The fallout from the subprime debacle has brought to the fore, once again, the role of the state in the management and containment of crisis. The stakes involved in this debate, for both capital and progressive social movements, are potentially enormous. Even ardent defenders of neoliberalism concede that the proximate cause of the current downturn was Wall Street’s own speculative excesses that culminated a nearly two-decade-long deregulation of finance. The problem facing leading sectors of US business and finance is that the resulting reliance on public expenditure to sustain rates of return on private investment poses a threat to the ideological legitimacy of the neoliberal project. A growing chorus of voices is raising concerns over the supposedly deleterious effects of rising government deficits on the long-term growth potential of the US, as well as the threat posed to the international status of the dollar. It is no surprise that proponents of liberalization, including defenders in the Obama administration, have moved to limit meaningful discussion over the content and scope of ongoing government intervention.

Among the many tasks facing the left everywhere, those facing the US left are especially urgent and daunting. Given that attacks on the alleged failure of government were central to the ideological construction of neoliberalism, challenging the devaluation of the public sector is a necessary first step to opening space for the discussion of alternatives. In the most immediate sense, what is at stake is defending the living standards and employment prospects of tens of millions of unemployed workers. This requires countering claims regarding the alleged inflationary effects of government deficits, as well as claims that debt-financed government spending leads to the ‘crowding out’ of private investment. Doing so likewise requires clarifying what is

really at stake in arguments regarding the relation of deficits to the dollar’s international reserve currency status. Deficit spending need not involve any inflationary increase in the money supply. Nor do deficits lead to an automatic crowding out of private sector investment. The real issues at stake in the debate over deficits are efforts to defend and perpetuate a set of political-economic arrangements that benefit powerful private interests, particularly capital invested in the global circuits of finance. As we shall see, deficits do in fact pose a problem for capitalists. Particularly during periods of acute crisis, deficits are required to offset faltering rates of investment and profits. At the same time, deficits raise the possibility of government expenditure being used to provide direct benefits to popular constituents. For capital, this raises the spectre of government actions running counter to their own perceptions of economic self-interest. Underlying the growing alarm over deficits is a demand that the present (and any future) US government demonstrate its commitment to placing the interests of wealthy investors over and above the wellbeing and health of its popular classes.

Challenging the hegemonic consensus should not be misinterpreted as implying that deficits represent a panacea for stagnation or falling rates of return on investment. Nor is it our task, as socialists, to propose more ‘efficient’ means for managing the current crisis. Rather, the debate over government intervention is inseparable from the struggle to open the political space to pose meaningful questions about the efficiency of markets, the class interests served by present policy initiatives, and the viability of more progressive and egalitarian alternatives.

DO DEFICITS REALLY CAUSE INFLATION?

The contemporary critique of deficits draws upon some variant of the still influential monetarist strand of economics. Reduced to its essentials, the argument linking deficits to inflation rests on the assertion that government deficits lead to an ‘exogenous’ injection of bank reserves into the monetary circuit. Banks respond by seeking to lend these reserves out, leading to the creation of additional deposits. Banks that hold these deposits are in turn encouraged to issue more loans, expanding the money supply and hence total expenditure to a degree that far exceeds the rate of growth of output. This process of monetary expansion is what allegedly causes the inflation in the prices of goods and services.¹

This argument fundamentally misrepresents the relation between the money supply and prices. Government deficits are not, in general, the cause of excess liquidity or an excessive expansion of bank deposits. Nor does the US government compete for an existing pool of savings, driving up interest
rates and depressing the rate of private investment. While it is true that the Treasury finances deficits through ‘credits’ from the Federal Reserve, any additional liquidity pumped into the money market can be reabsorbed and extinguished through the issue of new government securities, or through ‘open market’ and ‘reverse repo’ operations conducted by the Federal Reserve. Further, because the issue of new government debt essentially ‘borrows back’ reserves created through the initial government payment, it is inaccurate to claim that the government competes for a fixed sum of investment-seeking savings. On the contrary, government borrowing functions to mop up any excess liquidity created by the initial financing of the government deficit.2

Contrary to the orthodox argument, the correct starting point is that the money supply – means of payment created through extension of credit – adjusts to the requirements of the production and circulation of the total commodity product. Increases or decreases in the money supply – purchasing power held in the form of deposits – are not the principal cause of increases or decreases in the prices of produced goods and services. Nor are prices set by ‘money chasing goods’. On the contrary, firms set prices by imposing markups over and above per unit costs, or some variant of administered, or full cost, pricing. Changes in output prices reflect changes in unit costs – i.e. wages, direct inputs, overhead, and interest – as well as changes in firms’ demanded profits as reflected in the markup.

If the rate of profit is falling, due to a fall in the output-to-capital ratio, firms may attempt to protect their existing profit margins by increasing the markups applied on per unit costs.3 Changes in the money supply are not the cause of this type of inflationary dynamic. On the contrary, the role of banks in the price-setting process is that of providing the necessary purchasing power to allow firms to realize, or monetize, their demanded profits. It is true that households can spend using demand deposits created by the initial government payment. However, this will induce a rise in prices only if the economy is operating at or near full employment, or if this additional nominal demand is absorbed by a firm’s decision to increase markups in lieu of increasing employment and output. The correct relation is thus not that an increase in money supply leads to higher prices. Rather, higher prices necessitate a greater volume of circulating means of payment.

The money supply is in this sense fully endogenous to the capital circuit, with the volume of means of payment adjusting to the needs of capitalists to purchase labour power and other inputs to the production process and to ensure the turnover of the commodity product (subject to lenders decisions to ration, or otherwise limit, the supply of credit. This basic dynamic is entirely
independent of the level of the government deficit. Nor do government deficits undermine the ability of the Fed to siphon excess liquidity out of the inter-bank market to regulate the overnight interest rate (see footnote 2). This is why, as seen in the Figures for the US, Japan and Germany in the appendix to this essay, we find essentially no correlation between higher deficits and either inflation or higher interest rates in the major developed capitalist countries over recent decades.

DEFICITS AND INVESTOR CONFIDENCE

Orthodox critics of government deficits might concede some of the points argued above, given the lack of empirical evidence linking deficits to either higher inflation or lower profits. Even if these points are conceded, however, critics of government deficits can still raise what is perhaps the most substantial argument regarding the need for governments to exercise fiscal restraint. This is the claim that higher deficits will at some point undermine investor ‘confidence’ in the policy choices of the offending government. Once the issue is stated as such, the reason for the loss of confidence is ultimately of secondary importance. The proximate cause can be fear over inflation, the alleged crowding out effect of private investment, anxiety over the longer-term threat of higher taxes (this is often a prime issue of concern), or simply a crisis of confidence once some tipping point in the acceptable ratio of total sovereign debt to GDP is breached. Once this point is reached, the result is the well-known sequence that begins when the collapse of confidence triggers capital flight as investors dump the bonds and other investments denominated in the currency of the offending government. Bond prices and exchange rates both plummet. This increases long-term interest rates and, via the depreciation of the exchange rate, increases the prices of imported goods and services. Higher interest rates and rising inflation further undermine confidence, depressing investment. This induces a contraction in employment and output. Capital flight accelerates, leading to even higher inflation. Eventually, the government is forced to boost interest rates to defend the currency and re-attract investment. Once investors are satisfied that the government is sufficiently committed to the principles of ‘sound finance’ – i.e., fiscal restraint, imposition of limits on social expenditure and wages, and restraint on taxes – capital returns and inflation abates. The restoration of business confidence in turn provides a renewed stimulus to the restoration of a higher rate of investment.

Clearly, the concern over deficits is in large part a question of the confidence creditors have in the policies of the debtor government. Stating matters as such, however, begs the question – confidence in what? We have
already seen that a deficit does not directly induce either higher inflation or the crowding out of private investment. Nor is the concern that rising US deficits threaten the spectre of sovereign default. On the contrary, because the US can borrow in its own currency, it can always pay off maturing obligations by simply issuing more dollars. Such is the nature of the seigniorage privilege: any sovereign government can always meet any and all repayment obligations by simply issuing more cheques, provided only that bondholders have ‘lent’ to this state in the currency of the debtor government. When investors, including foreign central banks, purchase the debt of the US government, capitalists (both foreign and domestic) and central banks have effectively replaced a claim on the Federal Reserve – the banking branch of the US government – with a claim on the Treasury Department – the spending and taxing branch of the central government. When the bond matures, investors can always demand repayment in dollars, thereby re-converting the form of the outstanding liability from the debt of the US central government back into dollar reserves that serve as means of payment on the international market. However, given that these funds (reserves) would generally be reinvested, creditors typically agree to roll over maturing debt at the interest rate then prevailing on the secondary market.

By so agreeing to defer perpetually the point of final settlement, bondholders are in effect granting to the US an open-ended line of credit that, for all practical purposes, can be treated as potentially ‘infinite’. If wealthy investors and foreign central banks are going to extend the US an essentially open-ended line of credit, they want to feel assured that the US will not abuse this confidence by acting in ways seen as inimical to their own class interests. Therein lies the real source of elite anxiety over deficits. Capital is simultaneously dependent upon and threatened by its own reliance on government deficits and the seigniorage privileges exercised by central governments able to borrow in their own currencies on the international market. On the one hand, government expenditures are essential to sustaining growth and accumulation, and are primary sources of firm’s realized profits that are typically either invested in financial instruments or distributed in the form of dividends to households. At the same time, deficits pose a potential threat to capital in revealing the latitude of governments to pursue progressive, even potentially socialist, programmes and initiatives.

There are no technical constraints on the ability of the US government to, for example, allocate an additional $1 trillion to urban reinvestment initiatives over and above existing spending commitments. The US government could institute a policy of full employment by embarking on a publicly led programme of infrastructure investment to create a more
environmentally sustainable form of urban development. Further, the latitude of the central government to determine the level and allocation of taxes means that imposing higher taxes on wealthy households can always be used to reduce the deficit. Clearly, any significant redirection of the scale and content of government spending towards expanding social programmes (such as health care and public employment) and the launching of a state-initiated, government-controlled programme of ‘green’ infrastructure investment would pose significant threats to the major political-economic advances achieved by capitalist owners over the past three decades. This is why any potential expansion of government expenditure that expands benefits to workers will be rigorously policed and resisted.⁵

The debate over the relation between government deficits and ‘confidence’ must therefore by understood as code for the demand that the US maintain a docile and disciplined workforce, stable prices, a climate favourable to generous and steady yields on financial investments, regulatory forbearance, and restraint on taxes. For global investors, including American finance, confidence is about the demonstrated commitment to preserving the major policy advances achieved by the top tiers of the capitalist class over the last three decades – i.e., financial deregulation and liberalization, reduced taxes, the enhanced power wielded by financial owners over corporate management via mergers and leveraged buyouts, ‘free trade’ agreements that have pried open formerly protected markets, and an open-ended commitment to socialize losses. Similarly, what is being signalled in statements by the Obama administration regarding its commitment to ensure cost-neutrality of any increase in social spending commitments is a publicly transmitted, ideologically coded discourse regarding the fealty of the US to act as pre-eminent guardian of the dominant propertied interests. Concerns over rising prices, the crowding out of private investment, the ‘job-destroying’ impact of imposing higher taxes on distributed profits and the capital gains of capitalist households, and the threat posed to long-term prosperity by ‘excessive’ regulation of Wall Street will all be mobilized as needed to preserve and defend these elite prerogatives.

At root, the debate over the ‘acceptable’ level of the deficits is about the perceived commitment of the US political class to act as the pre-eminent guardian of the dominant propertied interests. This applies not only to those interests in the US, but insofar as the American state continues to serve capitalism’s ‘global superintendent’, to capitalists headquartered in Japan and Western Europe.⁶ Certainly this requires US commitment of military power to insure the security of foreign direct investments, funding for which is rarely the subject of serious constraints due to its effect on
public deficits. This was one of the lessons of the Reagan period – the US can readily expand the deficit so long as it does so in a manner congruent with securing and defending the broader, system-wide interests of the most transnationalized sectors of the capitalist class. Hence, the US – particularly under a Democratic administration – must signal its ongoing commitment to uphold corporate and investor rights to markets and profits over and above the social entitlements of popular constituents. It must defend the principle of multilateral ‘free trade’ agreements that establish the right to own and dispose of foreign assets and repatriate profits without limit. And, perhaps most critical in the current context, the US must demonstrate its commitment, and ability, to balance price control with ongoing access to cheap credit to avert massive devaluation of capital invested in over-valued, over-leveraged circuits of global finance.

**CAN INVESTORS PUNISH THE US GOVERNMENT?**

The critical link in the claim that the US must limit social expenditures to appease the anxieties of the investor class is the assertion that governments that fail to maintain a sufficiently competitive business environment must contend with the threat of capital flight. Certainly smaller governments, particularly countries that cannot borrow in their own currencies on the international market, face something very akin to veto power over their policies. In relation to the major capitalist states, particularly those that issue currencies that serve as international means of payment and international reserves, matters are more complex. There is a significant disagreement at present regarding the ability of the dollar to sustain its present international reserve currency status. While the dollar’s status is certainly in question over the long-term, the fact is that it has no significant challenger at present, and thus will continue to occupy its de facto role as international reserve currency in the coming decade. This implies that there are limits on the degree to which global investors can wield veto power over policy choices solely through the conduit of the private market – i.e., solely through decisions to buy and sell the debt of the US government. We therefore require a more nuanced understanding of the relation between the ‘imperatives’ of liberalized finance and the policy choices available to governments issuing currencies that serve as international means of payment and reserve store-of-wealth.

What the story of financial liberalization tends to elide is that, while market integration has certainly enhanced the power of mobile finance, capital is equally constrained by the need for an international means of payment required to lubricate the circuits of international trade and finance, and the need for a highly liquid, yield-bearing asset that serves as a ‘safe haven’
reserve claim-on-wealth. This requirement can be solved in three ways. The first is to constitute the international monetary system on a commodity basis, with gold serving as the standard of value and the ultimate means of international settlement (even if rarely used as such in actual international payments). The second would be a global central bank able to issue and manage an international means of payment organized through a clearing union that would provide countries with some type of drawing rights, subject to various provisions and conditionalities.

The third – and current – arrangement is to constitute the international system on a pure ‘fiat money’ basis, with the world’s dominant state issuing the currency unit that serves as the de facto unit of account (vehicle currency), means of payment, and reserve claim-on-value. While the dollar presently serves as the world’s pre-eminent international means of payment, this arrangement is inherently problematic. For one, the dollar, being a non-convertible currency, cannot serve as an absolute standard through which the exchanges rates of all other currencies are measured. Nor do payments by US ‘residents’ (governments, firms, and households) using dollars constitute a means of final international settlement, as trade deficits have their corollary in an increase of the aggregate debt of the US to the rest of the world. The problem here is not that the US is likely to default on what amounts to a massive – and growing – ‘promissory note’. Rather, the issue is that, in the absence of gold convertibility, this massive dollar overhang raises the spectre of devaluation of the purchasing power of the dollar on the international market. The questions thus become: first, why do foreign central banks and global banking corporations presently continue to accept and hold dollars, as opposed to yen or euros; and second, what would undermine such willingness to continue to purchase and hold the debt of the US government?

Foreign demand for the dollar cannot be understood in the way the ‘neo-chartalist’ (state-based) approach to money would account for demand for dollars inside the US: that is, merely as the expression of the legal capacity to impose taxes and designate the money-unit that must be used by the general public for payment of said taxes owed to the central government. Such powers do not extend outside the territory under the sovereign authority of the central government. Nor does the Federal Reserve have the power to impose reserve requirements on foreign banks. Hence a disjunction arises in a global market environment between the need for an international means of payment and the fact that money-units are still primarily issued and managed on a national-territorial basis. The question remains, therefore, why is the dollar, and the debt of the US government, the world’s pre-eminent reserve claim-on-value, as opposed to the yen or the euro?
THE POWER OF THE DOLLAR

Powerful systemic forces continue, for now, to underpin international demand for dollars as means of payment and international reserve. Most obviously, accumulation in much of Europe and East Asia remains inextricably tied to the US market. The dollar is similarly the vehicle currency for the invoicing of the international oil trade. Foreign producers, and central banks, thus have little choice but to continue to accept and accumulate dollars. When foreign central banks recycle dollars back into the US capital account, they do so knowing this tends to lower the long-term US interest rate, supporting US demand for their products and sustaining their exporters’ profits. Willingness to hold dollars is the quid pro quo of a symbiotic and mutually beneficial arrangement wherein foreign exporters gain access to the world’s largest market while the US is assured that foreigners will continue to purchase Treasury bonds sold on the international market.

The status of the dollar is further buttressed by the still formidable position of the US multinationals, which still continue to control a significant share of international trade and investment. As powerfully argued by Ellen Frank, this creates demand for the home currency, given both the large share of US multinational assets denominated in dollars and the fact that these corporations will prefer to borrow and invoice payments – including the distribution of profits to shareholders – in dollars.10 Equally critical to the system of market support buttressing the dollar is the power and global reach of Wall Street and the presence of US offshore banking affiliates located in the London-centred Euromarkets. US multinational banks have the distinction of having their ‘home’ deposit and asset base located within the world’s largest domestic market. US banks are positioned in the ‘nexus’ between the US Treasury and the Federal Reserve, which confers privileged access to the world’s deepest and most liquid domestic bond market and, via their offshore affiliates, the London-based Euromarkets. The unrivalled depth and liquidity of the US bond and money market, and the extremely large base of dollar-denominated assets and deposits may be leveraged through the platform provided by the London Euromarkets to expand and consolidate the global reach, and dominance, of American finance.

Despite having been tarnished by the recent crisis, Wall Street continues to define the cutting edge investment strategies for private finance. US investment banks still retain leading positions in international bond underwriting and providing merger and acquisition advice. The centrality of the dollar is further buttressed by the role of hedge funds and private equity firms that collect and manage the savings of the US capitalist class, which constitutes one of the world’s largest nationally-based, yet globally-
scaled, pools of yield-seeking finance. All these factors position Wall Street as the critical link between the US and the international financial market, thereby reinforcing the role of the dollar as the international reserve currency supported by the sovereign guarantee of the world’s most powerful government.

The structural underpinnings of the dollar are further buttressed by the fact that it has no viable challenger at present. It is very clear today how overstated was all the talk of the ‘threat’ posed to the dollar by the emergence of the euro a decade ago. As Figures II and III in the appendix to this essay show, there has been no fundamental rebalancing of the composition of official foreign reserves away from dollars in favour of euros; indeed, adjusting for changes in the exchange rate, foreign central banks have actually increased their holdings of dollars relative to euros on a unit-for-unit basis.

While diversification of foreign exchange reserves into euros could in principle still take place, multiple factors presently mitigate against the likelihood of the euro and the ECB supplanting the present status of the Treasury-Fed ‘complex’. For one, the preference for the dollar reflects, in part, the ‘fractured sovereignty’ that characterizes the monetary integration of Europe. In the monetary sphere, the EU can, for practical purposes, be regarded as a single country for which the euro serves as money-of-account and means of payment. Control over fiscal policy, by contrast, remains vested at the level of sovereign national governments subject to influence by popular constituents. The result is a structural disarticulation between the procedures that sustain and reproduce the euro as a monetary unit vested within a multinational institution – the ECB – and the national legislative sphere within which governments retain authority over public finances. The ECB thus has no counterpart in the form of a single, nationally-controlled Treasury analogous to the case of the US Treasury–Federal Reserve. Because no single state wields sovereign authority over the territory in which the euro functions as unit of account, the euro lacks the support of a single, unified, and highly liquid sovereign debt market. Hence, we have the anomaly of a single currency unit ‘norming’ what amounts to a highly fragmented set of sovereign debt markets characterized by very different political and social dynamics.

The euro thus has run into trouble based on what was always a problematic attempt to treat the debt of a small peripheral country like Greece as if it were the same as the debt of the large powerful economies of Germany and France. The terms of the Maastricht Agreement and the founding articles under which the ECB was established attempted to resolve this contradiction by stipulating a rule-based policy framework that inscribed principles of
fiscal probity into member countries' public budgets. The fallout of the 2010 Greek crisis has revealed the underlying fissures and weaknesses inherent in the institutional arrangements that support the monetary unification of Europe. Although major European governments did eventually agree to a €750bn bailout package for distressed governments (subject to harsh conditionalities), the decision-making process evidenced a lack of any clear centre of political-economic leadership able to balance defence of rentier-managerial prerogatives with the type of pragmatic adjustments made necessary in times of crisis.

Moreover, the response to the Greek crisis revealed enduring tensions between the major EU governments, particularly divergences in the strategic orientations of the German and French political leadership. Despite shared commitment to the principle that fiscal adjustment must be ultimately be borne by the popular classes through welfare reductions, France’s current political leadership is more willing to tolerate higher deficits to provide needed government stimulus. Germany, by contrast, remains Europe’s most rigorous adherent to the principle of balanced budgets, for both historical reasons (the lingering memories of hyper-inflation and, more recently, the costs associated with East German integration), and due to the configuration of political forces inside Germany that underpins the unwillingness to be the ‘bail-out agent’ for greater Europe. This was seen, for instance, in the harsh conditions demanded by the Merkel government for German participation in any member-country bailout, raising questions concerning whether it is feasible to reconcile such ideological adherence to the principle of a balanced budget with the need for a more pragmatic approach to crisis management. This suggests the potential for a chronic, and potentially deepening, crisis of governance that does not bode well for the long-term future of monetary integration in Europe.

Most importantly, European elites share an insistence that social austerity is the only viable longer-term means available for shoring up confidence in the euro. This reveals the degree to which the regulatory architecture of the euro, as currently constituted, embodies a deflationary, profoundly anti-labour, bias. This is perhaps the central social contradiction inherent in the euro project. On the one hand, the euros’ status as an international currency rests upon the ongoing commitments of member governments that remain nominally accountable to popular constituents. Conversely, any deepening of the crisis will intensify demands for social and fiscal retrenchment to secure market confidence in the ongoing viability of a united Europe. This policy is not without its dangers. For one, austerity measures can result in a more overt politicalization of public budgets, as they reveal the profoundly pro-
rentier, pro-managerialist bias of the underpinnings of the EU-euro project. Moreover, it is difficult to simply annul entitlements to social welfare that reflect long histories of social compromise and class struggle. The class problem, from the vantage point of capitalist owners, is that popular classes can refuse the imposition of austerity and reductions in the living standards required to send the requisite signals of European governments willingness – and capacity – to appease the prerogatives of private finance. If such measures were successfully resisted, this could have equally profound repercussions on international confidence in the current regulatory configuration of Europe.

Whatever the outcome of the current crisis in the Eurozone, what does seem certain is that the underlying weaknesses of the euro will serve to reinforce, at least for the time being, the international reserve currency status of the dollar. Investors are simply unwilling to extend the same confidence never to default that they currently extend to the American government to European states. It is the sovereign debt of the US, not that of Germany or France, which remains the closest thing to a risk-free asset currently traded on the international market. For all these reasons, the euro and debt of the German and French governments are unlikely to usurp the role of the dollar or the debt of the US government as international means of payment and lubricant of the world market.

China potentially represents a more viable long-term threat to established US predominance in the realm of international finance. Much discussion has transpired regarding whether China will eventually ascend to superpower status and challenge the US for global hegemonic dominance. Bracketing for the moment the question of China’s long-term ascendance to dominant power status, it is clear that significant obstacles exist to the emergence of the renminbi as a global alternative to the dollar over the next decade. For one, transforming the renminbi into an international reserve currency would require a massive increase in the world renminbi supply. To do so, China would have to run sustained trade deficits, or organize a massive outflow of renminbi on its capital account in the form of renminbi-denominated loans, direct investment, and purchases of financial assets. Further, for the renminbi to function as a major reserve store-of-wealth, China could need to insure the existence of a sufficient stock of renminbi-denominated bonds that would be freely traded on the global market. China would be required to shift to full and free convertibility on its capital account, leaving foreigners free to buy and sell renminbi (and government bonds) in any desired amount. Finally, China would have to instil confidence among international investors regarding the central government’s unswerving commitment to liberalization of the capital account backed by a credible commitment to never default.
These conditions are unlikely to be met over the next ten-year period. China’s export capital continues to derive significant benefits from undervaluing the renminbi relative to the rate likely to prevail if the renminbi was allowed to freely float on the open market. There is ample reason to anticipate China will move with caution towards full liberalization of its capital account, as doing so would effectively cede control over the long-term interest rate to foreign holders of renminbi-denominated debt. Further, given the renminbi’s current lack of reserve status, there are limits on the willingness of foreigners to accept the renminbi as a medium of international settlement. Nor do the Chinese Central Bank and Treasury have the technical and institutional infrastructure in place that is required to manage the renminbi as a reserve currency on an international basis. China’s banking sector lacks the vast global reach of the US Treasury/Fed/Wall Street complex, and has no domestic counterpart to the vast liquidity and depth of the US bond market. Chinese banks presently have limited ability to underwrite new issues on the international bond and equity markets, and lack any meaningful institutional presence in the London-based Euromarkets. Nor are foreign investors likely to put the same degree of trust in China’s commitment never to default as they presently do in the commitment of the US government. For all these reasons, over the short-to-medium term China has neither the desire nor the capacity to launch the renminbi as a serious international alternative.\textsuperscript{14}

Discussions regarding the eventual formation of the East Asian currency union must similarly be evaluated with caution. While East Asia is characterized by deepening trade and investment integration, long-standing tensions in the Sino-Japanese relationship would appear to rule out any near-term currency union.\textsuperscript{15} Moreover, China’s international standing benefits from continued use of the renminbi as vehicle currency and means of payment in bi-lateral trade agreements. Beijing has to date given little indication of willingness to sacrifice national development goals in the interests of regional unity. Equally importantly, neither Japan nor China possesses the technical capacity at present to establish the full set of market infrastructure and regulatory supports that is a key prerequisite for currency union. In short, East Asia has no counterpart to Germany and the Bundesbank that provided the critical political and technical leadership in forging the terms of monetary integration in Europe.\textsuperscript{16} Nor are ASEAN countries likely to opt for full-fledged currency union with China anytime soon, given inevitable Chinese domination of the terms of such unification. While expansion of the Chaing Mai Initiative and Asian Bond Fund will continue to facilitate deepening of regional capital markets, and could thus lay the basis for monetary union,
such an eventuality presently appears some way off.

Proposals to shift to an international currency based on some variant of standard drawing rights (SDRs) are largely empty simply because this is not a real possibility at present. Institution of a Keynesian-type ‘bancor’ unit of account and medium of international settlement would impose severe restrictions on the currency policy prerogatives on the major capitalist governments. Despite floating a proposal for a greater role for SDRs as the medium of international settlement, it is doubtful China would actually accept the terms of such an arrangement. For one, China would be required to allow the renminbi to appreciate to eliminate the surplus on its current account. It would similarly be required to finance the drawing rights of countries running persistent deficits. Clearly the US would never accept such an arrangement. Nor would Japan and Europe elites readily cede control over their exchange rate to a global clearing bank. Recent proposals by the Chinese Central Bank regarding SDRs are in fact a demand that the US safeguard the international value of the dollar that serves as China’s basic reference point for managing the price of the renminbi on the global market.

These considerations highlight a critical point. In the absence of a world currency issued by a world central bank, the dollar’s status as reserve currency is required to reconcile the need for a global means of payment within an international economy wherein currencies are issued and regulated on an essentially national-territorial basis (the euro being a type of intermediate case). US trade deficits continue to supply the means of payment that lubricate the international circuits of trade and finance. US fiscal deficits supply the basic asset – the debt of the US government – that serves as the pre-eminent store of claims on value convertible on demand into the currency – the dollar – that functions as international means of payment. The credibility of the implicit guarantee to always pay any and all maturing obligations allows the US to issue the IOU that, for all practical purposes, is treated as a nearly risk-free asset on the international market. No other state, including the leading powers of Europe, can offer a similar guarantee at present.

In sum, there are compelling grounds for assuming the dollar will continue to occupy a privileged place in the realm of international finance over the coming decade. Both the self-interest of other leading capitalist states and the systemic need for a viable international means of payment and reserve claim on value will continue, over the near term, to underpin the dollar’s reserve role on the international market. Foreign governments will chafe over US abuse of its seigniorage privileges. Concerns will be raised about the long-term viability of this set of international financial arrangements,
including threats to shift some portion of world trade away from the dollar. These threats could one day certainly be realized. For now, however, it appears there are no real alternatives to the depth and size of the US securities market and the preeminent positions of Wall Street and London as nerve centres of global finance.

These considerations certainly do not rule out the possibility of a dollar crisis in the coming decade. What they suggest, however, is that other leading governments would intervene to support the dollar in the event of a major currency crisis, galvanizing multilateral support with the spectre of potentially catastrophic global consequences if the Fed was forced to impose higher interest rates to fend off a speculative attack on the dollar. In contrast to the 1979–1985 period, when the Fed was able to use high interest rates to crush organized labour and restore international confidence in the dollar, the US and global economy remains saddled with a staggering level of debt. In the current environment, increasing interest rates would be likely to result in massive asset deflation and plunge the world into deep recession.

All this adds impetus to the demand issuing from the leading sectors of global finance for the US to act as prudent guardian of the prerogatives of the capital-owning class: limit social expenditure, prevent ‘excessive’ regulation of financial markets, demonstrate continued support for liberalization, and provide de facto blanket guarantees to major banks in the event of a system-level crisis while refusing to contemplate any significant increase in taxes on the incomes and assets of capitalists. Warding off policy initiatives perceived as threats to class power and privilege has assumed renewed urgency given the tarnished legitimacy of the post-1980 model of deregulated, hyper-leveraged finance. Doing so requires constant vigilance to limit debate over the range of policy choices actually available. The powerful evocation of the threat of a dollar crisis is primarily a means of rallying the US population around the need to curtail social expenditures in the name of preserving American financial prerogatives.

A progressive alternative to the current system of dollar-based international finance is certainly needed – nowhere is this truer than in the Global South. In the interim, the left must question ‘belt-tightening’ arguments that primarily serve the interests of those that occupy the commanding heights of global finance. Rejection of orthodoxy is both analytically sound and a necessary, albeit partial, step in composing an intellectual framework of counter-hegemonic opposition to the still-prevailing neoliberal, pro-market consensus. There are no technical reasons why the US – and other major sovereign governments – cannot sustain significantly higher deficits then at present. Raising taxes on wealth-owning households can be used to reduce
deficits over the longer-term, and the policy autonomy of states can be supported through the re-imposition of capital controls – always the ultimate anathema of international finance.

The more general point is that policy choices are never strictly constrained by the impersonal imperatives of globalization or the operation of economic processes at the level of the international market. The rules of international finance are socially constructed, and hence can be changed to serve a very different set of social imperatives and interests. Nor are states constrained by the imperatives of balanced budgets. Certainly in the case of the major sovereign governments, seigniorage privileges allow for implementation of social programmes directly benefiting workers that run counter to the interests of owners. Aspirations for greater economic security, for stable income and employment, and for sustainable long-term infrastructural investment need not be sacrificed at the sacrosanct altar of ‘sound finance’. Reclaiming the ideological terrain from the centre-right must begin with a categorical, unequivocal rejection of the orthodox claims concerning the negative impacts of deficits. The real issue at stake is what set of social and class interests are to be served by existing arrangements.

THE LIMITS OF DEFICITS

Arguing that class interests and elite prerogatives, as opposed to the ‘laws’ of economics, underlie the debate over deficits does not imply that state spending can, in itself, resolve barriers to accumulation rooted in falling rates of profit and persistent underinvestment. Deficits can offset a fall in the rate of return on existing investments insofar as the decline reflects a fall in final demand linked to insufficient private investment. Deficits are far more limited in their ability to offset a deterioration in the supply-side determinants of the rate of profit – i.e., a fall in the output-to-capital ratio not offset by a sufficient increase in the share of profits in total income. Similarly, deficits can, for a time, compensate for a cyclical fall in output and employment. However, without a far more comprehensive socialization of investment, government stimulus is far less able to remedy the longer-term secular decline in the rate of net investment that appears endemic to developed capitalist economies.

This raises the spectre that long-term underaccumulation and higher unemployment leading to higher debt obligations of sovereign governments will define the real nature of any looming sovereign debt crisis. Global investors, including the largest central banks, will either have to adjust to a long-term increase in the acceptable level of sovereign debt that, particularly if tied to expenditures that directly benefit popular constituents, runs counter
to ruling interests and prerogatives. Barring this, capitalist owners, via representatives in the major political parties, will have to attempt to impose a wrenching downward adjustment on government budgets. Imposing such reductions will be problematic, given demographic pressures driving higher pension and health care outlays, political resistance to cuts in social insurance by the popular classes and, particularly critical for capitalists, the role of deficits in sustaining profits in the face of faltering rates of net investment.

Of course, those that own and manage the global corporate accumulation apparatus will not agree, solely on the basis of maintaining social cohesion and consensus, to higher taxes on distributed profits. Nor can the US (or Europe) readily shift the burden of adjustment onto the developing world in a manner analogous to the sovereign debt crisis of 1979–89. In short, outside of East Asia, capital in the developed ‘core’ of North America, Japan, and Western Europe appears to have fewer ‘external’ options at present for displacing the crisis and creating conditions favourable to the shift toward a more investment-centred regime of development. If so, this suggests that a steady rise in the debt of sovereign governments will be a defining characteristic of the unfolding of any long-term 21st century accumulation crisis.

STRATEGIES FOR THE LEFT
What then are the political and strategic implications for the US left in the coming period? The deep basis of support for the dollar as the basic pivot of global finance, ongoing coordination of policy amongst the major central banks, and the lack of a viable alternative to the dollar, all speak to a more flexible policy space than is typically implied in much of the writing on global finance by the left over the last decade. How all these dynamics will play out is impossible to predict. What seems clear, however, is that the level and composition of government budgets will be a critical terrain upon which social forces will seek to advance their opposing interests. This raises the question of how the broadly-defined left can attempt to strategically engage these developments in the coming decade. Clearly, the current balance of forces in unfavourable for advancing a left-progressive, much less socialist, project. But by forcefully rejecting arguments regarding the negative effects typically attributed to government deficits, we can start to carve out a space for developing a challenge to the still-prevailing dominance of the neoliberal, pro-market, hegemonic consensus. The use of deficit expenditure to protect income security and increase direct employment can be linked to calls for reductions in military budgets and higher taxation on capitalist households. Equally critical, it is incumbent on the left in the developed capitalist world
to support transformation of the rules governing international finance through capital controls; calls for a global clearing union; an enhanced role for regional development banks to support multilateral trade agreements in the Global South; and arrangements to allow smaller governments to fix repayment of debt in their home currency unit-of-account.\(^\text{18}\)

Our ability to press such demands will ultimately depend on the level of political development and independence of popular forces. That is why, to open space for developing an independent left-progressive politics, the first step is to engage in immediate, concrete struggles that provide direct benefits to working-class constituents. At the same time, it is necessary to link such demands to building a broader-based, multi-sector, anti-imperialist, and ultimately anti-capitalist, popular alliance. Obviously, capitalists will rigorously resist any change in existing financial arrangements as constituting infringements upon their by now taken-for-granted power and prerogatives. Such is the terrain of any future political engagement over the level and composition of government budgets. The radical ‘kernel’ of Keynesian intervention today lies in the contribution it can make to revealing the latitude that contemporary governments have to pursue progressive, potentially socialist, spending initiatives. This can allow socialists to point towards the possibility of a deepening socialization – and democratization – of investment. It is incumbent on us, as radical intellectuals, to reveal how struggles to defend the value of the public sector and to expand public employment in the face of capitalist crises can call forth initiatives that prefigure post-capitalist, potentially socialist, alternatives.

APPENDIX

Figures Ia, b, and c show the annual change in government deficits, the annual inflation rate, and the 10-year interest rate for Japan, Germany and the US respectively. We find no evidence of any relation between higher deficits and inflation. Nor is there any clear link between deficits and the long-term interest rate.
Sources: World Economic Outlook (IMF) and Bank of Japan.

Sources: World Economic Outlook (IMF) and Bundesbank.
### Figure Ic: US, 1986-2009

- % change debt/gdp
- % change cpi
- ten year bond yield

Sources: World Economic Outlook (IMF); Federal Reserve Bank.

### Figure II: Dollar Share of Official Reserves

Sources: Currency Composition of Official Foreign Exchange Reserves and World Economic Outlook (IMF).
Figure III: Ratio of Euro/Dollar of Official FX

Note: in Figure II, the two different lines for the percentage of dollars in official reserves are due to different recoding and accounting methodologies used by the IMF. In Figure III, the ‘exchange adjusted’ ratio of euros to dollars is the total nominal ratio adjusted to account for changes in the euro:dollar exchange rate. The adjusted rate thus reflects the ratio of units of dollars to units of euros held in the official reserves of the world’s central banks.

NOTES


2 To illustrate this argument consider how the government actually finances a deficit payment. When the Treasury Department makes a payment, it issues a check or, more commonly today, makes a direct electronic deposit into the bank account of the payment recipient. The recipient’s bank credits the payee’s account, while simultaneously sending a signal to the Federal Reserve informing the central bank of receipt of this Treasury-issued check or electronic deposit. The Fed credits the account held by this bank at the Federal Reserve with reserves of an equal amount. Banks finding themselves in possession of reserves created by the deficit-generated deposit will typically seek to lend these reserves out, primarily on the short-term inter-bank money market at the lending rate set by the Federal Reserve (the federal funds rate). The Fed and
The Treasury uses various mechanisms such as open market operations, reverse repo agreements, and payment of interest on deposits held at the Federal Reserve to drain liquidity from the inter-bank money market, thus allowing the inter-bank market to clear at the target rate set by the Federal Reserve. See Randall Wray, *Understanding Modern Money: The Key to Full Employment and Price Stability*, Northampton: Edward Elgar, 1998, pp. 74-94.


This is the channel through which a crisis of confidence triggered by deficits can lead to higher prices, appearing to confirm claims that deficits cause inflation. It is necessary, however, to distinguish between direct effects of government deficits on money supply and prices and a rise in prices due to a decision to punish the offending government.


This contradiction is inherent in the use of a non-convertible fiat money possessed of a relative value as the de facto international unit of account and means of payment. See David McNally, ‘From Crisis to World Slump: Accumulation, Financialisation, and the Global Slowdown’, *Historical Materialism*, 17(2), 2009.


Frank, ‘The Surprising Resilience of the U.S. Dollar’.


See Adam Tooze, ‘The Message From Berlin that Europe Failed to Grasp’, *Financial Times*, 5 May 2010; and Quentin Peel, ‘Merkel Struggles to Justify the
Arrangements between the ECB and member governments functioned to undermine the ability of smaller countries such as Greece to offer credible guarantees not to default. Further, the Articles limit access to overdraft accounts by member governments with unfunded deficits – i.e. debits in these government’s accounts held at the regional central banks that have not been redeemed through the sale of new securities on the capital market. Moreover, the Articles of the European Central Bank appeared to forbid central bank direct purchases of newly issued government debt - although this was finally ignored as the crisis worsened through the spring of 2010.

Bilateral trading arrangements using the renminbi, not the dollar, as vehicle currency and means of payment, if eventually linked to the growing presence of Chinese banks on the international market, could lay the basis for the full liberalization of China’s capital account. This could, over time, transform China’s role as provider of liquidity to the world market.

The US has exploited Japanese anxiety over China’s global re-emergence through security arrangements that integrate Japan into the umbrella of a regional US-led protectorate. The effect is to drive a wedge between any possible China-Japan rapprochements that would be a necessary prerequisite to the construction of a framework of consensual regional leadership outside the US imperial orbit. China’s pursuit of an independent defence policy similarly rules out any move towards more comprehensive regional integration along lines similar to that which occurred in Europe under the aegis of the NATO compact.


To reiterate – the dollar is not immune from a crisis of confidence. Because the dollar does not constitute a stable monetary standard, an international disturbance could well occur in the coming decade. Rather, the argument here is that there are no technical constraints on the US ability to run higher deficits at present, nor is there an objective ‘tipping point’ when the debt-to-GDP ratio becomes structurally unsustainable. The dollar’s future will be determined by international geo-politics and class struggle, not by immutable ‘laws’ of economics. Further, global capital has no exit strategy or alternative, which is why other major governments and central banks would support the dollar in the event of a crisis.