Books

Debt, innovation and the durable dollar

by Arthur Kroeber

Globalizing Capital: A History of the International Monetary System (2nd ed.)
by Barry Eichengreen
Princeton University Press, 2008

The Venturesome Economy: How Innovation Sustains Prosperity in a More Connected World
by Amar Bhidé
Princeton University Press, 2008

I. Is power moving east?

An increasingly popular idea is that economic (and by implication, political) power is inexorably moving east – that is to say, away from the 20th-century centers of Europe and the United States, towards Asia, and in particular towards China. This idea first gained traction two or three years ago when China started accumulating gigantic balance-of-payments surpluses, and the United States accumulated corresponding deficits. America was clearly spending beyond its means, and plunging into a hopeless quagmire of debt. China, conversely, was graduating from its earlier role as the world's sweatshop, and building up not only vast cash resources but a group of powerful industrial and financial companies poised to gain control of key assets throughout the world. Clearly, over the long run, economic and political power must drain away from the prodigal debtor with its decreasingly "real" and increasingly financialized economy, and towards the responsible, productive creditor nation.

A new world order?

With the collapse of the American financial pyramid following the September bankruptcy of Lehman Brothers, this idea looks even more convincing. The American banking system is in ruins, the United States Treasury will need to borrow another trillion dollars next year to finance its reconstruction, and the economy faces at best sub-trend growth for several years. Europe, which briefly fantasized itself immune from the crisis, is headed for similar or even worse difficulties. The foundations of the post-war global economic order are crumbling. Talk of a "new Bretton Woods" became fashionable. French president Nicolas Sarkozy theatrically called for a meeting of the heads of state of the world's 20 largest economies (the G-20) to reorganize the world financial system. The meeting was duly held in mid-November in Washington under the sullen aegis of President Bush, and predictably accomplished nothing. But inconsequential as the event turned out to be, surely it was the first halting step towards a new world order that will emerge over the coming years or decades, in which America's economic power and political influence must inevitably decline and the star of thrifty China must correspondingly rise.

Prudent China gains on profligate America

This scenario is satisfying to those who view global economics as a morality play – a modern version of the Rake's Progress. The carefree American grasshopper, merrily whiling away the hours in heedless amusement, is destined to live at the mercy of the sensible Chinese ant, who will dole out crumbs from his carefully accumulated surplus in exchange for ever greater subservience. Yet this vision is wrong – and wrong not merely in the trivial sense that America is still big and powerful, China has troubles

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of its own, and such sea-changes take a long time to effect. It is wrong in the more profound sense that it fundamentally misunderstands how modern economies and international financial arrangements work, and misses the true sources of prosperity and economic dynamism. It assumes, falsely, that debt and consumption are bad, and that thrift and surpluses are good. It ignores the role of innovation in generating sustained economic growth, and misconceives the relationship between debt, consumption and innovation.

II. From gold standard to dollar-debt standard

The financial crisis turned out different than expected

The financial crisis we got this year was not, in important respects, the crisis that was expected. The expected crisis was that holders of dollar assets would get tired of seeing the value of these assets eroded by the dollar's continuous devaluation (about 26% in trade-weighted terms between 2002 and mid-2008) and eventually would sell them *en masse*, leading to a dollar collapse. The worst-case result of such an event would be a balance-of-payments and economic crisis in the United States and the destruction (immediate or gradual) of the dollar's position as the world's reserve currency.

So far the opposite has occurred. Rather than dumping their dollars, China and the other surplus countries kept stubbornly accumulating them, keeping interest rates low and stoking a frenzy of excessive dollar borrowing, not just in the United States but also in the rest of the world. When the debt mountain imploded, as such mountains always do, the result was a sudden *rise* in the value of the dollar. This was because many of the dollars that had been borrowed to finance investment in other places (apartments in Shanghai, shopping malls in Dubai) had to be repaid in a hurry, because the banks needed their money back, and refused to extend new credit. Borrowers sold other currencies and scrambled to acquire dollars to repay their loans. As the prices of stocks, bonds and most other investments collapsed, sovereign and private investors around the world rushed to the safest haven: US Treasury bonds. In other words, they *increased* their holdings of the government securities of the very country that had caused the world's worst financial crisis since the Great Depression. The dollar's share of global reserve assets, a bit over 60% a year ago, climbed to over 70%, and the dollar rose by 12% in trade-weighted terms in three months.

The dollar will not resume its descent

This outcome appears paradoxical, and many analysts assume that once the heat of the crisis is past, the dollar will resume its descent and (again in a worst-case scenario) ultimately lose its reserve currency status. This is unlikely. To understand why, one must start with the realization that the dollar does not act like a normal currency: it acts like gold. Theoretically, under a gold standard, when a country accumulates a big trade deficit and runs into financial difficulties, gold will flow into the deficit country from surplus countries, to take advantage of lower relative prices.

In practice, in the globalized gold standard era (1870-1914), physical gold did not flow into deficit countries – but capital did, attracted by lower relative prices and the promise of higher investment returns. It did so even when central banks violated what Keynes later called the "rules of the game" by not taking the policy actions (such as raising interest rates) normally required to attract those capital inflows. That is, foreign investors under the gold standard routinely ignored the risk that their prospective investment gains would be wiped out by currency devaluation. Why? University of California economist Barry Eichengreen, in his lucid history of the global monetary system since 1870, explains that this system of re-balancing capital flows functioned because of widespread trust that, in the end, governments would sacrifice all other goals (including short-term economic growth and employment) in order to maintain their currency's convertibility to gold:

> Central banks possessed the capacity to violate the rules of the game in the short run because there was no question about obeying them in the long run. Knowing that the authorities would ultimately take whatever steps were needed to defend convertibility, investors shifted capital toward weak-currency countries, financing their deficits even when their central banks temporarily violated the rules of the game.

Trust me

Monetary standards work because of credible economic promises

In short the gold standard worked not because of some intrinsic quality of gold, but because of the *credibility of the promise* to convert currencies into gold at a fixed rate. This credibility hinged on the ability of governments to sacrifice all other economic objectives to maintain convertibility. That ability, Eichengreen argues, depended in turn on the relative lack of democracy, and in particular the weak bargaining power of labor, in pre-World War I governments. The crucial point, in any case, is that the ultimate foundation of an international monetary order is not a physical store of value, but a credible economic promise.

The inter-war gold standard system fell apart because the political systems of the major economies became substantially more democratic, and more powerful labor constituencies could demand that other objectives – such as full employment or high growth rates – be put on a par with currency convertibility. As a result, the credibility of the long-term promise of stable currency values was destroyed. The post-World War II Bretton Woods system, which was a gold standard once removed (a system of fixed parities to a gold-based US dollar) failed for similar reasons: fixed exchange rates proved incompatible with political democracy and the vastly increased international capital flows of the late 1960s.

The dollar-debt standard rests on the promise of US productivity growth

The subsequent system of pure fiat currencies, more or less floating exchange rates, and primarily dollar reserves, could be called a "dollar-debt standard," and is founded on a new credible promise: the United States' commitment to maintaining a high rate of productivity growth which in the long run will reliably generate the cash flows necessary to service any reasonable level of debt issued by the Treasury. This commitment, which makes Treasury bonds rather than gold the so-called "risk-free" asset, constitutes the new "rules of the game." So even though the United States may violate the "rules of the game" in the short run (by recklessly permitting an asset bubble), there is no question about its obeying them in the long run. Hence investors will readily buy Treasury bonds, based on this long-term promise, even in the midst of a financial crisis that appears to undermine their value in the short run.

Thus the current global monetary system exists not in spite of America's chronic deficit, but because of it. Pretty much ever since the end of Bretton Woods, the United States has run a current account deficit. This is not coincidental. It is precisely the United States' unique willingness to run a perpetual deficit, combined with a uniquely credible commitment to perpetual reform of its economy that will generate debt-servicing cash flows, that makes the dollar the world's main reserve currency. The dollar-debt standard has already lasted longer than the Bretton Woods system, and will likely prove more durable than the pre-World War I gold standard. It will not last for ever, of course. But as the global economy is now structured, the dollar can only be replaced as the principal reserve currency if another major currency area makes a substantially more credible promise of perpetual deficit financing. So far there is no evidence that anyone is willing to make such a commitment.

The current global monetary systems exists because of America's chronic deficit – not in spite of it

III. Innovation

The above discussion begs the question of why the American promise of future productivity growth is so uniquely credible. Cynics answer that this promise is irrelevant: to them, the dollar standard is simply a protection racket. The United States is a well-armed gangster exacting tribute from everyone else in exchange for ensuring a stable world safe for investment and trade. There is more than a little truth to this view: without hegemonic military and political power the United States would probably not possess the world's reserve currency, regardless of its economic prospects. But if this were the whole truth the system would not last long, or would work poorly.

A more convincing answer is obliquely suggested by a fascinating, albeit dense and labyrinthine, book on innovation by Amar Bhidé, a business professor at Columbia University. Bhidé devotes much of the book to detailed analysis of surveys he conducted of how innovation works in start-up firms; but the broad argument is a fierce polemic against "techno-nationalism." Techno-nationalists, according to Bhidé, agree that technical innovation drives productivity growth, which in turn is the main source of long-term economic growth. But they see innovation mainly as a matter of developing "core" technologies, from which all other applications descend. They are Schumpeterians: innovation is the rare result of occasional heroic entrepreneurs whose inventions overturn previous economic structures (the famous idea of "creative destruction"); those who follow the entrepreneur are simply copycats whose combined efforts ultimately drive the profit from the original invention to zero. Whoever controls the production of core technologies has an economic edge over everyone else, because most of the profit from an innovation accrues to the innovator at the beginning of the cycle.

Schumpeter was wrong: innovation is everywhere

Bhidé rejects this view. He contends that, rather than being a product of inspired producers, innovation arises from a dynamic interaction between "venturesome consumers" who create new demands, and patient producers who gradually work out how to meet those demands. Innovation is not a matter of inventing "core technologies" and then mechanically churning out applications. Innovation occurs across all types of basic, intermediate and final products and services, and across all the various types of know-how required to develop those products; and innovation in one area is not intrinsically more valuable than in any other.

Innovation occurs in all links of the production chain

A laptop computer, for instance, can incorporate innovations in design, in a particular combination of functions that hits a consumer "sweet spot," in improvements to the motherboard that raise reliability, or breakthroughs in microprocessor technology that increase speed. And in the development of any product, many levels of know-how are required, each offering scope for innovation. The production of microprocessors, for instance, requires basic research in solid-state physics, intermediate know-how in circuit design, and practical expertise in the management of silicon wafer fabrication plants. Innovations in "core" technologies can lie fallow for years or decades until fertilized by a sufficient cascade of know-how innovations.

Bhidé attaches immense importance to innovation in marketing – ignored or derided by Schumpeterians, techno-nationalists and economic moralists – because it is precisely here, in the continuous tweaking of products to meet consumers' unformed demands, that the dynamic and interactive nature of innovation in a post-industrial economy is most clearly revealed. The Starbucks latte and *The Economist* magazine are two examples of commodity products turned into large stores of economic value mainly by innovative marketing.

Innovation is most likely to thrive in a vibrant consumption culture

There are thus two basic reasons why innovation is most likely to thrive in a vibrant consumption culture. First, since consumer demand stimulates producer innovation, more consumption is likely to generate more innovation. Second, Bhidé argues that most of the economic benefit of a technical innovation flows not to the innovator but to the consumers who can make best use of the innovation: for instance modern retailers like Wal-Mart, which create value by being smart consumers of information technology.

The virtue of profligacy

In other words: economic prosperity is a function of productivity, which derives from innovation, which thrives most in a dynamic consumer culture. And this brings us back to the question we posed above: why is the American promise of future productivity and economic growth so uniquely credible? Because the United States, uniquely, is willing to use debt to finance extra consumption – which moralists call "excess" and Bhidé terms "venturesome." America's willingness to consume more than it produces – to run a perpetual deficit – is the source of its innovation edge, and this edge in turn reliably generates the future cash flows that enable the deficit to be indefinitely financed. America's "profligate" consumer culture, often taken as a sign of obvious weakness, is in fact its hidden source of strength.

This reflexive system is extremely robust; but its capacity is not unlimited, and the limits are now being severely tested. A current account deficit of 2-3% of GDP may be indefinitely sustainable, but the recent deficit of 6-7% is not, because it far exceeds any plausible range of future productivity growth. And if the United States repeatedly robs foreign investors by luring them into asset bubbles, it may eventually drive them into another system.

Europe, Japan and China are averse to the risks required for a reserve currency

But investors can only flee if an alternative system exists, and none is on the horizon. A competing monetary order can only arise if some other currency area makes a long-term credible commitment whose value exceeds the United States' proven commitment to future productivity growth, and builds a deep and liquid debt market around that commitment. The obvious candidates – Europe, Japan and China – all view "venturesome consumption" with suspicion, and all have domestic political bargains requiring substantial trade-offs of economic efficiency for social stability. These bargains are excellent guarantors of domestic prosperity and harmony, but inadequate foundations for a global monetary system.

Of the three, China is the least plausible candidate for a reserve currency because the sustainability of the political system is doubtful, and because its high economic growth based on factor inputs will inevitably decline in the coming decades. Until China proves that it can achieve sustained high growth through efficiency, and convince the world that its political system is not at risk, it cannot provide an alternative to the current dollar-debt monetary standard. In this respect, at least, power is not moving east.