Background Concepts and Relationships in a Globalized World

The United States has, historically, enjoyed a large degree of self-sufficiency in international economic affairs so that the ratio of exports and imports to gross domestic product is extremely low in comparison with smaller countries such as those in western Europe and in East Asia. There is, therefore, a tendency for US-trained economists and economic policymakers to downplay international phenomena in much of their thinking and to focus on closed-economy models. The ratio of exports and imports to gross domestic product in the United States has increased in recent years and the value of international financial transactions has also grown. There are many reasons. They include the liberalization of international trade, the greater freedom of international transfers of funds, the growth of foreign direct investments by multinational corporations and the end of approximate self-sufficiency in petroleum and other sources of energy. The word “globalization” has come to signify the greater interdependence of national economies. Some relationships must be spelled out. In addition, some of the issues of major concern to the subject matter of this volume are not a part of the mainstream of modern economic thought. Because the apparatus to be used will rely on little-used concepts and relationships that are not generally emphasized, it is useful, at this juncture, to provide some conceptual and definitional background before beginning to consider the subject of balance-of-payments adjustment by a hegemon under modern conditions in Chapter 3. Clearly, readers will only read those topic sections with which they are not familiar. A list of the topics is as follows:

1. Capital flows, the rate of exchange and the current balance.
2. The relationship between a country’s current deficit or surplus and its INW.

H. P. Gray, The Exhaustion of the Dollar
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3. The world as a closed economic system (global financial and economic constraints).
4. The costs of adjustment after a major financial shock.
5. Asset positions and functional currencies.
6. The burdens of hegemony.
7. Enlarging the burdens of hegemony: the American experience.
8. Regulation of financial markets and allocative efficiency.
9. Recent years: a retrospective.

I Capital flows, the rate of exchange and the current balance

The rate of exchange is determined by the international flows of funds. The presumption is that capital flows are relatively immune to current rates of exchange (but certainly not completely so). Speculative flows will frequently be largely covered by other offsetting transactions and long-term capital flows will have a pronounced lead time so the assets which are acquired by capital flows with a long-term horizon will be relatively immune to small and/or short-lived variations in the rate of exchange. This simple model is illustrated in Figure 2.1. The implications are that the lion’s share of net capital flows is reflected, with the opposite sign, in the current balance (and by the reported statistical discrepancy). The recipient country’s currency (the dollar) generates credits earned largely through the sale of goods and services plus the net capital inflow (K). The cheaper the currency, the more willing are foreign nations to spend increasing amounts of foreign currencies on goods made in the United States. When there are no capital movements, the rate of exchange is marked at r_0 and the current account is balanced (current credits equal current debits). When there exist net capital inflows into the United States, the dollar is strengthened to r_1 by the net inflow of funds and, since capital movements are relatively insensitive to the existing rate of exchange, the US current account will run a deficit large enough to offset the main part of the net capital inflow. In this simple model, the capital movements, through their effect on the rate of exchange, generate the net exports (international saving) needed to pay for the acquisition of the assets. The electorate of the investing country is presumably sufficiently docile to allow the reduction in the standard of living brought about by the weakening of their home currency.