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HEGEMONY, INTERNATIONAL DEBT AND INTERNATIONAL ECONOMIC INSTABILITY

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Can the Great Depression recur? Forget worries inspired by the 1987 US stock market crash. The real parallel with the 1920s is in the origins, structure, and trend of current patterns of international indebtedness. Their consequences for global economic leadership closely resemble those 1920s debt structures which helped precipitate the depression of the 1930s. Briefly, European and primary product exporting (PPE) countries emerged from World War I either owing enormous amounts of money to the US, or in the case of former European creditors like France and Britain, with seriously compromised asset positions. Given the economic superiority of taylorized manufacturing and mechanized agriculture in the US, it was nearly impossible for debtor nations to generate the trade surpluses they needed to offset net invisible payments to creditor nations.

For a short time in the mid-1920s, US willingness to finance current account deficits elsewhere averted a contraction of global trade because of these imbalances. In particular, US lending helped the UK act as a market of last resort for its empire, then a huge part of the world economy. When the US became unwilling or, like the British by the middle of the 1920s, unable

to continue this finance on a global scale, a disastrous contraction of world trade ensued. Nations sought international payments balance through currency devaluation, exclusive tariffs, and bilateral exchanges, and the value of world trade fell by nearly two-thirds.

Similarly, most PPEs and developed economies emerged from the crises of the 1970s with large external imbalances and high levels of foreign debt. The historically high fiscal deficits of the 1980s everywhere exacerbated debt levels, particularly in the weaker developed country economies, as excess aggregate demand flowed into increased imports. During the 1980s the US again acted as a lender of last resort, particularly by supporting the IMF as it coerced new lending from developed country banks. But this lending fell far short of that needed to cover the enlarged current account deficits of LDCs and even some developed PPEs. Instead, unlike the 1920s, the US provided 'lender of last resort' financing by expanding *imports* from debtor countries. In turn the US financed its own ballooning current account deficit by borrowing from Japan and Germany, who acted as lenders of last resort respectively for the US and European debtors.

Just as with Britain in the late 1920s, however, the US can no longer continue acting as a market of last resort; the US is now a net debtor and must run a trade *surplus* to finance its debts. If the US were willing to continue eroding its asset position and lenders were willing to finance this debt build-up, global balance could be achieved without any contraction of trade. But Japan and Germany, for different reasons, are both unwilling and unable to continue to finance the US deficit. How can a repetition of the 1930s trade collapse be averted?

This chapter uses a schematic version of hegemonic stability theory to examine this question. This schematic version of the theory allows us to present an organized picture of international capital movements, debts, and trade patterns in the 1920s and early 1930s showing why collapse occurred. Then a parallel picture of the 1970s and 1980s will be drawn. Just because similar structures exist, however, does not necessarily imply similar outcomes. Therefore we must return to theories of hegemony to understand the largely domestic bases for remedial action. The situation is not yet as gloomy as that of the late 1920s; but if the parallels hold, we have about two or three years to find a solution.

Hegemonic Stability Theory - or - the need for leadership?

The proximate cause of the Great Depression, according to Charles Kindleberger, was that the "International economic system [was] rendered unstable by British inability and US unwillingness to assume responsibility for stabilizing it." For Kindleberger, the international economic system only worked when a leader provided five kinds of public goods. The leader had to provide countercyclic or at least stable long term lending, to police a relatively stable system of exchange rates, to ensure the coordination of macro-economic policy, to maintain a relatively open market for distress goods, and finally to act as lender of last resort by discounting or otherwise providing liquidity in a financial crisis.

World War I clearly disrupted the first three of Kindleberger's public goods, which pertain mostly to long term stability. Abandonment of pre-war gold parities for fiduciary currencies caused differential rates of inflation and dislocated exchange rates. The major (and many minor)

combatants borrowed heavily to finance the enormous costs of war production. This decreased the ability of the major pre-war creditor countries, Britain, France and Germany, to continue relatively high and stable patterns of long term lending to developing and (almost the same thing) primary product exporting areas. Both factors destroyed the Bank of England's pre-war capacity for regulating the gold standard.

The last two public goods, though, pertain more to short term crisis management in a period of instability. The preeminent international economic question during the inter-war period was what country would take on these tasks. The need for short-term financing and some settlement of inter-allied debt and other debts was particularly acute. The British attempted to take on this role, but the war had crippled their ability to refinance the debts of all but the most important colonial economies. In the US meanwhile, lenders were hesitant to commit capital outside of traditional areas like Canada and Central America, and no domestic political coalition supported intervention in Europe.

Thus when the British put forward a variety of cooperative schemes for financing inter-allied debts or sorting out the economies of the new central European nations, the US obstructed or ignored them. The British, while willing to write down inter- allied debt, were unwilling for domestic political reasons to similarly write down German reparations. Private lenders everywhere were unwilling to lend to the politically unstable new states of central Europe, scuttling British efforts, like the Ter Meulen scheme, for stabilizing those countries' economies.(1) The US meanwhile attempted to use its creditor position to force open markets in League of Nation mandated territories and in European imperial markets. Why did the failure to resolve debt questions after the war help create international economic instability in the 1920s? Finance was needed to prevent countries from resorting to non-market means of balancing their international payments.

Imbalances arise when countries cannot generate enough exports to cover a relatively rigid level of "imports," including, of course, debt service. This is particularly the case for debtor countries which have borrowed money to capitalize new export or import-substituting industries, in what Albert Fishlow has called "development borrowing."(2) In such countries amortization usually creates an invisibles deficit. They typically try to compensate for this invisible deficit by exporting merchandise produced in the new industries. These export industries take time to mature and come 'on-stream,' however, and until they do begin generating exports (or reducing imports) the debtor country needs some kind of bridge or short term financing to avoid illiquidity.(3)

Financing need not only take the form of direct lending. Maintaining an open market for distress goods -- goods a seller needs to liquidate in order to raise cash -- also provides a kind of financing. This market either allows a kind of rediscounting for sellers, or, as the hegemon runs down its creditor position overseas, a kind of forced lending to debtor countries.

By the end of the 1920s neither a lender nor a market of last resort existed. In the absence of either sort of financing, countries experiencing illiquidity were forced to use various non- market measures like quantitative limits, bilateral exchanges, or default to constrict their imports and so

bring their current account back into balance. This in turn constricted export opportunities for other countries, which, either in retaliation, or because they too were becoming illiquid also resorted to market closure. In 1929 the combination of retaliation, desperation, and default sparked a closing of world markets, a two-thirds reduction of world trade, and ushered in the depression of the 1930s.

A Stylized Model of the 1920s and 1980s

What exactly about the structure of international debt in the inter-war period and today undermined the ability of Britain and the US respectively to provide economic leadership via either direct or indirect lending? A stylized picture of the world economy in both periods will help clarify the salient issues. Imagine an international economic system with three types of countries: a large developed country which is also a large net creditor; several smaller developed countries which are only marginally net creditors or perhaps even marginal net debtors; and a large group of highly indebted developed and less developed countries (LDCs) that mostly are primary product exporters (PPEs). To service their debts, the developed and LDC PPEs must either run large trade (goods and services) surpluses with developed countries in general, or attract new lending to cover cumulating investment income deficits.

Meanwhile all developed countries which are themselves net debtors must run trade surpluses with the creditor country in order to prevent their own net investment income deficit from cumulating into more debt. (These developed countries obviously cannot run surpluses as a group with developing countries as a group, because this would only expand the latter's deficit and thus debt.) Economic stability in this system depends on the large creditor country providing direct or indirect finance and thus balancing debtors' current accounts. When the large creditor either cannot or will not provide this finance, the trade system will tend to contract as countries try to maximize their merchandise surplus by restricting imports. This individually rational constriction is collectively and systemically irrational.

The Structure of Inter-war Debt

How did the inter-war period resemble this stylized picture?

Primary Product Exporters and International Debt

The costs and consequences of World War I created a massive overhang of debt in the inter-war period. Most PPEs began the war with enormous levels of developmental debt. Collectively, Australia, Canada, New Zealand, British South Africa, Argentina, Chile and Uruguay had overseas debts amounting to their combined gross domestic products (GDP) in 1914.(4) Both these developed PPEs and LDC PPEs in residual Latin America massively expanded output of foodstuffs and raw materials to supply European combatants. Britain spurred expansion by promising to buy at a fixed price as much wheat, wool and other primary commodities as its traditional suppliers could produce. Wheat acreage, for example, expanded by 34 percent in non-European areas during the War.(5) As European labor and land were returned to production, and equally important as governments cut back on guaranteed fixed price purchases, primary

commodities experienced enormous price declines. The war thus had mixed consequences for these PPE debtors. While wartime inflation and payments surpluses helped them run down their foreign debts about 10 percent, falling prices post-war made it harder to service the large residual debt.

Falling prices did not spur any quick reduction in acreage. Among PPEs the British Dominions borrowed extensively to establish returning soldiers as farmers. Consequently PPEs of all sorts faced declining terms of trade through-out the 1920s. Among the most important traded commodities 1920 to 1931, wheat prices fell by 75 percent; coffee prices 75 percent; wool prices 70 percent; cotton prices 66 percent. Overall all primary product export prices fell by about 30 percent to 50 percent in the 1920s.(6)

Declining terms of trade combined with debt service to create massive current account deficits. This situation was aggravated by protectionism, which rose even in advance of the 1930s debacle. After 1920 virtually all countries began to raise tariffs. In 1921 the British passed the Safeguarding of Industries Tariff; in 1922 the US raised its already high tariffs in the Fordney-McCumber Tariff; in the 1920s the entire Commonwealth raised preferential tariffs favoring UK and requested British preference for Dominion exports; and all the new central European countries, bereft of revenue sources and with infant industries to protect, resorted to tariffs to prevent dumping by other countries. Four international conferences in the 1920s on mutual tariff reduction failed. Rising European protectionism reflected Europe's declining importance in international trade after the war. While world trade in 1926 in volume terms was roughly 10 percent greater than in 1913, Europe's share had fallen from nearly 60 percent to less than 50 percent in the same period.(7) Most of the expansion in trade benefitted the US, which consistently ran both merchandise and current account surpluses in the 1920s.

PPEs themselves found themselves unable to generate enough foreign exchange to service both debt and import bills; they in turn resorted to even higher levels of protection.(8) By the end of the decade these tariffs had become exclusionary barriers rather than merely revenue generating devices. What prevented a wholesale 1930s style increase in tariffs in the 1920s was the limited ability of PPEs to finance their deficits on the London and New York markets. What limited and ultimately eliminated access?

Intermediate European Countries

The problem of inter-allied war-time debts overshadowed the PPE debt crisis. Excepting Britain, Europe emerged from the war in a net debtor position. Only the US emerged from the war as a major net creditor. France owed Britain \$3 billion and the US \$4 billion, Britain owed the US \$4.7 billion, and the other European countries owed France \$3.5 billion, Britain \$8.1 billion, and the US \$3.2 billion.(9) This shift in the status of most European industrial nations upset the balance between flows of capital and goods achieved in the 19th century. This was true even for Britain. While Britain lent to other European countries, it in turn borrowed heavily from the US, transforming itself from the international system's major creditor into an marginal net creditor overall, and a net debtor vis-a-vis the US. As a net debtor to the US, the UK had to run either a bilateral trade surplus with the US, or a huge surplus with other countries which themselves ran

surpluses with the US. This was quite difficult. For example, in 1923, British exports to the US amounted to a bit over $\text{€ } 61$ million. But the British *government* alone, aside from private debtors, needed to find about $\text{€ } 33$ million to pay off its war debts to the US.(10) These difficulties were reflected in Britain's inability to carry on its leadership role. In the 1920s Britain lent in real terms less than half as much overseas as it had loaned in the pre-War decade (in current terms an average of $\text{€ } 115$ million versus over $\text{€ } 200$ million). Unable to lend as much to old debtors, the British opted for buying more. In real terms the UK's merchandise trade deficit increased by 43 percent 1921- 1931 as compared to the pre-War decade. But at the same time Britain's invisible (interest) trade surplus fell by about 20 percent, leaving it less to lend.(11)

Elsewhere in Europe German reparations (or the lack there-of) aggravated this problem. If the Germans ran current account surpluses large enough to pay reparations, this would unbalance the accounts of both traditional debtors and non-European countries. German non-payment, however, put additional burdens on the new European debtors, in particular France. Everyone except the US thus was forced to try to maximize their dollar or pound surplus in international trade, so as to have foreign exchange to service debt. This was impossible for most countries though.

First, before the war the larger European countries generated surpluses by running merchandise surpluses with Britain, or by skimming off surpluses their tightly controlled colonial economies made with the external world, including the US. Britain thus offset trade deficits with the US and Europe through trade surpluses with and investment income from its Dominions; they in turn ran trade surpluses with the US and Europe. But the post-war terms of trade decline and debt overhangs in the PPEs forced those areas to restrict imports from their metropolis. Colonial empires thus generated less foreign exchange for the imperial countries while those countries were forced to rely even more heavily on their colonies. Nor could European countries run surpluses with each other to pay the US; on an accounting basis, one country's surplus implied a deficit (and crisis) for another.

The obvious solution was to export to the US to earn dollars for dollar denominated debt service directly. But the European countries and PPEs alike found it very difficult to run surpluses via direct exports to the US. Few European countries or PPEs had goods marketable in the US. The US was self sufficient in most natural resources and agricultural products; where it was not, mostly tropical products, it drew much of its supply from 'captive' sources like Liberia (rubber) or Central America (fruit). The exceptions, like coffee, silk and residual demand for rubber and tin, were too small for Europeans to generate surpluses out of colonial exports.

Similar impediments to manufactured exports existed. In the US, World War I consolidated the domination of the highly productive taylorized, assembly line methods of production. Added to the natural advantages of market proximity, extant distribution networks, and customer loyalty, this productivity advantage made it impossible for Europeans to export all but a handful of product lines to the US. Prominent among these were German electrical and chemical products and a few British and French luxury goods. The advantages inherent in assembly line production not only precluded imports but allowed US firms to go multinational, consolidating or creating subsidiaries in Europe.(12) Imports as a share of US GDP actually fell during the 1920s; thus

absolute levels held roughly constant in a time when Europeans had to expand exports. So while the US remained a net importer of a few very specific goods, overall the US ran an enormous merchandise trade surplus. While this surplus amounted to only 1 percent of US GDP annually on average through the 1920s, US GDP was so large in relation to world GDP that it itself tended to unbalance everyone else's balance of payments. During the 1920s the US grew from roughly 30 to 40 percent of world manufacturing and income.(13)

As developed and developing debtors collectively could not generate enough sales to the US to balance their accounts, only three things could make international transactions balance. First, Germany could be made -- somehow -- to provide commodities worth the 132 billion marks in reparations the European allies demanded. The French occupation of the Saar proved this would not happen.

Second, the debt overhang from World War I could be written down by creditors, freeing debtors' cash for commodity trade. A partial writedown occurred in the many bilateral renegotiations the US held with its debtors after 1924. But these writedowns mostly stretched out amortization periods and slightly lowered interest rates for these debt. They did not eliminate it. It took World War II's massive inflation to fully devalue them.

Third, the US could become a lender of last resort to the world, financing debtors' dollar deficits. This in fact happened, and made the world economy function through the 1920s. During the 1920s the US lent about \$ 10 billion. By way of comparison, this \$ 10 billion in real terms equalled about one quarter of all 19th century lending by all creditor countries; rivaled the post-World War II Marshall Plan (though over a longer time period); and represented in cumulative terms about 12% of annual US GDP in the 1920s. The US more than recycled its current account surpluses during the 1920s, much as Japan has more than recycled its current account surplus in the 1980s.

Lending began in earnest with the 1924 Dawes Plan and its associated reductions in inter-allied debt. The \$100 million government-government Dawes loan to Germany sparked a flood of US lending overseas. 1924-1929 the US financial community floated \$6.4 billion in loans, roughly double the rate of the 1920-1923 period, with about 75 percent of this going directly to foreign governments. Roughly half of American lending went to Europe, one quarter to Latin America, one sixth to Canada, and the remainder to Asia, primarily Japan.

By allowing European and PPE debtors to make debt payments to and import from Britain, US lending also enabled Britain to expand its lending. Except for 1925, 1929 and 1931, when the state embargoed overseas loans, the British lent \$3.3 billion overseas in the 1920s, primarily (72 percent) to its own colonies, and among these primarily to Australia. For a sense of proportion, US and UK lending in the 1920s was roughly equal to half of all international lending prior to 1914 in nominal terms and about one quarter after accounting for inflation.(14)

US lending solved the problem of how to balance primary flows among trading countries. But compared with simply having the US buy goods, lending only put off an eventual day of reckoning. For if the flow of capital were shut off, the underlying problem not only would

remain, but would be worsened by five years of additional debt accumulation. And this is just what happened. For example debt service for the major British colonies and Dominions increased from \$725 million per annum in 1923 to \$900 million by 1928.(15)

In this period US multinational manufacturing and financial firms did make large, long maturing investments in Europe, and consequently forged tight and complex ties with European financial and industrial circles.(16) But economic and political realities defeated this group's desires to bind the US to Europe's fate. Most US firms were oriented to the domestic market, explaining the victory of Hoover and continued tariffs in the 1928 election. Economically, holders of liquid capital in the US were not as tied to Europe as multinational manufacturers, and moreover were extremely speculative in their investment outlook. They redirected their investments into the booming stock market in 1928 as US firms aggressively invested in new plant and equipment. When the 1929 stock market crash was aggravated by bank failures and tight domestic monetary policy, little capital was left for investment overseas. Absent a last resort lender, international trade collapsed under the weight of competitive currency devaluations, trade restrictions and bilateral deals, falling from \$2.9 billion in 1929 to \$1.1 billion in 1932.(17)

Debt Structures Today

Unfortunately, the origins, structure and trends of international indebtedness today closely resemble those of the inter-war period. As then, two interconnected debt problems exist. First, PPEs and most of the newly industrializing countries (NICs) carry high and unsustainable levels of debt. Second, high levels of debt in the natural, developed country markets for PPE and NIC exports preclude the kinds of current account deficits needed to amortize PPE/NIC debt. Let us start with developed country debt first.

Among the developed countries, unlike the inter-war period, debt cannot be attributed to the costs of financing a mighty armed struggle, (unless we so label the Reagan administration's efforts to roll-back the Soviet Union). Developed country debt largely arose from efforts to sustain existing living standards in the face of the dual oil shocks and economic instability of the 1970s, and then from an orgy of keynesian deficit financing during the 1980s. This deficit spending created debt, particularly in Europe, where most currencies were tied to the non-inflatable deutschmark. Depending on the scale of local resources, debt first took the form of domestically held public debt and then of foreign held debt. The weakest economies, among which were Australia, Canada, New Zealand, Denmark, and Ireland, experienced an almost immediate flow-through of deficit spending into extra imports and rising foreign debt. By 1990 for example, Australia owed over US\$100 billion, making it the world's third largest overseas debtor behind the US and Brazil, and proportionate to GDP in the same league as Brazil.

As in the 1920s these indebted developed countries could not cover their investment income deficits with each other, leaving only exports to either PPEs and NICs, borrowing from creditor countries, or exports to creditors. Obviously, the first option was not available. Indeed, under pressure from the IMF to maximize their trade surplus, most PPEs and NICs erected a phenomenal array of import controls and undertook massive devaluations during the late 1980s. The sustained decline in oil prices removed OPEC as a major importer; even Saudi Arabia

became a net borrower by the late 1980s.

Instead, during the 1980s most developed countries chose to borrow from the few net creditors left in the system, namely the US, Japan, and Germany.(18) 1988 to 1990 the OECD-Europe countries ran an annual average current account surplus of about \$7 billion. But Germany alone was running a surplus of \$55 billion, suggesting that the rest of OECD-Europe ran a deficit of \$48 billion.(19) OECD-Europe thus borrowed heavily from Germany to make ends meet. This ploy worked until the end of the 1980s, at which time developed country external debt had risen to post-World War II highs and the pool of capital suddenly evaporated. Because the collapse of lending was closely tied to debt among the NICs and PPEs, we will consider them before looking at creditors and lending.

The sources of debt among the developing countries, both PPEs and NICs, closely parallel those in the 1920s, as do their problems. Even before the 1979/80 oil shock the major LDC debtors all pursued deliberate policies of developmental borrowing. Paradoxically the success of these development strategies in borrowing money to capitalize new export industries led to debt servicing difficulties after the oil shock. This developmental borrowing created an oversupply of exported commodities, and terms of trade for LDC exporters fell. Unlike the inter-war period this terms of trade decline encompassed manufactured exports too. Thus even a country with a highly diversified export base like Brazil experienced a terms of trade decline of 45 percent 1977 to 1985 - - a decline that began *before* the second oil shock and was magnified by it.(20) Like the sudden change in postwar demand patterns in the 1920s, the 1979/80 oil shock aggravated the terms of trade decline problem NICs faced. When interest rates rose to historic heights 1980 to 1982, default was a certainty, unlike the early 1920s.

As in the 1920s, PPEs and NICs needed to finance their debt service by either borrowing new money from creditors or by generating export surpluses with those countries. But, as in the inter-war period, rising levels of external debt and rising levels of protectionism in developed countries eliminated them as an outlet for goods, excepting the US. Unlike Britain in the immediate aftermath of the First World War, the US had more economic breathing room to organize last resort lending to the indebted PPEs and NICs emerging from the economic chaos of the 1970s.

During the 1980s the US organized both kinds of lending to indebted LDCs. First, the US fulfilled the traditional role of lender of last resort subsequent to the Mexican near default of August 1982. The financial bureaucracies of the US state, using the IMF as their instrumentality, coerced US and other banks into refinancing LDC debt as a condition of those banks receiving such interest payments as LDCs could make.(21) But the outflow of interest, commissions, and (occasionally) principal, exceeded this forced lending, leaving LDCs with invisible deficits that had to be financed via trade surpluses. Here the US played its second stabilizing role, as a market of last resort.

While protection rose in the US during this period, the US market remained open in comparison to other markets. Alone among creditor countries in the 1980s, the US consistently ran current account deficits. Whatever the domestic origins of this deficit in policy making coalitions or

factory-floor realities, the ultimate consequences of this deficit are clear. The US allowed debtor LDCs (and, during the period of the overvalued dollar in the mid-1980s, debtor European countries) to run the current account surpluses they needed in order to service debt. In 1987 the US absorbed 22 percent of the world's manufactured exports, up from 12 percent in 1975. Moreover, the US also absorbed over 50 percent of NIC exports of manufactures. In contrast, despite an economy half the size of the US, Japan in 1987 absorbed only 4 percent of world manufactured exports, up from 2 percent in 1975. As this point runs counter to the prevailing image of Japan as the major source of the US trade deficit, it is worth some repetition: the enormous US trade deficits of the 1980s owe much more to "extra" imports from indebted LDCs and "lost" exports to those same very protectionist LDCs than they do to expanded imports of Japanese goods. The US had a cumulative current account deficit of \$998,097,000 in the years 1980-1989. Deficits with LDCs account for 47 percent of this, while the bilateral deficit with Japan accounts for only 38 percent.(22) Lest it seem I am comparing apples and oranges, it should be noted that the LDCs as a group had an aggregate GDP slightly smaller than Japan by the end of the decade; logically they should account for a smaller proportion of the deficit as well. Just like US lending in the inter-war period, the injection of dollars into the international economy via the US current account deficit kept countries from resorting to even harsher non-market measures of balancing. Unfortunately, just as in the 1920s, this US injection of liquidity could not continue indefinitely. Like Britain at the end of the 1920s, the US by the end of the 1980s was unable to continue financing global trade and was retreating to a much smaller zone of influence in the Western Hemisphere via free trade pacts with Canada and Mexico.

How did the US position erode in the 1980s? US current account deficits during the 1980s created the equivalent on a Brazil's worth of foreign debt every year after 1985. Consequently, while the US began the 1980s as a large net creditor, the US owed as much as \$375 billion net at the end of 1990.(23) This shift was politically and economically unsustainable in the US. With the US became a net debtor, it too faced the same choices faced by other debtors. It either had to generate a merchandise surplus to offset its invisible deficit, or it had to find some country willing to continue to finance its current account deficit. And indeed, 1987 to 1990 US exports boomed, growing faster than any other OECD country and regaining the number one exporter position for the US in 1990 for the first time since the early 1980s.

By serving as a market of last resort during the 1980s, then, the US staved off LDC and perhaps some developed country default, but it also undermined its ability to function as either a lender of last resort or a market of last. US foreign and domestic economic policy during the 1980s thus 'liquidated' US hegemony, leaving open the question of how the US would recover its position of what country, if any, would replace it. As in the 1920s, when the US financed Britain's liquidation of its hegemony, the US too had a financier through the 1980s.

Who financed the US deficit while the US ran a current account deficit in order to keep things going? Who, thus, functioned as lender of last resort during the 1980s? The counterparts to US trade deficits were enormous Japanese and German current account surpluses. 1983 to 1989 the Japanese lent nearly \$600 billion overseas, the Germans not quite \$240 billion. But since much German lending went to Europe to cover non-German Europe's persistent current account deficit, the Japanese effectively financed the US' ability to function as market of last resort, buying about

\$250 billion of US government securities and about \$150 billion of private assets. If the US was creating a new Brazil's worth of debt each year in the late 1980s, Japan was exporting a Brazil's worth of capital. In 1987, for example, Japan exported \$137 billion dollars of capital.

Thus it was really the Japanese who functioned as an indirect lender of last resort during the 1980s. As in the 1920s' US, the Japanese state took the lead, and a sweeping liberalization of the Japanese financial system opened pipelines for the capital outflow. Reluctant to lend directly to uncreditworthy LDCs, the Japanese instead financed the US as it strove to sustain world trade. Japanese promises to recycle some \$30 billion of its trade surplus to LDCs after 1987 turned out to mean marginal increases in tied aid, bailouts of Japanese banks and participation in US initiatives like the 1989 Brady plan for Mexico.(24) Like the US in the inter-war period, the Japanese lent hesitantly, lent mostly to other near creditors, and do not yet appear fully committed to making the political and economic changes necessary to keep the international economy functioning. As with the US in the 1920s, a Japanese cession of lending will probably signal the beginning of a contraction in world trade. Will the Japanese cease lending?

Japanese withdrawal from the world economy

Can world trade and capital flows be stabilized at their current high levels? Now as then the problem is one of assuring that the large net creditor either continues to finance debtors' current account imbalances or itself runs a current account imbalance. Structurally economic conditions in the 1980s are much better than those of the 1920s; but the political problems may prove more intractable. Why are the Japanese unwilling and soon unable to replace the US?

Like the US in the 1920s, the Japanese economy is essentially closed to imports. Like introduction of the assembly line in the 1920s US, Japanese introduction of just-in-time manufacturing and systems for continuous improvement make many sectors import resistant simply on the basis of differential productivity. In the automotive sector, for example, the best Japanese plants are about 80 percent more efficient than the world-wide average for automobile factories.(25) In many other sectors, particularly agriculture, extreme levels of protection prevent Japan from functioning as a market of last resort. Absent reform of Japanese trade practices, Japan can only function as a lender, not a market of last resort.

But even this Japanese activity is likely to ebb, in a withdrawal from international lending almost as severe as that which accompanied the US withdrawal after 1928, and for much the same reasons. As in the 1920s with the US, extreme productivity advantages translated into direct investment by multinational and multinationalizing industries. But like the 1920s US, most Japanese lending occurred as portfolio investment. In 1989, the peak year for portfolio investment, Japanese investors bought \$94.1 billion in bonds, of which roughly 30 percent were US Treasury securities.(26) Similarly, internationalized Japanese banks provided about 25 percent of all Eurocurrency placements. As in 1929 US, this flow of portfolio investment will be curtailed by both supply and demand factors in the 1990s.

Japanese lending in the 1980s was fueled in equal parts by an enormous expansion in the monetary base in Japan, by a wave of property and stock market speculation triggered by this

monetary base expansion and the high profits Japanese firms earned in export markets, and by the enormous devaluation of dollar denominated assets after 1986. But rising domestic interest rates and falling stock and property markets are undermining Japan's willingness and ability to invest overseas. On the demand side, domestic opportunities in Japan in 1989 and 1990 looked much better than those overseas. Those years, the monetary supply measured broadly increased at roughly 10 percent per annum, compared to only 2.3 percent in the US.(27) Afraid of domestic inflation subsequent to this monetary expansion, the Bank of Japan significantly tightened monetary policy in late 1990, and despite a mid-1991 drop in the official discount rate, Japanese government bonds offered historically high interest rates through 1991. The steep rise in domestic interest rates, plus continuing fears of a further collapse in the dollar relative to the Yen lowered the demand side basis for overseas investment by Japanese. While more overseas investment is better for continued health of the global economy, the very weakness of the US economy after eight years of serving as market of last resort served to deter further Japanese lending in support of that role.

On the supply side, much of the money lent by banks and other investors involved the export of capital created by the explosion of stock and property market value during the second half of the 1980s. 1982 to 1989 land prices more than tripled.(28) A similar explosion of stock market values occurred as the Nikkei index also tripled during the 1980s. But both property and stock values tumbled during 1990. By 1991 the Nikkei had fallen 40 percent from its 1989 peak. Property values fell 20 percent, perhaps on their way towards the 30 percent total fall that would bring land values back to their historic level in relation to GDP.

Even if the further declines many fear do not occur, new international banking standards mean that current declines in property and stock value seriously undercut the ability of Japanese banks to continue lending overseas. In 1987, the G-10 countries agreed that their banks would be bound by a set of capital adequacy standards promulgated by the Bank for International Settlements (BIS) in Basel.(29) These new BIS standards required banks to have risk adjusted capital to assets (loans) ratios of 8 percent by 1992. Under the BIS's accounting rules, Japanese banks were allowed to count 45 percent of unrealized capital gains on stocks and property towards these ratios. At pre-crash values, most Japanese banks easily met the new capital ratio requirements. But after the 1990 crash only one major Japanese international bank, Fuji, came close to meeting the new BIS requirement in 1991. The rest were well below the 8 percent level, and forced to borrow new capital at very high interest rates to meet the new standard. Barring some recovery in land and share values, this means that Japanese banks will probably curtail overseas lending to protect their profit margins.

If Japan is unable to act as lender of last resort, might it act as a market of last resort, replacing the US in this role? There are some indications that this may occur. Since 1985, imports of goods from the East Asian NICs have risen by 20 percent per annum off of a low base. But political and economic considerations suggest that it is very unlikely Japan will become a market of last resort. First, this would further harm weak but politically powerful sectors of the economy. The small and medium sized businesses most vulnerable to overseas competition, were heavily invested in stock and property markets and are unlikely to countenance more competition from NICs or liberalization of agricultural trade.(30) Second, among larger businesses, liberalization of import

markets, especially in agriculture, has ambiguous consequences. While it may remove protectionist pressures elsewhere, the resulting fall in land values -- estimated at 50 percent off the 1989 peak should agricultural trade be c

banks' Latin American debt and judging by its hesitancy about 'recycling' its trade surplus to LDCs is likely to be as unforthcoming as the US.

Second, successful liberalization of agricultural trade at the Uruguay round would ease pressure on the US', developed PPEs', and LDC PPEs' current accounts. Liberalization would increase US exports by an estimated \$40 billion -- nearly half its trade deficit -- and also increase LDC exports by about \$25 billion -- about one quarter of their interest payments. While this is economically the best possible outcome, it is also the most unlikely politically. Domestic political pressure against liberalization of Japan's agricultural markets is intense; one-third of the governing party's seats in the Diet represent agricultural constituencies. Similar pressures against liberalization exist in Europe, particularly in France and Germany. Aside from the US, counter-pressures come only from a weak collection of agricultural exporters known as the Cairns group.

Third, relatively debt free manufactured goods exporting NICs, particularly Taiwan and South Korea, could increase their imports. The gains from this would not be as extensive as from liberalization of agricultural trade, however, and Korea's recent behavior in the area of agricultural trade suggests that it will behave more like Japan than anything else, making this option also unlikely.

The unlikeliness of all these scenarios suggests that the danger of a contraction of world trade and lending during the 1990s is real. What does this tell us about the nature of global leadership? It confirms that domestic politics -- willingness -- is just as important in creating hegemony as a country's structural position in the world economy -- ability. Moreover domestic politics really is prior to the creation of hegemony. While merely opening up domestic markets in Japan would ameliorate some of the current imbalances in the international economy, it would not change the underlying problem, namely high levels of external debt which cannot be serviced by existing levels and types of exports. Truly resolving these problems would require a domestic political coalition willing and able to implement far-reaching domestic and international policies of restructuring.

Domestic politics here thus cannot be a simple choice by some (new) dominant coalition to allow market access. These kinds of policies have as their underlying basis a whole range of choices about (re-) distribution of income and power relationships among different industries and between business and labor. One need only look at the changes in US domestic politics and economic arrangements which accompanied the New Deal to understand first that the kinds of changes we have seen in Japanese politics do not signal in any way movement towards an acceptance of a hegemonic role and second just how difficult such changes would be. Minimally farmers' and small business' power in the LDP would have to be subordinated to some new coalition based on internationalized businesses and perhaps the upper tiers of urban consumers. Economically this would imply a massive transfer of purchasing power away from landowners and an equally massive devaluation of retail stores' "rights" to certain market shares.

Just as with US in the 1920s, it may take catastrophe to force a break with prior practices in the potential hegemonies of the late 1990s. As in the 1920s, the problem is not simply that the willing

leader/lender is unable and the able leader is unwilling. It is that ability and willingness are tried together in complex ways. The basis of inability -- declining competitiveness and current account imbalance -- often impel uncompetitive countries to protect and competitive ones to use direct investment to defeat protection. Inability and protection thus reinforce themselves as potential supporters of a collective solution to preserving open markets find private solutions to their needs. Similarly the bases for ability as often make it difficult to get political support for "willingness" without imaginative and courageous politics. Until such politics or policies emerge, who can blame the strong (i.e. competitive) for seeking private solutions in the market and the weak (i.e. uncompetitive) for pressing for collective protection through market distorting practices?

NOTES:

(1) Charles Kindleberger, *The World In Depression 1929-1939*, (Berkeley: University of California, 1986), p. 289.

(2) Anne Orde, *British Policy and European Reconstruction after the First World War* (Cambridge: Cambridge University Press, 1990), pp. 77-129.

(3) Albert Fishlow, "Lessons from the Past: Capital Markets during the 19th Century and Inter-war Period," pp. 37-93 in Miles Kahler, ed., *Politics of International Debt* (Ithaca: Cornell University Press, 1985).

(4) Illiquidity is a situation where the long run stream of income from a given set of assets is sufficient to cover all claims on that asset (e.g. amortization of debt payments), but in which for any of a number of reasons income at time $T=0$ does not cover payments due at $T=0$. If payment could be delayed until time $T=1$ enough income would exist to cover payments due at $T=0$ and $T=1$. The problem for the debtor is thus one of finding enough short term, or 'bridge' financing to cover payments at $T=0$, in anticipation of receipts at $T=1$. This situation should be contrasted with 'insolvency,' where the stream of income at all times is insufficient to cover claims on a given set of assets. Short term financing here only delays the inevitable liquidation of assets.

(5) Herman Schwartz, *In the Dominions of Debt: Historical Perspectives on Dependent Development* (Ithaca: Cornell University Press, 1989), p. 36.

(6) Wilfred Malenbaum, *The World Wheat Economy, 1885-1939*, (Cambridge: Harvard University, 1953), pp. 236-237.

(7) The scale of the fall depends on which of 1920, 1921 or 1922 is chosen as the first "normal" post-war year.

(8) Orde, *British Policy and European Reconstruction*, p. 328.

(9) For different national responses among the most important PPEs in this period see C. B. Schedvin, *Australia in the Great Depression* (Sydney: Sydney University Press, 1970), Peter

Cochrane, *Industrialization and Dependence: Australia's Road to Economic Development* (St Lucia: Queensland University, 1980), M. F. Lloyd- Pritchard, *An Economic History of New Zealand to 1939*, (Auckland: Collins, 1970), Carlos Waisman, *Reversal of Development in Argentina* (Princeton: Princeton University, 1987), Hans Christian Johansen, *The Danish Economy in the 20th Century* (London: Croom Helm, 1987), A. E. Safarian, *The Canadian Economy in the Great Depression* (Toronto: University of Toronto Press, 1959). Ian M. Drummond, *Imperial Economic Policy 1917-1939* (London: George Allen and Unwin, 1974) provides a useful survey of events in the context of the entire British Commonwealth.

(10) Kindleberger, *The World in Depression*, p. 24.

(11) William Pullen, *World War Debts and United States Foreign Policy 1919-1929* (New York: Columbia University Press, 1987), p. 143. See also Harold Moulton and Leo Pasvolsky, *War Debts and World Prosperity* (Washington DC: Brookings Institution, 1932), and Cleona Lewis, *America's Stake in International Investments*, (Washington DC: Brookings Institution, 1938).

(12) Orde, *British Policy and European Reconstruction*, pp. 328-329; Brian Mitchell, *European Historical Statistics 1750-1970*, (New York: Columbia University Press, 1975).

(13) Alfred Chandler, "The Emergence of Managerial Capitalism," *Business History Review* 58, Winter 1984, pp. 473-503, provides the essentials of Chandler's well known argument about differences among US, German, British and Japanese firms in this period. The more dedicated should see Alfred Chandler, *Strategy and Structure: Chapters in the History of the American Industrial Enterprise*, (Cambridge: MIT Press, 1962); Alfred Chandler *The Visible Hand: The Managerial Revolution in American Business*, (Cambridge: Harvard University, 1977). See also Mira Wilkins, *The Emergence of Multinational enterprise*, (Cambridge: Harvard University Press, 1970).

(14) Paul Bairoch, "International Industrialization Levels, 1750- 1980," *Journal of European Economic History* 11, 1982, pp. 292, 299.

(15) Fishlow, "Lessons from the Past," pp. 72-73.

(16) Charles Kindleberger, *World in Depression*, p. 84.

(17) Kees van der Pijl, *Making of an Atlantic Ruling Class*, (London: Verso, 1984).

(18) Kindleberger, *World in Depression*, p. 170.

(19) There is some dispute as to the real creditor status of the UK; its seeming creditor status rests on how one assigns the enormous "discrepancies" and "unrecorded transfers" that fill its international balance sheet. Its net international investment income is negative, suggesting either a real (inflation adjusted) negative net asset position or continual sub-optimal investment overseas by British capitalists. The same is roughly true for the Netherlands, also a marginal net creditor with a marginal net inflow of investment income. Only Switzerland has any sizable net

inflow of investment income among the smaller European states.

(20) OECD, OECD Economic Outlook # 47, June 1990, (Paris: OECD, 1990), p.31.

(21) Eliana Cardoso and Albert Fishlow: "Macroeconomics of Brazilian External Debt," in Jeffrey Sachs, ed., *Developing Country Debt and the World Economy*, (Chicago: University of Chicago Press, 1989), p. 98.

(22) Philip Wellons, *Passing the Buck: banks, government and Third World Debt*, (Cambridge: Harvard University Press, 1987).

(23) OECD, *Monthly Statistics of Foreign Trade* (Paris: OECD), various dates.

(24) This figure, based on market valuation of assets was released by the Department of Commerce in May 1991. Prior data based on book values suggested a net liability of \$675 billion at year end 1989; *Economist* 15 December 1990, p. 100.

(25) Terutomo Ozawa, *Recycling Japan's Surplus* (Paris: OECD, 1989).

(26) Paul Anderson and Mark Snowdon, "Globalization: Implications for the Automotive Industry," in *EIU International Motor Business*, (London: Economist Intelligence Unit, January 1990), pp. 96-97.

(27) *New York Times*, 11 January 1991, D-8.

(28) *Economist* various issues.

(29) *Economist* 15 December 1990, p. 31.

(30) Ethan Kapstein, "Resolving the Regulator's Dilemma: International Coordination of banking Regulations," *International Organization* 43:2, Spring 1989, p. 323.

(31) *Economist* 22 December 1990. p. 88.

(32) Jeffrey Sachs, "Making the Brady Plan Work," *Foreign Affairs* 68:3, Summer 1989, pp. 87-104.