficits for prolonged periods something of a national emergency is proclaimed as private investors pick up and leave. In order to be persuaded to stay, official investors – both governments and international institutions such as the World Bank and the IMF – demand reform and attach different levels of conditionality to their policy prescriptions. Caught in this bind, deficit countries are forced to sacrifice significant policy flexibility to prevent massive capital outflow. Given the inherent tendency of all governments to maximize policy autonomy, developing countries often choose import-restricting policies as a way of eschewing excessive deficits. Middle-rank traders, consisting of super-developing countries such as China, Brazil, and India on the one hand, and advanced economies such as Japan (and until recently, the euro-zone) on the other, have looser constraints. But they have for the most part reaped big benefits by prioritizing

[1] BEA 2009a, BEA 2008a, BEA 2009b.

exports over imports, since it enables them to use world markets to compensate for slack domestic demand or to expand their industrial base and absorb excess labor.

If it is generally wise to shun a deficit policy, why has the single most dominant state in the international system opted for policies which have systematically provoked a shortfall between exports and imports for twenty-seven of the thirty-seven years of the post-Bretton Woods era? Answering this question requires an understanding of how and why the United States enjoys a privileged position in the modern international economic order.

## The argument

In sketching my argument, I will show that the United States gains both materially and in terms of policy autonomy from running persistent deficits because of its multi-purpose power base. It gains economically by absorbing more capital and goods from the rest of the world and through capital and exchange rate gains on the international investment position (IIP).[2] It also gains in terms of policy autonomy. Because foreigners have a wide range of incentives to invest in dollar-denominated assets (in the United States) and, when necessary, help soft-land the economy, the United States can adjust imbalances over a longer time horizon. The gain in policy flexibility means it can adjust imbalances using its preferred policy instruments, and that its 'policy error' threshold is higher than it is for other countries. Therefore, it can more easily avoid the kind of shock therapy that is normally associated with a consistent pattern of trade deficits and high external liabilities.

My claim is not merely that America has benefited from its hegemonic position but that it has benefited disproportionately, and that the system through which it benefits is sustainable. By disproportionate I mean that it has received more than what it 'pays' for the public goods it provides, and that it reaps a higher benefit than other states. I argue that the United States reaps increasing returns in trade, money, and security – in other words, that it gets more back than it puts in. In the trade realm, it systematically absorbs more imports than it gives

[2] The net international investment position (NIIP) is the difference between American claims on foreigners and foreign claims on Americans.

back to the world in the form of exports. In the monetary sphere, it makes more money from its lending than it pays on its borrowing. In the security domain, it is well known that the United States spends more on security than all other states combined. Just how much mileage the United States gets on its military spending is not common knowledge, however. At least part of the reason the United States has been able to attract capital on a grand scale is that it provides a safe investment environment, which is tied to a strong tradition of property rights protection, and the ability to secure American territory militarily. A portion of defense spending has also been used to protect and expand foreign investments, and to protect allies. The economic return on this stabilizing role has been huge in terms of allied support for dollar adjustment.

## Methodology and value added

In this book, I adopt the analytical framework from economics that treats agents as rational actors seeking to achieve economic gains and avoid economic loss. The primary agents in this case, however, are states, not firms, and I am particularly interested in exploring the logic of economic action for a state possessing attributes that the United States has today, namely the largest domestic economy, the key world currency, and the strongest military. I argue that these attributes give the United States certain positional and structural advantages in the international economic system, including advantages in shaping the institutions of the international economic system, and that, as a result, the United States gains disproportionately from international economic institutions and interactions. This notion of disproportionality will be assessed in precise theoretical and empirical terms.

To avoid misunderstanding, let me make three points clear right away. First, I am not claiming that the United States is the only state to gain from international economic activity. For reasons that will be explored in more detail later, all states gain from cooperating in an international economic system in which trade across state borders is relatively free, in which there is a stable, abundant, and liquid currency that can be used for purposes of international exchange, and in which relations between states are peaceful rather than violent. These three goods interact. Even if trade is permitted, it will not take place to any considerable extent unless there is a viable international currency and relations between states are peaceful. The existence of an international currency does not matter much unless there is a lot of trade and the viability of such a currency is in various ways dependent on military backing. Finally, peace and security have economic benefits. So, the question is not whether all gain from international cooperation but rather how the gains from economic cooperation (and any costs associated with cooperation) are allocated among various states. My claim is that the United States is able to get other states to bear some of the costs that one would expect it (or any other similarly situated state) to bear on its own, that it gains in ways that others cannot, and that it is more able than other states to structure the rules and institutions of international economic life to its advantage. In sum, the international economy is a system of asymmetrical cooperation in which the United States has an advantaged position and enjoys disproportionate gains as a result. Some might see this as a proposition so obvious as not to be worth stating, but I will show in chapter 2 that it is not a view that has been embraced by the majority of scholars in international relations and that even those who are sympathetic to the view rarely spell out the precise ways in which the United States enjoys a position of privilege or how it is able to achieve disproportionate gains.

Second, the purpose of this book is not to criticize or praise the United States for its policies. I seek merely to understand and explain, or, more cautiously, to show the close fit between what a rational state actor, seeking to achieve economic gain and avoid economic loss, would do if positioned like the United States and what the United States has actually done. The whole point of the underlying framework is that any rational actor would pursue a similar course, so there is no purchase within this framework for praise or blame. Instead, the obvious question is why other states, which are presumably seeking their own economic advantage as well, do not try to challenge the positional advantages of the United States. I try to show that the courses pursued by other states are also economically rational, given the constraints they face and the obstacles in removing those constraints. Chapter 7, in particular, considers what major actors in Asia and Europe would have to do to reduce or even take over the positional advantages enjoyed by the United States and why it is so difficult for them to do so, although they can make a little headway in some areas, and where they can, they do.

Finally, I want to emphasize that this is a book about international political economy, not a book about all aspects of international relations. I am not claiming that states are only seeking economic gains in their policies or that this would provide a good framework for thinking about, say, international security issues. Although I do pay attention to the ways in which the dominant military position of the United States contributes to its positional advantage in the international economy and yields direct and indirect economic benefits, I do not claim that the United States' military policy is primarily driven by the pursuit of economic advantage. This book does not attempt to give a full account of the motivations for military expenditures, nor am I claiming that all military expenditure is economically rational in the sense that the economic benefits gained from those expenditures always outweigh their costs. In the same vein, I do not view national security as reducible to economic strength or foreign policy as reducible to the pursuit of economic gain. In assuming that states are rational economic actors in the sphere of international political economy, I do not rule out that states sometimes pursue values in their foreign policies, nor do I mean to suggest that international life is reducible to international political economy.

## Plan of the book

This book consists of seven chapters, apart from this introduction and a conclusion. The next chapter (chapter 2) offers descriptive indicators of America's hegemonic position and places the argument in relation to the literature on hegemony in international political economy.

Chapter 3 is conceptual. It models cooperation under hegemony and shows that the hegemon is often in a good position to reap disproportionate benefits from providing public goods as a result of its ability to credibly threaten exclusion. Its ability to shift gains in its favor is, however, variable and depends at least as much on the relative power gap between other Great Powers as on its own preponderance. Paradoxically, the hegemon actually acquires a greater capacity to shift gains in its favor as it declines.

Chapter 4 examines the sources of trade according to different theories – Traditional (the Classical and Neo-Classical approach) and New Trade theories. The analysis will be familiar to political economists but I have included it for the benefit of readers not well versed in the economics of trade. I have left out class-based theories, such as Dependencia and World Systems theories because of their uneasy fit with mainstream economic theory. Some of the critiques voiced by these perspectives – for instance, the difficulty in rectifying unequal gains from trade and the politicization of commercial interactions – are, however, echoed in the analysis. The aim of chapter 4 is to demonstrate how firm and country size determine trade policies and patterns, and to explain the significance of trade deficits. After unpacking the trade deficit, relating it to other deficits (and external liabilities), and emphasizing the danger associated with them, I argue that they have been beneficial for the United States and even a source of bargaining power, which has been used to advance American commercial interests.

Chapter 5 explains the rationality of American hegemony, and demonstrates how the United States benefits from serial trade deficits and from having net external liabilities. I argue that American privilege cuts across trade and monetary matters (currency and investment) and look at the interactive effects between trade and monetary affairs. The chapter provides a thorough examination of how the United States' special position in the monetary domain has produced commercial advantages, and how commercial power has enhanced monetary gains. For example, a strong dollar has subsidized American imports while only minimally affecting American sales from foreign locations, partially offsetting the negative impact on American export performance. A weak dollar, on the other hand, has increased exports from the United States with imports declining relatively slowly despite weakening terms of trade. This is because foreign producers are ready to lower their prices in order to compensate for the implicit tax which a low dollar represents. This allows foreigners to maintain and expand exports to the United States. I discuss the extent of the gains that flow from the structure of America's trade and investment links with other countries, and in what measure these gains are generalized, rewarding other countries as well. At the end of the chapter, I discuss to how this advantage might be exhausted in the future.

Chapter 6 relates military and economic power. According to prevailing wisdom, the special currency country must also be the dominant military power so that it can persuade countries to repay loans in case they default. But if this rationale is correct, countries should not be willing to lend extensively to the United States since in addition to having the world's largest external liabilities, it is the world's biggest military power. The fact that military power cannot be used to collect American debt does not preclude a connection between military, monetary, and commercial power. I make a different argument about how the United States has used military power to promote economic interests. The claim is in four parts. First, military means were used to keep the European Great Powers out of the western hemisphere in the late nineteenth and early twentieth centuries. As a result, American lending, including the dollar, could be extended over a large area. Second, widely regarded as safe, foreign investors have been willing to pay a security premium to invest in the American market. Third, the United States has intervened militarily for economic reasons, both for narrow economic purposes, in support of American business interests, and for broader economic goals in order to provide a stable political context in which economic exchange can take place, and in order to safeguard the current capitalist structure from Communist encroachment. Fourth, and last, the United States is obliged by treaty to defend roughly fifty countries. These interventions, whether to push back aggressors, or for humanitarian reasons, have purchased goodwill and provided Great Powers with an interest in preserving an American-centered world order.

Chapter 7 examines two trends in world affairs that could prove damaging to the United States. The rise of the euro and heightened military cooperation in Europe on the one hand, and, on the other hand, stronger commercial links in East Asia, which could create viable alternatives to American power over the long term. In their current form, however, neither development is likely to upset the status quo because of internal rivalries, institutional deficiencies, and dilemmas of sovereignty. For reasons explained in chapter 3, it is not sufficient for the combined power base of the European Union and East Asia to exceed that of the United States. To create an alternative to American power, a cohesive entity, whether in the form of a single state or a cooperative effort, must alone command greater resources than the United States. Barring this, the only other trigger for change is for Great Powers to experience substantial and painful loss as a result of American policies, provoking them to openly defy American hegemony. More exploitative policies on the part of the American government could change the calculus of strategic interaction.