The Global Economy Bubble Equilibrium

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Many of the greatest deficiencies of neoclassical economics follow, logically enough, from its central concept: equilibrium. Attacks on its single-equilibrium assumptions in favor of multiple equilibria, most notably in New Trade Theory, are one response to this. Another is the growing realization[23] that, in Keynes's words, "markets can remain irrational longer than you can remain solvent," an obvious practical fact that has resisted embodiment in theory. Neoclassical accounts of market irrationality tend to treat this irrationality as mere noise, whose systematic mechanisms are at best artifacts of behavioral psychology. But in truth, the mechanisms by which markets can remain out of equilibrium are as profound as those by which they find equilibrium, and the present global economy is a case in point.

Intelligent commentators have been crying "unsustainable" about the value of the US dollar, and its relationship to the rest of the world economy, for nearly ten years now, bringing two facts into collision:

1. The underlying assumptions of these commentators are reasonable, well-accepted ideas about the supply and demand for currencies.

2. The dollar's value and relationship has, in fact, observably been sustained.

Despite the dollar's recent decline, which may have become decisive by the time the reader sees these words, it has still remained above the value that neoclassical assumptions would predict for a very long time. And unfortunately, most rejections of the first assumption above have been implausible.

Some such rejections have been rhetorically wild, but analytically insubstantial, assertions about the New Economy. For example, they have taken admittedly-impressive technologies like the Internet as economic changes in their own right, failing to explain how they abolish technology-independent economic facts like the propensity of competitive markets to deliver zero profit. (Sometimes, they have not even established the relevance of such technologies to foreign exchange at all.)

Some such rejections have been conceptual sleight-of-hand, like the assertion that trade deficits simply don't matter anymore, because national borders are supposedly arbitrary. But even if one concedes this (questionable) premise, it still follows that, under accepted economic assumptions, currencies assigned to the economic activity within arbitrary lines on the map will observe certain relationships with other similarly-defined currencies.

Some such rejections have been sober but still implausible assertions about how the US and world economies have changed, like Allan Greenspan's attempts to justify everything with claims of productivity growth in the US economy. Among other things, this would not explain the current situation, even if it were true.

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[23] Something that was obviously realized a long time ago, but seems to have been forgotten and re-learned in decades-long cycles.

The rational response is neither to embrace any of the above pseudo-solutions, nor to ignore the fact that we are confronting a stark contradiction between standard economic assumptions and observed facts. Instead, the key lies in recognizing that while the US and world economies have indeed changed, they have *not* changed into some Alice in Wonderland world in which no rules apply. Instead, they have changed into a world in which the old rules, for clearly-cognizable reasons, have been relaxed or changed, creating new rules – which can potentially be exploited by appropriate trading strategies.

These new rules are defined by something we can call the Global Economy Dollar Mechanism, or GEDM for short. The rational way to construct a model of the new world economy, and the GEDM according to which currencies function inside it, is to begin with the conventional model of the old world economy, identify its key assumptions, and identify which of these no longer hold and why.

Since the observed condition we face is a speculative boom in financial assets, let us begin with the conventional model of how this happens: the money supply expands. Now in the old economy, the natural result of this is inflation, for the classically-stated reason of "too much money chasing too few goods." And yet we observe (or observed until very recently, and mainly due to cost-push problems like Peak Oil) low inflation. So what has changed?

The main thing is this:

The US dollar is no longer just an American currency. It has become WorldMoney.

So the first key assumption of conventional economic models we must relax is the assumed tight connection between national economies and national currencies. This is true both in the case of the US, because the dollar is being used so much elsewhere in the world, and in the case of foreign countries, because their economies are now using dollars, rather than their own currencies, so much. This has two main consequences.

First, the quantity of dollars in circulation is backed not just by the goods production of the US economy, but by the production of all goods bought and sold for dollars anywhere in the world. As a result, the constraint of "too few goods" has been loosened considerably, and the US money supply can expand considerably more than it otherwise could without simply inflating away. (This constraint on dollar inflation in goods prices is buttressed by the constraint on inflation in *any* currency created by the global surge in cheap manufactured goods from China and elsewhere.)

Second, growth in the sophistication, international tradability, and penetration into the non-financial economy of financial instruments has meant that the dollar is not just backed by production of goods, but by production of financial instruments and investable assets (like real estate) as well. So the conventional assumption, that exchange rates are ultimately dominated by trade in goods, with financial factors like interest rates exercising a subordinate influence, can now be reversed. The tail can now wag the dog.

The key is not mainly the increased technical intricacy of these instruments as such, though this does make them more potent. It is their increased penetration into the US non-financial economy. For example, 30 years ago, the wealth embodied in a typical suburban house, or a college education, was not typically converted into financial instruments that could be traded around the world. The same goes for corporate receivables, securitized debt, and many other things. The net result has been that a radically increased percentage of the

wealth in the American economy, in all forms, has been made a tradable part of the financial system.

Furthermore, at the same time as this wealth has been "put on wheels" by financialization, the barriers to pushing claims on that wealth, i.e. financial instruments, across national borders have been coming down – almost continually since 1979. As a result, the quantity of wealth that can flow, the range of places it can flow, and the ease with which it can do so have radically increased. And this is all *before* factoring in the effects of the collapse of communism in 1989.

The result has been a vast increase in the value of financial instruments (debt and various forms of asset ownership) that Americans have available for "export" in exchange for their imports. Because these imports are just the obverse of foreign nations' export-led growth, this has coincided with a boom in the amount of money foreigners have to buy these "exports" with. The final result: the large-scale substitution of financial exports for goods exports by the US that we have empirically observed.

This sounds perverse, upon conventional economic assumptions. But looked at one way, it is well-nigh inevitable, indeed an obvious consequence of taking financialization to its logical conclusion. In principle, the sum total of 300 years of accumulated American wealth has now been made tradable, and the sloshing about of this sum, in the global market for purchasable wealth, dwarfs the mere annual *increment* to this sum constituted by present production. So of course financial exports dominate.

It used to be the case that present production dominated international trade, because of constraints on converting accumulated wealth into financial instruments, and constraints on selling these instruments to foreigners (or constraints in their own countries on their buying them from us, ranging from sheer lack of money to government regulations.) So we came to think of this as the normal state of affairs, especially because it just seems somehow natural that finance should be the tail and the "real" economy the dog. But in fact, it is quite arguably more natural for *finance* to dominate, because finance embraces all accumulated wealth than can be converted to a tradable asset, while the "real" economy embraces only present incremental additions to that wealth.

The oft-noticed, but to the author's knowledge untheorized, consequence of this has been that the financial system has been largely de-coupled from the health and functioning of the US current-production economy. Case in point: in the first quarter of 2007, US economic growth slowed to 1.3%, and yet the Dow rose to an intraday all-time high of 13,284, closing at 13,264 on May 4th. The US current-production economy continues to exert, of course, a heavy influence upon the US financial system, but it is the US financial economy, consisting of America's accumulated wealth, that dominates.

Importantly, the health of the financial economy can deviate substantially from the health of the production economy[24]. After Michael Porter, we can call an economy in which the asset economy is dominant a "wealth economy,"[25] though the radicalization of this

[24] There is also no necessary reason to suppose (especially if we abandon naïve assumptions of perfect markets, but quite possibly even with such assumptions) that those policies which will be best for the one economy, will be best for the other.

[25] Although Porter uses the term in *The Competitive Advantage of Nations* as a pejorative, implying an

phenomenon appears to have outstripped what was observable when he coined this phrase in 1990.

It follows from all this that anyone who wishes to speculate on the value of the dollar needs to identify the true contemporary uses of the dollar, and base their analysis on that instead. It must be understood, above all, that the US's titanic trade deficit is *not* necessarily a peculiar aberration from the normal, equilibrium-reverting, course of world trade. A trade deficit in mere *goods*, when the "trade" in assets is just as big or bigger, is nothing illogical whatsoever. There are good reasons for what is happening, and although it may not be able to last forever (no economic era does), it may not be on the verge of collapse that pessimistic commentators imagine. It is simply *not* necessarily aberrational.

Even if it does represent a deviation from equilibrium, it is entirely possible that it may take a long time for that deviation to be rectified, just as the water level in two connected pools can take an arbitrarily long time to equilibrate, if the pipe connecting them is of small enough diameter, relative to the volume of water in the pools. And if the hypothetical equilibrium changes during this time faster than the "water" can flow to equilibrate to it, the system can conceivably remain *permanently* out of equilibrium.

The Role of Speculative Booms in the GEDM

The key to understanding the constraining rules of the GEDM lies in understanding why the GEDM requires speculative booms to survive. The above-described facts, alone, would not be sufficient to produce the speculative boom we have been living with, intermittently, since the GEDM crystallized[26] in the early 90's. But what needs to be added to the above model is obvious: radical expansion of liquidity. The facts already described have not themselves done this; they have merely made it *easier* for it to happen. However, they have made it so easy that, once the political dimensions are brought into the picture, they have created well-nigh irresistible temptations for liquidity to expand radically.

The first key fact, is that the proliferation of sophisticated financial instruments has simply made it a lot harder for central banks to rein in liquidity. The second, is that the Fed has been expanding the money supply rapidly, and getting away from it. The third, is that because the US runs a huge trade deficit, there $800 billion doesn't get spent buying goods, but on buying financial assets. The US trade deficit is like a giant pump inside the world economy, converting wealth that would otherwise be "flared off" into immediate consumption into financial assets. This endlessly-piling-up wealth, rendered ultra-liquid by sophisticated modern finance, must go *somewhere*. It cannot go into goods prices, so there is nowhere else for it to go, than into the price of debt (including sophisticated repackagings of debt) and assets.

This dynamic is accelerated by a number of factors. First, the availability of easy credit to Americans increases their spending levels. (Selling the bubble-inflated equity in

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economy in which present wealth-creation is sabotaged by an economy optimized to favor the profitable exploitation of accumulated wealth, no value judgment is intended by this essay, though hopefully the formulation here may bring some clarity to his somewhat-vague concept.)

[26] The author takes no position, concerning whether the GEDM was deliberately designed, or came about by historical accident. The literature is full of accusations that Clinton Treasury Secretary Robert Rubin "engineered" it, but this is not an essay on conspiracy theory.

one's house to a foreign purchaser by means of a second mortgage is the classic example.) And the more Americans spend, the more they import, forcing foreigners to buy more American assets or debt. Then there is the wealth effect, in which an increase in the nominal wealth of American consumers, due to inflated prices for stocks, real estate, and other assets, makes them more willing to spend money. Then there is the fact that bubbles don't operate against a static class of base assets, and bubble-induced rises in the price of an asset class will tend to encourage production of those assets. The obvious example is real estate. Demand for real estate, as a speculative asset, increases the construction of houses. This creates a spill-over into the non-financial economy, heating it up, and producing more spending, more imports, *et cetera*.

Will the Global Economy Dollar Mechanism endure?

The key question, if the above analysis is true, is obviously, "Why *is* the dollar WorldMoney, and what could make it cease to be?" There are two answers:

The most obvious reason is that there are perfectly-good theoretical reasons[27] to expect that an established vehicle currency, once established, will remain so – even if the establishing conditions, like dominance of global GNP or trade, cease to be true. The British pound remained the international reserve currency of choice for decades after Britain had shrunk to a relatively small portion of world GNP.

The second reason is political. There appear to be[28] no *a priori* political reasons for the key foreign economic players to prefer that the dollar be WorldMoney, given their stated postures of rivalry with the US and their apparent belief that the dollar's status increases America's undesired power. There exist, instead, reasons of status quo lock-in which make it advantageous, at least for the time being, for them to continue to support the dollar's status.

For a start, if they ceased to be willing to recycle America's trade deficit into dollar-denominated assets, their trade surpluses against the US would collapse. Conversely, if cheap foreign imports ceased to be readily available to the US, this would trigger a surge of inflation, which would push up interest rates and tip the heavily-indebted US economy into recession.

But why can't China just switch to satisfying internal demand? After all, would it not be more advantageous to the Chinese to get the benefits of both economic growth *and* increased consumption, rather than merely building up their productive capacity satisfying foreign demand? The reason is that the Chinese economy has risen on production of goods suitable for consumption by rich First-World consumers. Despite burgeoning demand by the population of the developed cities along China's coast, China simply does not have a population base that can absorb China's production of fax machines. This mismatched demand base is the price China pays for having embraced an export-led growth strategy, and the ultimate short-term reason for Chinese dependence upon the US.

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[27] See Paul Krugman's 1980 article *Vehicle Currencies and the Structure of International Exchange*.

[28] I use the phrase "appear to be" because there are all sorts of rumors about, concerning deals done with various foreign players, like agreeing to defend Saudi Arabia in exchange for OPEC pricing oil in dollars. But this is not an article on conspiracy theory.

Leaving politics aside, and as a purely economic question, there is no absolute reason why this is an unhealthy[29] or unreasonable process, if we assume – as conventional economic assumptions would argue – that the process will not go on beyond the ability of the US economy to assume foreign debt and sell off existing assets to foreigners. If we make this happy assumption, then it follows that the market price of American debt is a rational indicator of America's ability to assume debt, and the market price of America's existing assets likewise. These market prices will not only provide us early warning, of when America may have gone too far, but will tend to naturally choke off the process at that time. The key question, therefore, is whether this happy assumption is, in fact, correct here, or whether the smoothly-adjusting dynamic that they assert is interfered with by anything. Here the plot thickens, as a number of things may do just this.

Most obviously, there we are dealing with asset bubbles, the popping of which can derail the whole process. Asset bubbles are not, of course, exclusive to the GEDM. But they are uniquely destructive under such circumstances, because the entire world economy has now become dependent upon the dollar, as the dollar is now WorldMoney and foreign nations are dependent upon its reliably continuing to fulfill this role.

Under the GEDM, asset bubbles are an almost-irresistible temptation, for a number of reasons. Most obviously: although asset-bubbles are, while they last, self-sustaining, in that the expectation of further price rises props up prices at their present (ultimately unsustainable) level, they almost always require *some* triggering device, which detaches market price expectations from initial moderation. The classic case is unrigorously-formulated but charismatic arguments, like "the Internet changes everything," which enabled the dot-com boom. But arguments are not the only thing that can have this effect: all that is needed, is that there be some factor impinging, which is outside conventional market rationality.

In this case, we have two (which may be arbitrarily reduced to one, analytically, as they are related):

1. The fact that the world economic system as a whole is dependent on the smooth functioning of the dollar machine.

2. The political expressions of the knowledge of the above fact.

In other words, the recycling of America's trade deficit into American debt and asset sales is artificially stimulated by the fact that this activity is not only taking place for the conventional economic reason of paying a positive return to the investors involved. It is taking place in order to sustain the entire global economic *system*. One way to look at it is view the (mediocre) direct returns to the investors as incremented by profits made by the system elsewhere. This relationship is formal, in the case of players like the central banks of Tokyo and Beijing, which accept the mediocre (indeed, negative over the last 5 years, given the decline of the dollar) returns they get on US Treasury debt as the fee they pay to stop the dollar from declining even more, and choking off their exports to the US.

[29] It is only unhealthy for Americans to be financing present consumption by selling off existing assets and assuming debts if we take the ethical position (which is outside economics) that this is an irrational trade-off between present and future consumption. Ian Fletcher explored the economic analysis that follows from this assertion in this paper: "A Neoclassical Hole in Neoclassical Free Trade" (http://www.paecon.net/PAEReview/issue26/Fletcher26.htm)

The GEDM thus has a firm basis for generating irrational asset prices. Another way of looking at it is to say that because holders of dollars *can't* spend them on anything other than dollar-denominated investments, they keep buying them even when they would otherwise be unattractive. We could even say that the US dollar enjoys monopoly pricing power for itself.

The temptation for the key players to accept asset bubbles in dollar-denominated assets is irresistible, because the more each bubble expands, the larger is the nominal value of dollar-denominated assets (which pleases the holders of those assets abroad) and the larger the absolute size of the pool of dollars that Americans have to sell, which pleases Americans. The asset bubble, by generating nominal returns while it lasts, compensates investors for the problem of buying assets for artificial reasons not justified by their fundamental returns. In fact, a bubble is so perfect a solution to the problem of making the GEDM run smoothly, that there exists a well-night irresistible pressure to find new bubbles.

One way of looking at this is to see the endless blowing-up of bubbles as a way to replace the actual returns that are missing from the system, i.e. the gap caused by the aforementioned biases that cause investors to accept returns on dollar-denominated assets that are artificially low. The whole system *does* balance – does maintain a sufficient equilibrium to sustain the system – despite its underlying inadequacies, and bubbles are key to making it do so.

Based on the above insight, we may conclude that if Allan Greenspan may be assumed to understand (whatever his public pronouncements) the existence and functioning of the GEDM, then this would explain his decision to allow the systematic inflation of several bubbles in succession. (Whether he agrees with the model sketched here, of the mechanism of the GEDM, is an open question. That he knows that something like it is in effect, is clear from his defenses of "dollar hegemony" to the US Congress. Furthermore, any player in his position who understood the GEDM would have an interest in not talking about it.) This would also explain why Greenspan was so explicit (indeed, disarmingly honest, once one grasps the game) about the need to avoid pricking bubbles, and avoid preventing them, preferring to defend the need to avoid a hard crash when they pop.

The natural question then is, will the US economy run out of bubbles to inflate? Given that the economy, and the number of (meaningfully different) tradable asset classes, is by definition finite at any given moment, and a developed economy like the US cannot be expected to expand fast enough to actually keep pace with a bubble, it would seem that at some point it must. Unless, of course, either or both of two possibilities holds:

1. The possibility that bubbles can be recycled, and at some point previous bubbles can be re-inflated. For example, the old tech bubble, based mainly on the Internet, obviously cannot be re-inflated, but a new tech bubble, based on the long-awaited breakthrough of nanotechnology, say, or pattern recognition, into mass commercial viability, could emerge.

2. The possibility that the bubble need not be in American assets as such, but in any assets, anywhere in the world, that are denominated in dollars. If this is true, then the "playing field" for possible bubbles is four times as large, and insulated from the obvious problems of the US economy.

The Global Economy Dollar Mechanism's Effect on Non-Dollar Currencies

The GEDM explains a number of other things, too. Like why the British pound has been so strong, despite Britain's persistent trade deficit and interest rates not greatly out-of-line with other economies. The strength of the British pound is perfectly easy to understand, if one remembers that pounds are demanded, by definition, not only for British *goods*, but for pound-denominated debt and pound-denominated existing assets. And Britain experiences exceptionally-strong demand for both, due to:

1. Britain's high level of personal and corporate indebtedness, which creates a vast pool of pound-denominated debt available for foreign investors to purchase. But foreigners need to buy pounds in order to purchase this debt.

2. Britain's political decision to make her existing assets, from London real estate to shares in British-owned companies, easy for foreigners to buy. There are far fewer overt and covert barriers to purchasing either than in the case of, say, France or Germany, so demand for British assets is artificially stimulated.

It follows from the above analysis that many common criticisms of current exchange rates are simply laughable. For example, the obsessive political attention given to the charge that China manipulates its currency, which attention is logically predicated upon the assumption that the "free market" exchange rate for its currency would be different, higher, and would (at least help to) redress the US trade deficit with China. Upon GEDM assumptions, China doesn't *need* to deliberately manipulate its currency (beyond the demands, which its government admits, probably honestly, of stability) to obtain the giant surplus it enjoys against the US. The GEDM structurally rigs the game that way, as long as it lasts[30].

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[30] It follows that bickering over currency manipulation is quite possibly understood to be empty, by the key players on both sides, and is allowed to go on purely to soak up populist dissatisfaction. The great advantage of allowing manipulation to be the focus of dissent is of course that it by definition frames the solution in terms of free markets.