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What is This?
Financialization and Global Imbalances: Prelude to Crisis

Dr Bill Lucarelli¹

Abstract
The concept of “financialization” has informed recent analyses of the contemporary dynamics of monopoly capitalism. In the wake of the global financial crisis in 2007-08, the strategic role of finance and its capacity to destabilize the real economy and push it to the brink of economic depression has rekindled debates over the historical causes and institutional forms which have characterized this phase of capitalist evolution. In other words, to what extent have the neoliberal policies pursued by most OECD countries over the past 30 years contributed to the emergence of this finance-led regime of accumulation? More specifically, what are the implications of the extraordinary build-up of private debt, which has financed private consumption and fuelled successive asset price and stock market euphoric bubbles over this period? At the same time, the problem of growing global imbalances between the surplus countries/regions and the deficit countries/regions has emerged as a major source of financial instability. It will be proposed that the breakdown of the mechanisms, which have supported the dynamics of financialization, have set the stage for the current global capitalist crisis.

JEL codes: B5, B14, B16, B23

Keywords
financialization, money, credit, crisis, labor, capital

1. Introduction
It will be argued that the origins of the global financial crisis of 2007-08 were rooted in the peculiar logic of capital accumulation in the two decades preceding the crisis. In this context, problems of severe excess capacity and growing income inequalities in the United States manifested themselves in a general crisis of over-accumulation. The falling rate of profit experienced during the 1970s and early 1980s was eventually counteracted and reversed by the 1990s through the repression of wages and sustained by the phenomenon of “financialization.” The fall in the wages share of national income was a necessary condition in the reversal of the tendency

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toward falling profitability (Dumenil and Levy 1993). However, the restoration of profitability inevitably encountered the limits set by the chronic lack of effective demand. In most advanced capitalist countries, income inequalities only worsened over time as real wages stagnated. In order to maintain their real purchasing power in the face of stagnating real wages, workers were compelled to resort more than ever to the privations of debt servitude. Real purchasing power was increasingly augmented by burgeoning levels of household debt (Barba and Pivetti 2009: 122). Instead of providing the foundations for technological reconversion and industrial upgrading, the sharp increases in aggregate profits were dissipated into corporate mergers and acquisitions, speculative financial engineering, and other forms of rent-seeking and entirely fictitious forms of capital. In the aftermath of financial deregulation in the early 1980s, these speculative propensities reached truly astounding proportions and led to an unprecedented series of asset price booms. At the same time, these phases of excess liquidity and speculative asset booms were sustained by the massive inflow of highly liquid short-term capital from the surplus countries, most notably from East Asia. From a Marxian perspective, the crisis exhibits features of a stylized Kaleckian problem of realization, which has been superimposed onto and has accentuated the underlying and longstanding structural crisis of capital. In other words, it will be proposed that the phenomenon of financialization merely postponed the impending structural problem of falling profitability.1

Part 2 examines the processes of financialization over the past two decades, which have temporarily counteracted and reversed the tendency toward a falling rate of profit experienced during the 1970s and 1980s. Part 3 elaborates on this analysis to incorporate the problems of global balance of payments disequilibria, which have served to exacerbate these perverse asset-price booms via the channels of credit recycling between the surplus and deficit poles of the international economy. The analysis will be confined to the historical developments culminating in the “Great Recession” of 2008-10. At the time of writing, the consequences of the crisis are still unravelling and could constitute a separate study in the near future.

2. Financialization

The global economy has experienced a protracted phase of over-accumulation over the past two decades. This pervasive crisis has been characterized by chronic excess productive capacity in the manufacturing sector relative to the level of global effective demand and has coincided with the rise of the East Asian countries as major manufacturing exporters (Brenner 2006; Lucarelli 2004). The lack of effective demand has led to the growth of excess liquidity, which has been increasingly channelled into the financial markets and financed burgeoning levels of debt, which in turn have supported hyper-excessive private consumption and generated recurrent asset-price booms. Similarly, the perverse “wealth effects” induced by this type of financial leverage have set in motion a negative feedback loop, which further reinforces the vicious circle of debt-financed consumption and asset-price inflation. Indeed, the normal business cycle itself has become immersed by this finance-led regime of accumulation in which asset-price booms and busts tend to amplify the fluctuations of the investment cycle.

The stagnation of real wages during the neoliberal era led to an increase in private indebtedness as workers resorted more than ever to the lure of credit in order to maintain their purchasing power (Dumenil and Levy 2004: 84). Wage repression was accompanied by growing income

1A more detailed theoretical treatment of this Kaleckian dynamic can be found in my (2004) Monopoly Capitalism in Crisis and the forthcoming Economics of Financial Turbulence (2011), to be published by Elgar.
inequalities and greater job insecurities with the growth of casualized and more precarious forms of low wage employment. For instance, in 1979 the income of the top 5 percent of households in the United States was 11.4 times the income of the bottom 20 percent of households. By 2004, this ratio had increased to 20.7 times (Palley 2007: 11). These negative trends had the overall effect of dampening the level of effective demand, which put more pressure on government spending as the automatic stabilizers were considerably weakened by the neoliberal ideological obsession for small government and middle-class tax cuts. With the decline of public investment in physical and social infrastructure, the neoliberal state relentlessly pursued policies of privatization as integral elements of a much broader strategy of market liberalization. As noted by Mason: “From near zero in 1981, the privatisation market topped $US160 billion a year in the late 1990s. Globally, by the end of the decade 675 privatisations had generated $US700 billion; the 18 biggest initial public offerings in history had all been state-owned companies privatised through flotation” (Mason 2009: 64). The financial sector doubtless benefited enormously from these policies.

Financialization is governed by the transformation of future streams of income (profit, dividends, and interest) into marketable and traded assets in the form of equities or bonds (Vasudevan 2009b: 474). In other words, financialization represents a profound shift away from direct investment in productive capacity, towards the open financial markets in which profitability can be temporarily boosted through speculative operations in the stock markets. Shareholder value can be temporarily bolstered in the short term by corporate mergers and acquisitions or through equity buy-backs. These predatory forms of fictitious capital also bred a new managerial class motivated almost entirely by the lure of stock options and bonuses. The whole logic of subjecting corporate profitability to the short-term valuation of the stock market in order to maximize shareholder returns was a response to the profitability crisis in the 1970s and 1980s (Dumenil and Levy 2004). Confronted by a profit squeeze and rising capital/output ratios as a result of persistent and chronic problems of excess capacity, non-financial firms were compelled to restore profitability not only through wage repression but also by diverting investment into the financial and equity markets (Krippner 2005: 182). To be sure, under the conditions of depressed profitability, non-financial firms were reluctant to increase productive capacity in the face of an intensification of price competition and saturated markets (Bramble 2009: 51). Instead, the recycling of distributed profits into capital markets generated a powerful unintended consequence. As the demand for tradeable financial assets exploded, a long-term inflationary tendency was experienced in asset prices. In this speculative dynamic, higher asset prices relative to the prices of current output only served to lower the margins of safety built into bank lending. Greater financial leverage in turn spurred higher asset prices. This whole process of debt-financed speculation has merely increased the degree of financial instability. At the same time, the perverse wealth effects of rising asset values, most notably in real estate and equities, augmented private consumption and compensated for a loss of purchasing power caused by stagnating real wages.

The 1990’s stock market boom was sustained by this massive wealth effect, which reached its zenith just before the “tech wreck” in early 2001. Although the rate of aggregate profits began to

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2This thesis generally supports the statistical evidence presented by Dumenil and Levy (2004) that the rate of aggregate profits, after declining in the 1970s and 1980s, recovered and peaked in the mid-1990s. The causes of this recovery remain the object of perennial controversies, which are beyond the scope of this paper. However, there is considerable evidence to support the Kaleckian proposition that an increase in the profit share of national income caused chronic problems of excess productive capacity in the absence of a concomitant increase in real wages. As long as real wages lagged behind productivity growth, the problem of a severe lack of effective demand persisted and became more acute (Lucarelli 2004b).
decline in 1995-2000, the increased rate of investment was driven by the consummate ease with which rising equity prices had over-valued market capitalization and had induced an unprecedented borrowing binge. Spurred by the easing of monetary policy, or what Wall Street celebrated as the “Greenspan put option” after the East Asian financial meltdown, corporations resorted more than ever to external borrowing to finance investment. During the postwar boom era of 1950-75, non-financial corporations had relied upon internal funds to finance investment with retained earnings accounting for 90 percent of their capital spending. In stark contrast, in the years 1995-2000, external borrowing to finance capital accumulation or to engage in mergers and acquisitions had reached its highest level in history. By 2000, gross equity issues by non-financial institutions had increased four-fold from the previous peak in the late 1980s (Brenner 2006: 295). Assets invested in hedge funds had more than tripled between 2000 and 2007, estimated at $US1.5 trillion (Wade 2007: 113).

When a large pool of assets become near-money, it can have a direct impact on liquidity levels, which can cause increases in asset prices as real interest rates decline. Since the euphoria entices new investors into the boom and so increases asset turnover (which causes liquidity in these assets to increase), it can have a self-reinforcing effect by making a larger amount of assets more money-like. The addition of very large, highly traded securities can cause a market’s liquidity to increase just as if there had been an increase in the money supply. (Nesvetailova 2005: 401)

Indeed, the U.S. Federal Reserve itself had created a longstanding moral hazard risk by easing monetary policy or injecting liquidity into the financial system whenever signs of instability threatened Wall Street. This was especially so after the collapse of the so-called “new economy” boom after 2001 in which the NASDAQ index fell by 40 percent between September 2000 and January 2001. The U.S. Federal Reserve reduced the short-term interest rate from 6.5 percent to 1 percent between 2000 and 2003 (Li and Zhu 2005: 6). At the same time, the U.S. government enacted expansionary fiscal policies and incurred growing fiscal deficits, partly as a result of the war in Iraq, which stimulated the recovery from the mild recession of 2001-02. The U.S. budget surplus of 2.4 percent of GDP in 2000 was reversed to a deficit of 4.6 percent of GDP in 2003. In retrospect, this phase of excess liquidity only served to fuel asset price inflation, most notably in the housing market. But the rapid expansion of liquidity has not been accompanied by a concomitant increase in the level of effective demand or an improvement in real wages. This accommodating monetary policy created an enormous wealth effect at the very moment when real net private saving in the United States was negative. As Lipietz warned: “But precisely there lies the danger: in a capitalist world without re-distribution of a Fordist type but with a ‘flexible’ labour market, the excess of money creates no inflation in the price of labour or of commodities, but does create it in the price of financial assets. Hence, a crash can occur at any moment in the United States” (Lipietz 2001: 35). Since consumption depends more upon credit creation than income growth, the emergence of a debt-trap could lead to a corresponding collapse in asset prices and set in train the dynamics of debt-deflation as credit is rationed in the event of a severe credit crunch. A Fisherian-type depressive phase of financial retrenchment could emerge under these extreme circumstances (Parenteau 2004: 57).

The policies of financial deregulation, privatization, and greater labor market flexibility enacted by the neoliberal state have created the objective conditions by which the logic of financialization has gained the ascendancy over the previous Keynesian policies of “financial repression.” Unleashed from the constraints imposed by state regulation, the neoliberal state provided the framework for the emergence of financialization. In this sense, the new monetarist orthodoxy signified the “revenge of the rentier” as the imposition of anti-inflationary policies sought to
restore the value of financial assets from the depredations of inflation and inflationary expectations caused by the series of oil-price shocks during the 1970s and 1980s. The policies of “sound finance,” which implied a curtailment of public spending and a return to the pre-Keynesian doctrine of balanced government budgets, was instrumental in reversing the postwar political consensus over the maintenance of full employment. Indeed, it was precisely the objective of restoring profitability by reducing the wages share of national income through the classical mechanism of the reserve army of unemployed labor which informed the neoliberal strategy of economic restructuring in favor of capital. With the labor movement on the defensive, the hegemony of capital was restored (Harvey 2006).

The ascendancy of a finance-led regime of accumulation therefore involved a shift away from the normal strategy of ploughing back profits into long-term investment, towards the short-term strategy of purchasing financial assets and bolstering shareholder value. In other words, as Lazonick and O’Sullivan argue, there has been a shift from the previous “Fordist” model of “retain and invest” to a finance-led strategy of “downsize and distribute” (Lazonick and O’Sullivan 2000). Corporate profits recovered throughout the 1990’s stock market boom to reach their highest level in 40 years (Arestis and Singh 2010: 228). The overwhelming preference for financial markets rather than indirect finance supplied by the commercial banks was evident with the astounding growth of pension funds, mutual funds, and more recently by the astronomical rise of hedge funds and equity funds (Guttmann 2009: 47). The other major bearer of the logic of financialization took the form of the exponential growth of the derivatives markets. Originally conceived as a means by which to reduce risk through financial arbitrage, derivatives have since increasingly been deployed as instruments of speculation, or to paraphrase Warren Buffet, as instruments of “mass destruction.”

Deprived of their traditional markets, the commercial banks themselves were drawn into the speculative maelstrom (Stockhammer 2004: 726). In the aftermath of financial deregulation, they began to engage in financial market mediation and expanded their operations into the functions that were previously the exclusive domain of investment banks. Since the early 1980s, commercial banks have increasingly mediated waves of mergers and acquisitions. To finance their own lending by attracting an inflow of liquid liabilities, commercial banks acted as financial intermediaries by borrowing in the short-term money markets in order to lend in the long run. These highly leveraged operations required the accumulation of relatively liquid reserves in order to avoid potential defaults. Consequently, the commercial banks, by engaging in the functions normally associated with investment banks, were compelled to balance the imperatives of liquidity with those of solvency. By stark contrast, investment banks borrow in the open markets and require a smaller capital adequacy ratio because they specialize in the investment of short-term securities. By assuming the functions performed by investment banks, the commercial banks were more vulnerable to the threat of a run on deposits in the event of insolvency. Indeed, it was precisely this separation between the commercial and investment banks which had informed the Glass-Steagall Act enacted during the 1930’s depression in the United States. The repeal of this act in 1999 re-created the disastrous conditions which had prevailed in the 1930s and which many economists argue was one of the major causes in the outbreak and prolongation of the Great Depression (Lapavitsas 2009: 135).

The emergence of the “shadow banking system” was the result of a deregulated financial system, especially after the repeal of the Glass-Steagall Act in 1999. The complex web of financial obligations was built upon a pyramid of financial leverage in which commercial banks established “special investment vehicles” (SIVs), which effectively existed outside the purview of the regulatory regime of the U.S. Federal Reserve (Panitch and Konings 2009: 75). This type of financial innovation had the effect of expanding the balance sheets of the banks and increased quite substantially their scope for greater leverage. In Minskyian terms, the rise of speculative
and Ponzi financial units shifted the whole banking system into a zone of heightened fragility (Minsky 1982). In this sense, the spectacular growth of the shadow banking system was simply an outgrowth of the “official” regulated system. The regulated banking sector acted as intermediaries and prime brokers for the shadow banking sector, amassing exorbitant fees and commissions (Gowan 2009: 13). These transactions were predominantly conducted in the “over-the-counter” credit derivatives markets in the form of collateralized debt obligations (CDOs). As Kregel notes: “Thus, the banking system that emerged from the 1980s real estate crisis no longer primarily served business lending, nor was it primarily dependent on net interest margins for its income. Rather, the system was based on the ability of the banks’ propriety trading desks to generate profits and to produce fee and commission income” (Kregel 2008: 10).

The speculative booms throughout the 1990s and early 2000s also encouraged persistent demands by finance capital and its political representatives for greater deregulation, which in turn reinforced the incessant competitive struggle between the banks themselves, waged by pursuing ever more complex forms of financial innovation. In other words, as these asset price booms gained momentum, perceived and real institutional obstacles to the expansion of lending were systematically removed, thereby increasing the banks’ exposure to risk. This culminated in the U.S. Securities and Exchange Commission (SEC) agreeing to increase the officially sanctioned leveraging ratios from 12 times capital to 40 times capital in 2004. The SEC further succumbed to pressures from the investment banks and made compliance of these new leveraging ratios voluntary. The floodgates were effectively opened to a torrent of excess liquidity, which propelled a rising tide of asset prices. Since a rising proportion of borrowing was short-term and highly liquid, the investment banks became exposed to the very real possibility of a reversal of deleveraging in the event of falling asset prices (Crotty 2009: 574).

After the repeal of the Glass-Steagall Act, which had legally enforced the separation of lending from underwriting, the commercial banks could now expand their lending through the new “originate and distribute” banking model. Commercial banks were now permitted to engage in the underwriting of debt. This implied that the commercial banks could also originate loans and after 30 days sell these collateralized debt obligations (CDOs) into secondary bond markets. In most cases, these secondary markets were simply the affiliates of the banks themselves. It was from this process of “securitization” that the origins of the shadow banking system could be traced. In the words of Davidson: “In order to ‘securitize’—that is, make liquid—the tranches in mortgage-backed assets, the underwriters had to assure buyers that the underwriters would function as a ‘market-maker’ in the market for these assets. A ‘market-maker’ is an institution that claims to guarantee holders of assets that the market for the resale of these assets always will be well organised and orderly” (Davidson 2008: 671). CDOs became very attractive assets because they could be held off the balance sheets of commercial banks and therefore escape any capital reserve requirements (Crotty 2009: 568). Quite simply, the commercial banks had discovered that the “originate and distribute” model presumably liberated them from the constraints of illiquidity in order to continue to expand their lending. This obvious delusion was reinforced by the view that their balance sheets would be endlessly liquid as long as credit was cheap and plentiful and as long as their returns on the issuing of MBSs were also high. In other words, as long as the U.S. housing market continued to boom and credit was cheap, these types of financial engineering could be validated. To be sure, the structured investment vehicles (SIVs) created by the commercial banks raised funds in the money markets in order to purchase securitized assets. According to Mason: “The value of asset-backed securities issued each year ballooned from a few billion in the late 1990s to $US2 trillion when the bubble burst” (Mason 2009: 93).

These new financial instruments were closely connected with the extraordinary growth of complex networks of underwriting contracts or derivatives known as credit default swaps (CDSs) issued by the investment banks. These derivatives were designed to act as a form of insurance
against counter-party default but soon became instruments of speculation. The CDS market expanded quite rapidly; between June 2005 and June 2007, the volume of CDSs traded increased from about $US1,021 billion to $US4,2850 billion (Lapavitsas 2009: 136). Needless to say, the crisis first broke out in the money markets and then spread to the investment banks. The full magnitude of this speculative euphoria can be grasped by the sheer size of this market, which was estimated at $US62 trillion in December 2007, even though the total value of the assets insured was estimated at only $US5 trillion. In other words, more than 80 percent of the CDSs outstanding were purely speculative (Crotty 2009: 569). At the same time, the combined pre-tax profits of the five largest investment banks increased from $US9.5 billion in 2002 to over $US30 billion in 2006 (Mason 2009: 93). By early 2007 the CDS market had turned into a gigantic casino that eventually contributed to the demise of the insurance behemoth American Insurance Group (AIG) and investment banks Bear Sterns and Lehman Brothers. The pernicious role of CDSs was evident in the pro-cyclical speculative frenzy which amplified the asset-price boom but acted as a powerful trigger in the subsequent credit crunch. As Guttmann succinctly notes: “The financial engineers of Wall Street put a highly volatile synthetic multiplier of credit derivatives on top of a fragile structured layer of securitisation, thereby unwittingly setting the stage for a devastating chain reaction at the first signs of stress, which ended up paralysing the global banking system” (Guttmann 2009: 58).

The other major trend, which accelerated the process of financialization, was the subsumption of wage labor to the imperatives of finance. As social provision of housing, pensions, education, and social welfare were drastically curtailed during the neoliberal era, ordinary workers were subjected to privatized services. At the same time, the savings of workers were channelled into financial markets as a result of these neoliberal policies, which encouraged the creation of private pension and mutual funds. These new forms of financial transfers became an integral element of the financialization of workers’ incomes. The subsumption of wages under the purview of private finance has doubtless been characterized by new forms of class subordination, which have augmented exploitation in the sphere of production.

Financialization witnessed an increase in financial profits as a share of total profits. In the years 1970-78, this share was estimated at about 47 percent but rose to 68 percent for the period 1979-2003 (Beitel 2009: 84). Indeed, the centralization of capital accelerated in the aftermath of the global financial crisis of 2007-08. According to Foster: “In 1990 the 10 largest financial institutions in the US accounted for 10 per cent of total US financial industry assets. In 2008 this rose to over 60 per cent. The same phenomenon is true globally with the largest banks in 2009 accounting for 70 per cent of global banking assets, compared to 59 per cent in 2006” (Foster 2010: 7). The complex instruments of financial intermediation and speculation form an intricate, interdependent web of globalized finance. This dense network of financial claims and obligations (i.e., collateralized debt obligations, credit default swaps) creates the conditions for global contagion. As the 2007-08 global financial meltdown revealed, the channels through which these speculative flights of capital are transmitted globally emanate from the credit-recycling mechanisms generated by the accumulation of U.S. dollar reserves by the surplus countries, most notably in East Asia.

### 3. Global Imbalances

Since the demise of the postwar, fixed exchange rate system of Bretton Woods in 1971-73, there has been an explosive growth of international central bank reserves, most of which are denominated in U.S. dollars. The expansion of these reserves has mirrored the widening trade imbalances between the United States and the rest of the world (Duncan 2003: 13). The United States had incurred a cumulative current account deficit exceeding $US5 trillion by 2006 (Iley and
According to Duncan (2003), between 1969 and 2003, international reserve assets expanded almost exponentially at around 20-fold. Conversely, the East Asian economies, most notably China, have been accumulating quite large balance of payments surpluses and the build-up of substantial foreign exchange reserves. At the same time, the level of reserves held by all central banks almost doubled between 2003 and 2007, increasing to about $US4 trillion. A high proportion of this increase has come from the less developed countries as their reserves climbed from $US1.3 trillion to $US3.1 trillion over the same period (Turner 2008: 115-16). These global imbalances are highlighted in Table 1.

The cessation of gold/dollar convertibility after the demise of the Bretton Woods regime did not necessarily imply the demise of the strategic international role of the dollar. U.S. trade deficits were no longer financed by the depletion of U.S. reserves but by the acceptance of central banks of U.S. treasury bonds and debts in the form of international reserves. Indeed, the U.S. dollar continued to reign supreme as the world’s foremost reserve currency, as the principal intervention currency by central banks, and as the major numeraire in international transactions. The “Triffin dilemma” as it became known essentially states that in order to supply the international economy with U.S. dollars, the United States itself would be obliged to run burgeoning balance of payments deficits to avoid a drain on international liquidity. But the very growth of these U.S. deficits would ultimately undermine the international status of the U.S. dollar and hasten a series of crises. This contradiction would set in motion cycles of expansion and contraction of international liquidity and generate systemic instability (Triffin 1961). The continued benefits conferred through dollar seigniorage suggests that the United States still enjoys a privileged position as “world banker” as long as the U.S. dollar continues to assume its role as the pre-eminent reserve asset. The “Triffin dilemma” is therefore writ large. In the post-Bretton Woods era of the floating dollar standard, the U.S. financial system has evolved from being simply the issuer of the reserve currency to the principal issuer of interest-bearing, short-term liabilities to the rest of the world.

The policies of capital account liberalization – remorselessly pursued by the IMF and the “Washington consensus” – inevitably promoted the rise of highly liquid, speculative, short-term flows of capital, mostly emanating from offshore financial centers, which began to have a destabilizing impact on international financial markets and hastened a whole series of financial-economic crises in Latin America, East Asia, and Russia (O’Hara 2003: 35). In the context of flexible exchange rates, these speculative flows of capital have become extremely destabilizing over the past several decades. Successive waves of speculative attacks have become widespread and endemic. The most serious episodes occurred during the implosion of the European monetary

Table 1. Global Imbalances Reserve Accumulation, Selected Developing Countries and Areas ($US Billions)

<table>
<thead>
<tr>
<th>Year</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total, of</td>
<td>895.8</td>
<td>1,072.6</td>
<td>1,395.3</td>
<td>1,848.3</td>
<td>2,339.3</td>
<td>3,095.5</td>
<td>4,283.4</td>
</tr>
<tr>
<td>which</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>216.3</td>
<td>292.0</td>
<td>409.0</td>
<td>615.5</td>
<td>822.5</td>
<td>1,069.5</td>
<td>1,531.4</td>
</tr>
<tr>
<td>Russia</td>
<td>33.1</td>
<td>44.6</td>
<td>73.8</td>
<td>121.5</td>
<td>156.5</td>
<td>296.2</td>
<td>445.3</td>
</tr>
<tr>
<td>India</td>
<td>46.4</td>
<td>68.2</td>
<td>99.5</td>
<td>127.2</td>
<td>132.5</td>
<td>171.3</td>
<td>256.8</td>
</tr>
<tr>
<td>Middle East</td>
<td>157.9</td>
<td>163.9</td>
<td>198.3</td>
<td>246.7</td>
<td>351.6</td>
<td>477.2</td>
<td>638.1</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>35.5</td>
<td>36.0</td>
<td>39.9</td>
<td>62.3</td>
<td>83.0</td>
<td>115.9</td>
<td>144.9</td>
</tr>
</tbody>
</table>

Source: IMF, World Outlook, 2008

Lewis 2007: 159).
system in 1992, the East Asian financial meltdown in 1997-98, and the Tequila crisis in Mexico in 1995 (Lucarelli 2002, 2004a, 2004b). These episodes support the view that financialization and the floating dollar standard amplify the transmission of financial instability on a global scale. The whole series of financial crises that have engulfed the emerging economies throughout the 1990s appear to have reinforced dollar hegemony and acted as a “safety valve” against the onset of a dollar crisis. Indeed, it can be argued that the capital flights provoked by these crises have served to preserve the international role of the dollar as a store of value.  

In response to these destabilizing capital flights, emerging economies, most notably in East Asia, have amassed vast foreign exchange reserves, which have been recycled to finance burgeoning U.S. current account deficits. This phenomenon has been coined by some economists as “Bretton Woods Mark II” (Dooley et al. 2003). Close analogies between the accumulation of dollar reserves by Germany and Japan during the 1950s and 1960s have been drawn with the recent East Asian experience. Germany and Japan launched export-led strategies of growth in the manufacturing sector, while supporting the U.S. dollar under the Bretton Woods system of fixed exchange rates and dollar/gold convertibility. A relatively over-valued U.S. exchange rate therefore improved the export competitiveness of Germany and Japan (de Cecco 2009: 121). A similar strategy has been pursued by the East Asian countries and the emerging economies of India, Brazil, and Russia, according to the proponents of the “Bretton Woods II” thesis. Quite apart from the existence of flexible exchange rates, this analogy fails to be convincing in the context of the post-Cold War international order. The willingness of Japan and Germany to accumulate dollar reserves was dependent upon the trade-off for geo-political and military security against the perceived threat of the Soviet Union. Needless to say, these historical conditions no longer apply, which makes the present imbalances more vulnerable to geo-political re-alignments. In this sense, the magnitude of the build-up of U.S. securities by foreign central banks is unprecedented. As de Cecco notes: “Foreign holders of US securities have no less than $US9.4 trillion worth of them in their hands, as much as the whole public debt of the US, and almost 37% of the 2007 US GNP. Major central banks have been mounting massive defence operations to keep the dollar afloat throughout 2007 and 2008” (de Cecco 2009: 140).

In the aftermath of the East Asian financial crisis in 1997-98, the East Asian economies restored their reserve positions and have amassed vast war chests of foreign exchange reserves in order to defend themselves against the possibility of another speculative attack on their respective currencies and avoid the destructive consequences of IMF stabilization programs in the event of a capital flight (Stiglitz 2003). The imposition of fixed and managed exchange rates has also offset the pressure for currency revaluations against the U.S. dollar, which would inevitably undermine their export-led strategies of growth. Between 1999 and 2005, East Asian central banks (excluding Japan) accumulated $US1.25 trillion in reserves. A large share of these reserves has simply been recycled through the purchase of U.S. bonds and securities or re-invested in U.S. dollar-denominated assets. As Arrighi notes: “Since Bush took office, East Asian central banks have added to their Treasury holdings at a rate of nearly half a billion dollars a day, that is, about a third of the average US current account deficit. The funding of the deficit was thus left increasingly to the mercy of these banks” (Arrighi 2005: 67).

Since 2002, China’s current account surpluses have increased quite sharply and now constitute the largest single nation component of the U.S. current account deficit, surpassing even those of Japan. These current account surpluses surged from only $US68.7 billion in 2004, to

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3The continued resilience of the U.S. dollar can also be explained by the pre-eminent military-political role performed by the U.S. state and by the export of capital by the dominant U.S.-based multinational corporations (Frank 2003).
SUS158 billion or 7.1 percent of GDP, in 2005. By 2006, China’s bilateral trade surplus with the United States was SUS235 billion, which represented over a third of the total U.S. trade deficit, making China by far the largest country component of the U.S. trade deficit. China’s current account surpluses translate into an enormous accumulation of dollar reserves. Between December 2000 and December 2003, foreign exchange holdings of China’s central bank more than doubled from SUS166 billion to SUS403 billion. In 2006, this figure had exceeded SUS1.2 trillion of which SUS600 billion was denominated in the U.S. currency. These reserves were estimated at SUS1.7 trillion in 2008. In the absence of central bank sterilization policies, the vast build-up of excess liquidity threatens to induce a phase of financial speculation in the real estate and equity markets reminiscent of the speculative boom which had preceded the East Asian financial crisis in 1997-98.

In order to maintain its competitive advantage, China is systematically intervening in the foreign exchange markets to maintain an undervalued exchange rate. China pegs its currency to the dollar and the yuan has traded, with small fluctuations, at about 8.28 per dollar since 1998.\(^4\) This situation has considerably improved China’s competitive advantage, making the yuan undervalued by between 25 and 40 percent, according to most estimates. At the same time, the temptation of the Chinese central bank to diversify out of U.S. dollar denominated bonds and securities threatens to trigger a crash in the U.S. bond market, which would ultimately imperil China’s major export market in the United States in the event of a U.S. recession (Taggart-Murphy 2006: 61). U.S. trade officials have argued that the under-valuation of the Chinese yuan has contributed to the trade deficit with China and has been a major factor in the hollowing out of the U.S. manufacturing sector. Needless to say, these trade imbalances and currency disputes have the potential to trigger a phase of destabilizing trade wars between China and the United States.

The other major source of global surpluses has recently emanated from the non-OECD oil producers. Whereas East Asian surpluses exceeded SUS700 billion in 2006-07, the surpluses of the non-OECD oil producers were estimated to be about SUS550 billion in 2007 (Burrell 2006). The cumulative surpluses of the oil exporters were estimated to be about SUS1.7 trillion between 2002 and 2007. This enormous expansion of petro-dollars has contributed to excess liquidity which has fuelled the equity boom over this period. However, these OPEC surpluses can be designated as cyclical in the sense that commodity prices tend to be highly dependent upon the vagaries of international trade cycles. By contrast, the East Asian surpluses are essentially structural and signify a profound shift in the international competitiveness of manufacturing in East Asia’s favor. Deindustrialization in the United States thus constitutes the rationalizing dynamic of this shift in the productive center of gravity to East Asia (Glyn 2006). Table 2 summarizes global current account balances in the years 1997-2006.

Consequently, this virtuous circle implies an increase in the net U.S. external debt but, at the same time, makes East Asian holders of U.S. dollar denominated assets quite vulnerable to a sudden depreciation of the U.S. dollar (Schnabl 2005: 161). U.S. deficits have been estimated to have absorbed about two-thirds of the combined global current account surpluses (Roubini and Setser 2004: 26). Summers (2004) has described the current configuration as a “balance of financial terror”: “The term ‘balance of financial terror’ refers to a situation where we rely on the costs of others of not financing our current account deficit as assurance that financing will continue”

\(^4\)China introduced a new exchange rate regime in July 2005. The yuan would be set with reference to a basket of currencies and allowed to fluctuate by 0.3 percent daily either side of parity on a bilateral basis. This implied a cumulative movement of 6.4 percent either side of parity over a monthly period. However, central bank interventions have made these fluctuations negligible. The yuan remains essentially an adjusted peg in relation to the U.S. dollar, with very limited flexibility (Frankel and Wei 2007: 582-83).
In the event of a sudden dollar devaluation, the fallacy of composition would suggest that the incentive for individual central banks to diversify out of an over-reliance on U.S. dollar denominated assets will intensify as the United States continues to experience an ever-growing and cumulative stock of foreign debt, which in turn puts pressure on a substantial dollar devaluation. This could quite easily become self-fulfilling to the extent that, if a growing number of central banks feel obliged to protect themselves against a falling U.S. dollar by diversifying their reserve holdings, the whole system of dollar recycling could collapse with quite devastating consequences. There is a classical dilemma akin to the prisoner’s dilemma in game theory: all central banks would be assured stability if no single central bank decided to diversify out of U.S. dollar reserve assets but, as the risk of a dollar crisis increases, each central bank is impelled to insulate itself from incurring huge losses.

The continued resilience of the U.S. dollar ultimately depends upon the U.S. role as “world banker.” As long as the U.S. financial system can continue to intermediate and recycle the surpluses generated in East Asia and the oil-exporting countries, the pre-eminent role of the dollar as the principal means of international payments and unit of account is preserved (Vasudevan 2004: 8). In the event of a sudden dollar devaluation, the fallacy of composition would suggest that the incentive for individual central banks to diversify out of an over-reliance on U.S. dollar denominated assets will intensify as the United States continues to experience an ever-growing and cumulative stock of foreign debt, which in turn puts pressure on a substantial dollar devaluation. This could quite easily become self-fulfilling to the extent that, if a growing number of central banks feel obliged to protect themselves against a falling U.S. dollar by diversifying their reserve holdings, the whole system of dollar recycling could collapse with quite devastating consequences. There is a classical dilemma akin to the prisoner’s dilemma in game theory: all central banks would be assured stability if no single central bank decided to diversify out of U.S. dollar reserve assets but, as the risk of a dollar crisis increases, each central bank is impelled to insulate itself from incurring huge losses.

Table 2. Global Current Account Balances, Selected Years, 1997-2006 ($US billions)

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>USA</td>
<td>-141</td>
<td>-416</td>
<td>-811</td>
<td>-395</td>
</tr>
<tr>
<td>Japan</td>
<td>97</td>
<td>120</td>
<td>170</td>
<td>50</td>
</tr>
<tr>
<td>Germany, Netherlands, Switzerland</td>
<td>41</td>
<td>5</td>
<td>263</td>
<td>258</td>
</tr>
<tr>
<td>Other developed countries</td>
<td>68</td>
<td>23</td>
<td>-139</td>
<td>-162</td>
</tr>
<tr>
<td>China</td>
<td>34</td>
<td>21</td>
<td>239</td>
<td>218</td>
</tr>
<tr>
<td>Other developing Asia</td>
<td>-27</td>
<td>26</td>
<td>-12</td>
<td>-38</td>
</tr>
<tr>
<td>Central and Eastern Europe</td>
<td>-21</td>
<td>-32</td>
<td>-89</td>
<td>-57</td>
</tr>
<tr>
<td>CIS</td>
<td>-9</td>
<td>48</td>
<td>99</td>
<td>51</td>
</tr>
<tr>
<td>Middle East</td>
<td>11</td>
<td>70</td>
<td>212</td>
<td>142</td>
</tr>
<tr>
<td>Latin America</td>
<td>-67</td>
<td>-48</td>
<td>49</td>
<td>97</td>
</tr>
<tr>
<td>Africa</td>
<td>-6</td>
<td>7</td>
<td>20</td>
<td>13</td>
</tr>
<tr>
<td>Discrepancy</td>
<td>14</td>
<td>176</td>
<td>-1</td>
<td>-177</td>
</tr>
<tr>
<td>Memo: Fuel exporters</td>
<td>16</td>
<td>149</td>
<td>396</td>
<td>247</td>
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To quote from Helleiner: “According to one estimate, each 10 per cent decline in the dollar has the effect of generating a loss equivalent to about 3 per cent of China’s GDP. The losses in China’s assets are increasingly becoming politicized within the country, with questions being raised about why such a large portion of Chinese savings are being transferred abroad instead of being invested domestically to boost China’s standard of living” (Helleiner 2009: 79).

Conversely, central banks might act to support the U.S. dollar as was evident during the Plaza accords of 1985. According to Morgan: “This can result in a gambler’s scenario where the institutions become locked into cycles of supporting the dollar because the sizes of the holdings are large and the banks’ exposure to the US markets is significant” (Morgan 2009: 48).
2008). At the same time, private capital inflows have acted as a “safety valve” or “shock absorber” in the event of a reverse flow of highly liquid capital from the indebted emerging markets of the periphery. In this case, the U.S. dollar performs the role as the major reserve asset. In other words, the mechanism of dollar recycling ultimately reinforces U.S. dollar hegemony in the event of a capital flight, which restores the U.S. dollar’s role as the pre-eminent international store of value. According to Vasudevan:

The US has played the role of the banker to the world, drawing in surpluses from Asia and the oil-exporting countries, and recycling these in the form of private capital flows to emerging markets in the periphery. The counter-cyclical pattern of the private flows to emerging markets... was critical to the mechanism by which the dollar’s role was preserved. These private capital flows served as a safety mechanism, enabling the export of crisis to the debtor-periphery. (Vasudevan 2009a: 27)

Indeed, the United States continues to live beyond its means by exploiting its privileges of dollar seigniorage (Eichengreen 2004: 28). In the event of a prolonged U.S. recession, however, the export-led strategies pursued by East Asian countries will encounter their limits. Sooner or later, these surplus countries will be forced to curtail their massive central bank interventions to mitigate the effects of exchange rate appreciation, and their support for the U.S. dollar will begin to wane. An effective exchange rate depreciation in the United States appears to be consistent with the view that growing and cumulative U.S. current account deficits will become more difficult to finance as investors diversify their holdings of U.S. dollar assets into other key currencies in order to hedge their exposure to exchange rate risk. In other words, if yields and spreads are no longer attractive relative to other key currencies, U.S. dollar denominated assets will be liquidated (Dooley et al. 2003: 5). In this context, the United States continues to act as the issuer of the most important international reserve asset, while its financial markets intermediate the allocation of global savings from the surplus countries/regions to the deficit countries/regions. Despite the alarming deterioration in the U.S.’s external debt, the net inflow of investment income remained positive until 2005. This apparent anomaly reflects the role of the United States as the foremost international financial intermediary as well as the exorbitant privileges bestowed by the pre-eminent role of the dollar as the major reserve asset and international means of payments. The United States therefore continues to derive a profitable stream of income from its foreign assets which, to a large degree, compensates for its net liabilities abroad (Bibow 2006: 19). A very high proportion of U.S. assets abroad are held in equities. By the end of 2005, more than 55 percent of the U.S. stock of $US10 trillion in overseas assets were in the form of corporate equities. In stark contrast, foreign claims on the United States are concentrated in the U.S. debt market. These financial claims were estimated at $US12.7 trillion in 2006 (Iley and Lewis 2007: 147-48). Even though the United States is a net creditor in relation to foreign direct investment and the ownership of equities abroad, this is more than offset by its net liability position in the more interest-sensitive debt markets. This apparent dichotomy resembles the financial structure of a venture capitalist in the sense that the U.S.’s “portfolio” is highly leveraged, with foreign liabilities over four times the size of net foreign debt and assets held abroad worth over three times net foreign debt. The bias towards the holding of debt and interest-bearing assets

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7 According to James: “In the whole period from 1960 to 2001, the annualized rate of return on US liabilities (3.61%) was more than two percentage points below the annualized real rate of return on US assets (5.72%), and that for the post-1973 period the difference is significantly larger (3.5% and 6.82% respectively)” (James 2009: 35).
by foreigners reinforces the seigniorage privileges enjoyed by U.S. financial markets and the pre-eminent role performed by the U.S. dollar as both a store of international value and means of payments. The extent to which the United States can sustain this apparent enigma will ultimately depend upon the willingness of its international capitalist rivals to continue to finance the U.S. current account deficits and the burgeoning foreign debt in the event of a major collapse of the U.S. dollar. As Gray notes:

Exhaustion can come about for either of two reasons: the loss of confidence on the part of foreign lenders and their unwillingness to continue to hold or to increase their holdings of dollar-denominated assets; and, second, economic and political pressures in the US that derive from the burden in the domestic economy of the duties of being the global locomotive (injecting aggregate demand into the global system by running current account deficits, thereby reducing aggregate demand for domestic capacity), may become intolerable. (Gray 2004: 8)

The problems that manifest themselves as a result of these growing global payments imbalances assume a logic in which the surplus countries experience incessant pressure toward exchange rate appreciation, which tends to induce recurrent asset booms in the non-tradeable sector, notably in real estate, and thus heightening financial fragility. On the other hand, the deficit countries experience a concomitant easing of financial conditions as the influx of these excess savings from the surplus countries tends to stimulate investment spending and the accumulation of private debt, which finances hyper-excessive consumer spending. It has been estimated that 10 Asian countries held more than $US3.4 trillion, or 59 percent, of foreign exchange reserves in 2007 (Lim 2008: 9). The excess saving of the surplus countries therefore acts as a channel through which monetary stimulus and credit growth becomes increasingly global (BIS 2008: 8). In the light of international financial deregulation, the global transmission of financial instability has been accentuated through the greater ease by which highly liquid, short-term funds are able to cross national borders and engage in speculative trading. These destabilizing flows of capital are also amplified by increased exchange rate exposure and international interest rate arbitrage and speculation, which are capable of setting in train self-fulfilling speculative manias and cross-border contagion (Wolfson 2002: 397). As Wade explains quite cogently in relation to the 2007-08 global financial crisis:

8The more recent resort to “quantitative easing” by the U.S. Federal Reserve represents a more perilous continuation of these U.S. predatory, “beggar-thy-neighbor” type policies. Since the onset of the global credit crunch in 2008-09, the U.S. Federal Reserve has injected enormous amounts of liquidity into the banking system. In the context of near-zero official short-term interest rates and the looming threat of pervasive liquidity trap, the U.S. Fed has injected over $US2 trillion during 2009-10 and proposes to inject another US$1 trillion in 2011. It is assumed that these expansionary monetary policies will revive bank lending, restore the housing market, and stimulate consumer spending. However, instead of lending domestically, the U.S. banks and hedge funds have engaged in speculative operations in foreign exchange and commodity markets. The flood of cheap dollars has destabilized international currency markets as U.S. dollars are recycled back into low-yielding U.S. Treasury securities by central bankers. Beyond a certain threshold, these enormous injections of liquidity could ultimately undermine confidence in the U.S. dollar as an international reserve asset.

9Unlike the “saving-glut” thesis, however, the causation runs from the demand for credit to its supply. Credit money, by its very nature, is assumed to be endogenous and demand-driven.
The resulting fragility manifested itself in two kinds of problems. The first was the external problem of currency recycling from the surplus countries (especially from China, with its giant dollar surplus, to the United States, with its giant deficit). The second was the corresponding credit recycling in the United States and the UK, as households and firms took on the debt corresponding to the external deficit, raising debt-to-income ratios to historically high levels. (Wade 2009b: 11)

These global imbalances have generated a destabilizing transmission mechanism through credit recycling, which sets in motion excess liquidity and credit-creation in the deficit countries and dampens the level of interest rates. The excessive creation of cheap credit finances consumption in the deficit countries beyond existing income levels and augments effective demand thereby maintaining the purchasing power of consumers. The circle is squared when this credit-fuelled consumption generates further demand for East Asian exports. This rather perverse dynamic fuelled the real estate boom in the United States in 2001-05 as inflows of capital and the purchase of U.S. dollar-denominated securities by foreigners was channelled into the speculative real estate market. Central banks in East Asia, most notably in China, increasingly absorbed mortgage-backed securities issued in the United States (Wade 2009a: 543). At the same time, the stream of recycled dollar earnings caused sharp falls in U.S. interest rates. Yields on long-term bonds crashed from about 8 percent in 2001 to as low as 3 percent in mid-2003 (Ferguson and Johnson 2009a: 14). As Ferguson and Johnson note: “The result was a fierce search for higher yields. Wall Street responded by pressing deregulation to new extremes, which put the nascent shadow banking system on steroids” (Ferguson and Johnson 2009a: 14). The ultimate irony was that the consequent flight from these toxic assets generated by the credit recycling mechanism during the 2007-08 financial meltdown led to a flight to the U.S. dollar, which then acted as a safe haven or an international store of value. Yet to restore these global imbalances, a downward adjustment of the U.S. exchange rate was required.

The problem of growing international payments imbalances has therefore spilled over into the U.S. domestic economy and has set in train successive phases of excess liquidity and the accumulation of historically high levels of household and corporate debt. These predatory features of U.S. capitalism have been characterized by recurrent booms and busts which have emanated from the growing financialization of the economy. In other words, the normal investment cycle has been superimposed by a layer of synthetic, speculative finance, which tends to amplify the fluctuations of the business cycle. At the same time, the U.S. Federal Reserve has contributed to these pathological phases of debt-induced speculative booms by cushioning the effects of sudden asset price and equity slumps by enacting expansionary monetary policies and acting as a lender of last resort in the event of a major credit crunch (Ferguson and Johnson 2009b). In this context, the recent subprime crisis represents the most recent and devastating culmination of these speculative episodes.

The mechanism of credit recycling between the surplus countries and the United States created a close connection between the rapid growth of U.S. mortgage debt and the foreign financing of this debt through the issuance of U.S. Treasury securities. The confluence of these favorable sets of circumstances set in train the U.S. real estate boom in the years preceding the financial meltdown of 2007-08. Given the privileged status of the U.S. dollar internationally, the U.S. financial markets intermediated these capital flows and engaged in arbitrage operations by borrowing in the short term in order to invest in the rest of the world in the long term at a higher rate of return. The astounding growth of the securitization market in mortgage-backed securities can be attributed to a large degree to the inflow of foreign capital to offset the chronic U.S. balance of payments deficits (Dymsky 2010: 246). Indeed, the inflow of relatively cheap credit into the United States, as a result of the massive accumulation of U.S. dollar reserves by the surplus
countries in East Asia, created the conditions for the subsequent housing boom in the United States. At the same time, interest rates were maintained at very low levels by the U.S. Federal Reserve after the crash of the “dot.com” boom in 2001 and in the wake of the events of September 11. These events set the stage for the real estate boom over the next five years.

Foreign purchases of U.S. Treasury debt and mortgage-backed securities (MBSs) by Fannie May and Freddie Mac therefore imparted downward pressure on U.S. interest rates in the 5 years preceding the crisis. Since almost all U.S. mortgages are calculated based upon the 10-year Treasury bond yield, the recycling of East Asian surpluses into U.S. Treasury bonds effectively depressed domestic interest rates quite drastically.\(^{10}\) By the end of 2006, foreign investors held 52 percent of U.S. Treasury bonds and 16.8 percent of outstanding U.S. agency debt issued by Fannie May and Freddie Mac (Schwartz 2009: 94). According to Schwartz:

> During the long 1990s, then, a virtuous (but not perpetual) cycle of rising home prices, rising consumption, rising income and employment, and rising profitability drew foreign capital into US dollar-denominated securities. Much of this investment flowed into Treasury and agency securities, reducing interest rates and providing a further boost to aggregate demand and housing prices. And this in turn reinforced investment flows from relatively slowly growing OECD economies toward economies with housing booms, particularly the US. All of this made US dollar-denominated securities attractive in the market, strengthening the dollar’s value and restoring its position as a top currency after the turbulent 1980s. (Schwartz 2009: 105)

The enormous inflow of relatively cheap credit therefore stimulated an increase in asset prices, which further encouraged greater financial innovation and ever higher levels of leverage. This virtuous circle was characterized by a Minskyian dynamic, which propelled the financial system into a zone of extreme fragility. As speculative and Ponzi financial units increased their overall proportion of total financing, the previous margins of safety built into bank lending were progressively eliminated. The entire financial structure therefore became vulnerable to minor rises in interest rates or falling asset prices (Wray 2009: 59).

### 4. Conclusion

The outbreak of the global financial crisis in 2007-08 signified the breakdown of the mechanisms which have governed the dynamics of financialization over the past two decades. In very stylized terms, the accumulation of private debt and the recurrent asset price booms and busts, which have characterized the neoliberal era, could only be sustained as long as U.S. dollar recycling from the surplus countries/regions continued unabated. Sooner or later, however, these imbalances and the insatiable appetite for debt in the deficit countries were bound to reach their limits. The U.S. subprime crisis, which triggered the most serious recession since the 1930s, provided a sobering testimony to the devastating consequences of global financialization. It revealed just how inter-connected and pervasive these financial markets have become. In short, the problem of global imbalances was inextricably connected with the mechanism of credit recycling from the surplus to the deficit poles of the global economy, which ultimately fuelled the speculative real estate boom in the United States in the years preceding the crash.

\(^{10}\)Some estimates suggest that these 10-year Treasury bond yields were responsible for depressing housing interest rates by as much as one percentage point during the late 1990s and early 2000s, peaking at 150 basis points in 2005 (Schwartz 2009: 94).
Since the demise of the Bretton Woods system in the early 1970s, the United States has enjoyed the enormous benefits of international dollar seigniorage. Since 2000, however, the U.S.’s net international investment position has deteriorated quite dramatically although the immanent flight from U.S. dollar assets has been temporarily postponed because the United States continues to exploit its hegemonic position as the pre-eminent international financial intermediary through Wall Street, while the U.S. dollar continues to act as an international store of value. The fact that the U.S. dollar continues to act as a temporary store of value in the event of a capital flight suggests that the existing regime of dollar recycling continues to finance burgeoning U.S. balance of payments deficits. Sooner or later, this position will no longer be tenable and a deflationary process of internal adjustment will occur as the fall-out from the vast accumulation of private debt could precipitate a phase of quite severe debt-deflation, similar to the Japanese experience in the 1990s (Halevi and Lucarelli 2002). The extent to which these payments imbalances can be sustained is a question of profound significance for the world capitalist economy.

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