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The Political Economy of Imbalance

> I think everybody wants to get to the bottom of why this happened. What were the failures of regulation? Was it regulatory negligence? Was it regulations were not sufficient?[1]
>
> Steny Hoyer

The fall of 2008 was momentous for the United States. Financial instability that had been simmering just beneath the crust of a deflating property bubble since the summer of 2007 erupted with full force in September. In a short span of time, the U.S. government took over Fannie Mae and Freddie Mac, the two government-sponsored entities that guaranteed half of all outstanding mortgage debt. Lehman Brothers was allowed to enter bankruptcy, Merrill Lynch was acquired by Bank of America, Washington Mutual was rendered insolvent and sold to JP Morgan, and Wells Fargo acquired Wachovia. Many of the banks that survived did so only because the federal government enacted an emergency $750 billion Toxic Asset Relief Program (TARP) that enabled rapid recapitalization, and the Federal Reserve Bank purchased mortgage-backed securities in unlimited amounts. As investors panicked in the face of the apparent meltdown of the American financial system, normally liquid credit markets froze and the crisis expanded into Europe. In all, some twenty-eight countries experienced systemic banking crises in 2008 and 2009. The financial crisis thus clearly marked the end of the credit boom that had driven the housing bubble through much of the previous five years.

[1] Quoted in Phillips (2009).

In mid-November of that same year, the U.S. and Iraqi governments signed a Status of Forces Agreement by which the United States committed to remove its combat troops from Iraqi cities by June 30, 2009 and to withdraw all U.S. forces from Iraq by the end of 2011. The U.S. ambassador to Iraq and the Iraqi foreign minister signed the agreement in mid-November, and then President George W. Bush traveled to Baghdad in December for a formal signing ceremony. The agreement thus brought to an end the largest and costliest military action that the United States had undertaken as part of the Bush administration's broader War on Terror. The occasion was marked by a December 14, 2008 press conference in Baghdad, at which President Bush was forced to duck two shoes thrown at his head by a disgruntled Iraqi. It is not much of an exaggeration to suggest that the financial crisis and the withdrawal from Iraq combined to mark a postwar low in global perceptions of American power.

And although the housing bubble that generated the financial crisis and the War on Terror traced a common trajectory and arrived at the same destination at practically the same moment, we typically assume that they traveled along parallel tracks. The housing bubble was a consequence of poor risk management practices by private financial institutions and bad regulatory policy by government agencies. To the extent that the crisis had a global dimension, it too was financial and lay in the emergence of the global savings glut at the turn of the century. The authoritative Financial Crisis Inquiry Commission (FCIC) final report, for instance, makes no mention of the War on Terror, Iraq, or Osama bin Laden (Financial Crisis Inquiry Commission 2011). Indeed, the report does not even consider whether broader macroeconomic factors could have contributed to the crisis. The causes of the financial crisis, according to the FCIC, were entirely financial. We treat the war in Iraq as well as the broader War on Terror as a national security matter that had no discernible impact on contemporaneous economic and financial developments. And though the increased military spending arising from the War on Terror may have contributed to a federal budget deficit, the primary impact of the deficit is to bequeath a larger debt to future generations and perhaps to constrain America's ability to project military power in the near term. The contemporaneous consequences of the War on Terror are entirely measurable in terms of national security.

This book argues that the War on Terror and the housing bubble ran along the same rail. The housing bubble and the financial crisis to which it gave rise emerged as a consequence of the U.S. government's decision to pay for the War on Terror by borrowing rather than by raising taxes. The book develops this argument in the context of a broader examination of the political economy of American hegemony. The study's motivating question is straightforward: How has the military dimension of American hegemony shaped the global political economy? The question is clearly important. Military spending has consumed about 6 percent of American income, on average, each year since 1950, an amount equal to 1 to 2 percent of world income. Moreover, the defense budget has been the single largest category of U.S. government expenditures across this period, accounting for between one-quarter and one-half of all government spending. Because military spending is so large a share of total government spending, military buildups have been the single most important source of sudden, large, and persistent changes in U.S. government spending across the postwar period.

Postwar military buildups have constituted large economic events – they have increased government spending on average by roughly 2 percent of gross domestic product (GDP) for four or more consecutive years. To put this in context, consider that the American Recovery and Reinvestment Act (ARRA), enacted in February 2009 as an economic stimulus package to combat the Great Recession, increased government spending by $230 billion, or approximately 1.5 percent of GDP, in 2009 and 2010 (Congressional Budget Office 2013). The entire ARRA stimulus package, including tax cuts and expenditures after 2010, was less than 6 percent of GDP and spread out over a ten-year period. The typical postwar military buildup thus has had a proportionately larger and more sustained impact on government expenditures than the fiscal stimulus enacted to combat America's deepest postwar recession. It is quite reasonable to suppose, therefore, that the military dimension of American hegemony has had powerful economic consequences. And yet, the economic impact of America's military buildups has attracted remarkably limited attention from academics, policymakers, and the media.

The Pattern

The book asserts that the military dimension of American hegemony has repeatedly pushed a distinctive "political economy of imbalance" to the center of the global political economy. The political economy of imbalance is a cycle that has emerged each time the United States has embarked on a deficit-financed military buildup in response to an unexpected military challenge. This repeating cycle is evident in Figure 1.1,

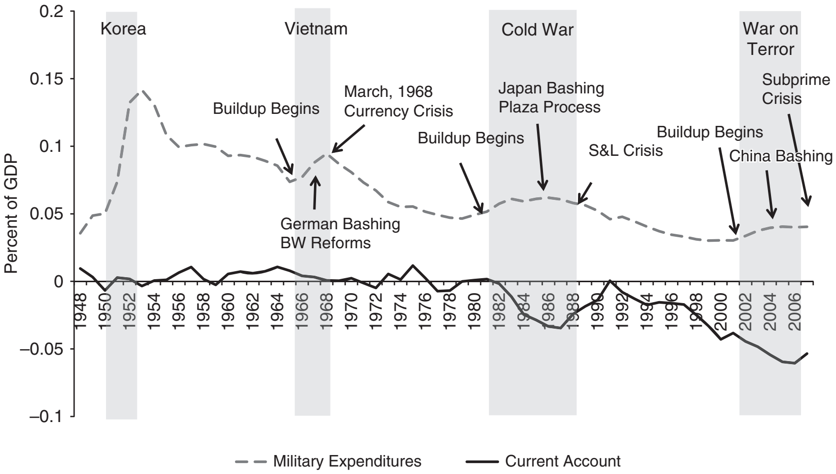

FIGURE 1.1. Military Buildups, Macroeconomic Imbalances, and Financial Crises.

which traces the evolution of the political economy of imbalance between 1950 and 2008.

Notice first that although the military's share of GDP has declined steadily across the postwar period, military spending rose sharply and persistently against this trend on four occasions. Each military buildup was triggered by a foreign event (or a sequence of foreign events in a short time span) that indicated to American policymakers that the international system was significantly more hostile to U.S. interests than policymakers had previously believed. North Korea invaded South Korea; the North Vietnamese were unexpectedly vigorous in their challenge to America's commitment to the South Vietnamese regime; the Soviets invaded Afghanistan; and al Qaeda unexpectedly hijacked commercial aircraft and crashed them into the Twin Towers and the Pentagon. Policymakers increased military spending in response to each of these foreign challenges by about 2 percent of GDP, and each military buildup persisted for three to four years.

Three of the four military buildups generated economic booms characterized by unbalanced growth. In Figure 1.1 the buildup-induced economic booms are shaded in gray and the associated economic imbalances are traced via the evolution of the current account balance. In all buildups except Korea, policymakers elected to pay for the additional military spending by borrowing rather than by raising taxes. And in all three of these deficit-financed military buildups, the resulting fiscal stimulus was pro-cyclical, adding demand to an economy already in the midst of the expansionary phase of the business cycle. The large and persistent budget deficits thus combined with existing investment and consumption expenditures to push total national expenditures well above national income. The capital inflows that financed the increased expenditures strengthened the dollar, and the stronger dollar eroded the competitiveness of ~~the~~ manufacturing industry.

With manufacturing competitiveness falling but the economy booming, investment and workers shifted into activities that were sheltered from international trade. Real estate construction and financial services, especially mortgage financing, were important, though certainly not the sole beneficiaries of this shift. Over the course of two of the economic booms (the Vietnam War boom was distinctive in ways I describe later in this chapter), activity in real estate construction and finance rose sharply, while manufacturing sector activity declined. And like the military buildups that triggered them, these episodes of unbalanced growth persisted for three to four years.

The economic imbalances drove the politics of economic policy in the United States and in the global arena. In the United States, the over-valued dollar and rising imports generated a surge of protectionism. Manufacturing industries and organized labor pressured Congress and turned to administrative agencies to seek temporary relief from the intensified foreign competition. Congress responded to this growing pressure by becoming increasingly protectionist. Individual legislators and congressional committees threatened to enact legislation that would restrict imports from countries that the United States Trade Representative identified as unfair traders unless their governments removed the offending practices. Congress pressured the Treasury Department to label governments "currency manipulators" and to threaten to restrict their access to the U.S. market in order to compel policy changes.

In the global arena, the administration responded to the rise of protectionism in Congress by engaging America's trade partners in negotiations intended to reduce America's trade deficit. America's creditors have been reluctant participants in these talks, engaging in negotiations primarily because they fear that refusal to do so would lead to congressionally imposed trade sanctions. These talks targeted specific trade barriers believed to restrict U.S. firms' market access, they focused on undervalued exchange rates that undermined American competitiveness, and they sought changes in macroeconomic policies to encourage consumption in the surplus countries. Through these negotiations, the U.S. government thus sought to push the burden of adjustment necessary to narrow "global imbalances" onto its creditors. America's creditors were generally reluctant to concede in the face of American pressure. They have viewed trade imbalances as a reflection of American fiscal policy rather than a result of specific industrial or exchange rate policies they pursue at home. Creditors have seen little benefit in increasing consumption at home, and most have resisted U.S. efforts to alter currency values. The political struggle over who should bear the cost of reducing global imbalances thus produced very little adjustment. As a result, the large global imbalances were allowed to persist for the length of the boom.

Each episode was brought to a close by a major financial crisis. The Vietnam War buildup led directly to an extended dollar crisis. Foreigners accumulated substantial claims against U.S. gold reserves even as total U.S. gold reserves fell. The currency crisis began once investors recognized that devaluation of the dollar against gold was inevitable, and speculative attacks against the dollar occurred whenever investors believed dollar devaluation was imminent. The two subsequent military buildups produced the savings and loan crisis and the subprime crisis. The shift of investment into real estate generated positive feedback: rising real estate prices attracted investment, and the shift of demand into the real estate sector pushed prices up further and thereby attracted additional investment. Positive feedback fueled the emergence of real estate bubbles, and over the course of the boom the banking system became increasingly exposed to overvalued real estate. The banking system suffered a systemic crisis when the bubbles deflated.

The military dimension of American hegemony has thus repeatedly pushed the political economy of imbalance to the center of the global economy. Buildups have generated economic booms; the resulting economic imbalances have sparked political conflict over trade and exchange rate policies. Over the course of the boom, financial imbalances accumulated and ultimately led to financial instability. This book argues that this political economy of imbalance has been a central characteristic of American hegemony and develops an explanation that helps us understand why it has been so.

The Argument

Why has American hegemony been characterized by this political economy of imbalance? In broad terms, I argue that the political economy of imbalance has been pushed to the center of the global economy by the interaction between America's domestic political institutions and its international financial power. America's political institutions channel the American policy response to unexpected foreign military challenges – what I call security shocks. These institutions enable policymakers to increase military spending quickly in response to the threat, but they also greatly restrict the ability to raise taxes or reduce spending on social welfare programs. As a consequence, the U.S. government has paid for most postwar military buildups by borrowing. America's financial power enables the United States to borrow from the rest of the world in large volumes, for extended periods, at low interest rates. The willingness of the rest of the world to lend to American borrowers ensures that the budget deficits generated by America's military buildups do not crowd out domestic investment or reduce private consumption. In combination, America's political institutions and financial power transform security shocks into a persistent, pro-cyclical fiscal stimulus that fuels booms and generates economic and financial imbalances.

American Political Institutions

American political institutions divide and decentralize political authority. At the broadest level, this division of authority is a consequence of the constitutionally mandated separation of powers that establishes the executive and legislative branches as independent bodies. The constitutional separation of powers is accentuated by a functional separation of power in the Congress imparted by the members' commitment to the committee system. The decentralization is perhaps further strengthened by relatively weak party discipline in an electoral system that creates strong incentives for each individual legislator to attach greater weight to the specific interests of district residents than to the broader concerns of the party as a whole. The decentralization of authority creates a political process in which policy choices must be negotiated between autonomous actors in Congress and the executive branch, as well as between the two houses of Congress, rather than selected and implemented authoritatively by an executive with an assured legislative majority.

This decentralized political system is prone to gridlock. Because departures from the status quo require the consent of a large number of veto players, the ability to shift policy quickly requires veto players' preferences to be homogeneous (Binder 1999; Binder 2003; Klarner, Phillips, and Muckler 2012; McCubbins 1991). Yet, because veto players represent diverse interests across a large geographic area, hold different views about the appropriate role of government in society, and adhere to distinct ideological orientations, the probability that all of them will prefer the same policy stance all the time is relatively low. Hence, the institutional structure tends to produce heterogeneous veto player preferences that impart a strong status quo bias to policy outcomes. Once politicians negotiate a policy outcome, subsequent movement away from that outcome requires substantial and convergent change of veto players' preferences.

Of course, policy does not remain locked into a single outcome forever. But when change does occur, it often occurs suddenly and shifts policy significantly. Existing research characterizes these dynamics of policy change in terms of punctuated equilibrium (Baumgartner et al. 2009; Baumgartner and Jones 1993; Jones and Baumgartner 2005; Jones et al. 2009). In a political system characterized by punctuated equilibrium an extended period of policy stability gives way to an abrupt and large policy change and then settles back into an extended period of policy stability. The underlying causal dynamics revolve around competing forces. On the one hand, changes in the social environment produce a steady accumulation of pressure for policy change. On the other hand, institutions impart friction to the policy process that restricts movement away from the status quo. Policy change occurs when the accumulated pressure is sufficient to override the institutional friction that keeps the system stable. When that threshold is crossed, the system lurches from its current state to a new one, which can be far from the status quo ante. Once policy has moved, institutional friction restricts further adjustment, and the system settles back into an extended period of policy stability (Baumgartner et al. 2009: 867).

The stickiness of policy outcomes in the American political system transforms security shocks into large and persistent budget deficits. The multiple veto player nature of the system constrains most year-to-year changes in military spending to small amounts. The need to gain agreement among a large number of actors who hold different assessments of the military threat America faces and the utility of military force as a deterrent against this threat constrain changes in defense spending. Sudden large changes of defense spending in this system are possible only in response to unexpected foreign military challenges, such as the terrorist attack of September 11. Such challenges produce an immediate convergence of veto players' preferences around the need for a substantially larger military. Yet, these security shocks have no impact on veto players' preferences over other dimensions of the budget. Policymakers continue to hold very different preferences over the appropriate tax rate and the appropriate levels of social welfare spending. In the face of this heterogeneity, veto players disagree sharply about how to pay for the larger military they all agree is necessary. As a result, as previously mentioned, the United States has paid for most postwar military buildups by borrowing rather than by raising taxes.

American Financial Power

The United States can borrow rather than tax to pay for military buildups because it possesses substantial financial power. Financial power is the ability of a national economy to borrow from the rest of the world in large volumes, for an extended period, at low interest rates (Cohen 2006; Krippner 2011; see also Schwartz 2009; Strange 1989, 1998). Financial power as such inheres to the national economy as a whole. That is, financial power does not inhere solely in the ability of the *government* to borrow cheaply from the rest of the world, but lies in the ability of the economy *as a whole* to borrow cheaply from the rest of the world in large volumes and for extended periods. Thus, when we speak of American financial power, we are not speaking narrowly about the U.S. government's ability to finance a budget deficit by selling bonds to China (or Japan). Nor are we restricting our attention to monetary power; the benefits that accrue to the U.S. government from the dollar's role as the world's primary reserve currency. We are talking more broadly about the ability of all U.S. residents to sell financial assets, such as mortgage-backed securities, corporate bonds, stocks, bank deposits, as well as government bonds, to foreigners. Financial power is thus the ability to escape the "crowding out" constraint: when government borrowing increases, foreign capital rushes in to plug the gap between the increased demand for and an unchanged domestic supply of savings.

Financial power derives from the interaction between country-level attributes and the network structure of the international financial system. At the country level, "confidence" is the key factor. Confidence is fundamentally a function of credit risk and liquidity risk. Credit risk is the probability that a borrower will default. The probability of default in turn is a function of the underlying strength of the economy, which shapes the health of the corporate sector and thus the likelihood of default on corporate bonds. Default risk is a function of government reputation that shapes the probability of a sovereign default. Default risk is a function of the stability of the banking system. On all of these dimensions, the U.S. financial system scores high in absolute and relative terms: the risk of default is extremely low, as low as or lower than that of all other countries. Liquidity risk is largely a function of the size of capital markets. Many countries offer sound investment opportunities; but most markets are relatively small. The United States, in contrast, has the largest and most active capital markets in the world. The liquidity of these markets generally enables holders of dollar-denominated assets of all kinds to liquidate their holdings quickly and at low cost. Country-level characteristics combine to make the U.S. financial system the market in which credit risk and liquidity risk are very low.

Country-level characteristics are reinforced by the network structure of the international financial system. The American financial system stands at the center of the global financial network (Oatley et al. 2013). The United States attracts financial assets in larger amounts and from more countries than any other national financial system in the world. And the difference between the United States and other countries is not linear; the United States is twice as central as the second most central system (the United Kingdom), four times as the third most central (Germany and Luxembourg), and orders of magnitude more central than the tenth most central countries. America's central location in the global financial network generates positive feedback that encourages capital to flow to the United States from the rest of the world. The extent to which the United States attracts foreign capital is a positive function of the amount of foreign capital it has attracted. The willingness of foreign investors to acquire additional dollar-denominated assets is a positive function of the volume of dollar-denominated assets foreigners hold. This dynamic contrasts sharply with the capital market dynamics that apply to other countries, where the volume of capital inflows is typically a negative function of current exposure. In a sense, then, the United States has financial power in part because it already has financial power.

One sees evidence of America's financial power in the evolution of net cross border capital flows between 1970 and 2008. Figure 1.2 traces the evolution of global imbalances, as well as the cross-national distribution of these imbalances, between 1970 and 2008. The measure of global imbalance is the sum of all national current account deficits each year as a share of world GDP. Between 1975 and 2003, global imbalances varied within a relatively narrow range, between 1 and 2 percent of world GDP. After 2003, global imbalances increased sharply, almost doubling the 1975–2003 average. The measure of the cross-national distribution of these imbalances is a Gini coefficient calculated for the ten largest national current account deficits – which account for about 70 percent of the total global imbalance – in each year. This Gini coefficient rises toward