Introduction

The author originally decided to write this book because of his dissatisfaction with the typical textbooks in international economics, macroeconomics, and the related subjects that he teaches. These textbooks do not present the major structural changes and recent events in the global economy to his satisfaction; insufficient attention is typically given to financial market globalization, new trade patterns, new forms and uses of money, monetary-wealth processes, recent changes in the velocity of circulation of money, and recent financial crises and recession. Chapters 1–4 cover these topics.

Chapters 1–3 are organized in a manner which provides background material for Chapter 4's discussions of economic crises. The detailed case studies include the global recession of the early 1980s, the world stock market crash of 1987, the 1980s and continuing world debt crisis, the slumps of the early 1990s, Mexico's crisis of 1994–95, Japan's crisis after 1989, and Asia's crisis after 1997. Less detailed mention is made of the Great Depression of the 1930s, the US savings and loan crisis of the 1980s, the Russian crisis of 1998, and various other slumps.

The concluding Chapter 5, International Adjustments and Political Responses, summarizes what the book might contribute to the fields of international economics, macroeconomics, and related subjects such as international political economy. In addition, Chapter 5 provides suggestions for policymakers — especially how they might minimize the risk of economic crises. The role of the G7, the World Bank, and the IMF are developed, and policy proposals are provided. Chapter 5 also directs attention to the ways that nations might find domestic advantage within the evolving structure of the global economy with domestically driven monetary, fiscal, and trade policies. The conclusions of previous chapters are contrasted with current thinking on the processes of international economic adjustment.

This book is rooted more in the international economics, macroeconomics, and international political economy literature than in other disciplines, but the author hopes that it can be useful to a wide range of social scientists, practitioners, and policymakers. The case studies are not tailored to a particular discipline; instead the author has tried to make them accessible to a wide audience. If the reader has some practical experience in the international economy or some academic training in economics and related
fields, then most of his discussions should be readily accessible. Unlike most scholarly books, there are many citations from periodicals such as *The Wall Street Journal* and *The Economist* in addition to academic references.

Occasionally, as per the more theoretical interest rate parity discussions of Chapter 1, foreign exchange market discussions of Chapter 2, and monetary velocity discussions of Chapter 3, the less academic reader or non-economist reader may want to skip forward. Unfortunately, the more profound and insightful conclusions require these difficult sections, and the reader is encouraged to devote extra time fighting through them. At least to the author sorting out this theoretical material has been well worth the effort — it has gained him many new insights into the globalizing economic system, and it has resolved much of his dissatisfaction with the typical textbooks.

One source of the author's dissatisfaction with the textbooks in international economics, macroeconomics, and related fields is that they typically explain change as an out-of-equilibrium situation which will eventually adjust back to equilibrium based upon traditional, static models. Instead, in the new global economy, economists and others should think of change as something more evolutionary, and even revolutionary. A whole series of related structural changes that are presented in this book have no historical precedent, and they continue to provoke other structural changes.

In the author's view, it is within this context of an evolving global economy that one must attempt to understand recent financial crises and recession. He does not see recent economic crises as stages of typical Keynesian business cycles. Nor does he believe that recent crises are fully explained by the well-researched excesses within free-market capitalist systems or other systems. If these crises could be so rooted in traditional thinking, then typical textbook coverage of them would suffice.

This book elaborates a whole series of related structural changes in the globalizing economy that then might allow the reader a more realistic understanding of recent economic crises.

Chapter 1 presents a structural change which shadows most other recent developments in the international economy: the rapid expansion and globalization of financial markets. This chapter documents and defines financial globalization and discusses what caused it: developments in information-processing technologies; government deregulation; and the more global nature of all economic activity. International interest rate parities and financial strategy parities within 'one-world financial markets' are discussed, including the recent convergence of international debt/equity and price/earnings ratios.

In contrast to traditional economic thinking, Chapter 2 argues that the financial market globalization, interest rate parity, and financial strategy parity processes as discussed in Chapter 1 have caused, rather than
accommodated, large trade imbalances since the 1980s. Proper consideration of these structural changes leads to new conclusions about the international adjustment mechanisms and key variables that affect trade and investment flows. Increasingly, the nation should not be seen as a self-sufficient or ‘balanced’ economic region. Identifying exactly what is meant by ‘trade’ versus ‘investment’ in the new global economy also leads to some interesting conclusions.

In Chapter 2 typical trade protectionism is shown to be increasingly impractical because: trade deficits are now required by countries which, due to interest rate and financial strategy parity conditions, receive a net capital inflow; rising imports as a share of national purchases are increasing the national welfare cost of using trade protectionism; increases in international joint business venture activity and overseas production are making it less likely that trade protectionism will achieve the desired income transfers; and the increase in international ownership of once national corporations is also making it less likely that trade protectionism will achieve the desired income transfers.

Chapter 3 argues that the expansion and globalization of financial markets as discussed in Chapter 1 has in turn altered the use of money in the international economy. Proportionally more money has been used to accommodate the fast growth of financial markets and proportionally less money has been available for non-financial or GDP purposes. Stated in terms of the famous quantity equation, the income velocity of money has declined from its historic trend. Explosions of financial activity lead to increased demands for money balances for financial market participation and less of the available money supply facilitates the production and sale of GDP. This recent absorption of money for financial market purposes is not generally accepted by the economics profession, but it is demonstrated in Chapter 3. If central bankers do not accommodate this extra demand for money for financial market participation by increasing money supplies, then a ‘money-liquidity crisis’ can result and increase the risk of economic crises.

The author quantifies the profitability of financial versus non-financial market activity in Chapter 3 by introducing ‘financial market turnover’ as a significant new variable into monetary policy research. His builds upon his previous research (Allen, 1989), and his regression analysis appears in the Appendix to Chapter 3. International flows of capital also prove to be helpful in identifying which regions of the global economy are experiencing lower relative profitability, and therefore which regions are more likely to experience financial crises and recession.

Also in Chapter 3, ‘the recent history of money and wealth’ is presented, which includes case studies of the Great Depression, the recent rise of ‘offshore financial markets’, and an assessment of how monetary wealth is
currently being created and transferred across the global economy. In contrast to mainstream economic thinking, the author demonstrates that new money forms, new payment systems, and the labor of financial operators in ‘one-world financial markets’ can create, destroy and transfer wealth independently of the real economic activity that is occurring in non-financial markets. Changing perceptions and expectations of underlying wealth or value in ‘real’ economic activity has always provoked chaotic and unpredictable repackaging of this value in financial markets, but value has none the less been thought to flow from the real economic activity. However, the author argues that wealth can be created, destroyed, and transferred independently of what is even perceived to be happening in non-financial markets.

Chapter 4 presents the case studies of recent financial crises and recession, and finds common patterns. Typically a country or region initially experiences a financial liberalization phase. The financial sector expands as it captures profit from new efficiencies and opportunities allowed by globalization. The country or region, for a time, may be favored by international investors; thus the banking system, including government, is well-capitalized and able to expand money-liquidity. Assets increase in monetary value and interest rates are low, and consumption, borrowing, business investment, and government spending are encouraged. Productive resources are more fully utilized and economic growth is well supported. There is a ‘boom’, as measured by increased (a) monetary wealth held by private and public sectors of an economy, such as the value of stocks, real estate, currency reserves, etc., and/or (b) the current production of merchandise and services (GDP). In this financial liberalization phase, excessive, risky speculation and investment is sometimes encouraged by the notion that ‘if I fail, a lender of last resort or government institution will bail me out’, i.e. the ‘moral hazard problem’.

Then, typically, the supply of base money (m) times its rate of circulation or velocity for GDP purposes (v) contracts, and therefore so does the equivalent nominal GDP. The decline in nominal GDP is usually split between its two components, real GDP which is the volume of current production measured in constant prices (q), and the GDP price level (p). By definition, the quantity equation requires (m x v = p x q). When (q) declines for a sustained period (typically at least six months) we call it a recession, and when (p) declines we call it deflation. After this process starts, monetary policymakers may react by rapidly expanding (m), but this action may be too little too late — individuals and institutions may have unpayable debts, banks may even be failing, and international confidence in the country or region may already be damaged. A weak financial system may be unable to maintain the circulation rate of secure currencies for productive activities,
especially if people are hoarding money. An unsecured domestic currency may lose much of its value in undesirable episodes of inflation and depreciation.

The initial contraction in ‘effective money’ \( (m \times v) \) may be caused by monetary authorities or national and international investors draining money \( (m) \) from the country or region, or there may be a decline in \( (v) \) for reasons having to do with the inability of the financial system to direct money toward productive activities. A contraction in effective money supplies or withdrawal of international investment may undermine equity markets, debt markets, bank capital, or government reserves, and monetary wealth is then revalued downwards. General economic or political uncertainty worsens the situation — the resulting austerity mentality causes a contraction of spending and credit, and an increased ‘risk premium’ attached to business activity scares away investment. Interest rates rise, the demand for quasi-money and credit — i.e. the desire to hold and use the insecure ‘monetary float’ — declines and people try to convert the monetary float into more secure base money such as cash. No reserve-currency banking system is able to cover all of its monetary float with secure bank reserves if customers try to redeem all of the float at once, and thus ‘runs’ on banks can destroy the banks. A deteriorated banking sector may be unable to honor its deposits, bad loan problems surface and a ‘lender of last resort’ such as the International Monetary Fund (IMF) may need to be found.

The author would call these types of episodes (a) a ‘financial crisis’ if there is a significant decline in monetary wealth held by private and public sectors, and/or (b) a ‘recession’ if there is a significant decline in real GDP.

Based upon these processes and the discussions of Chapters 1–4, in this Second Edition the author outlines ‘a new political economy of money’ (Chapter 5). Essentially, he finds that financial markets can redistribute wealth and redirect production and consumption intensities somewhat independently of what is initially happening, or even perceived to be happening, in the ‘real’ economy. This finding, not accepted by either mainstream or Marxist economics, can nevertheless account for what the mainstream has understood as ‘business cycles’ or ‘debt-deflation’ and what Marxists have understood as crises of ‘underconsumption’, ‘overproduction’, and ‘disproportionality’.

Following up on some recent developments in the international political economy literature, the author's new political economy of money treats money, stocks, and other pecuniary assets as ‘wealth’ in the sense that they give the holder a claim on the social product. Monetary wealth is understood not only as consumption power and production power, but also as the power to direct and control large social processes. The accumulation of monetary assets, or what Marxists would call the accumulation of finance capital,
represents a social-power-claim that becomes a key driver in the evolution of the world system. Reversing Marx’s causality, it is sometimes true that autonomous (even transcendental) financial processes drive the physical (empirical) relations of production. Once monetary capital is understood as ownership claims over the entire social product, then its growth is limited only by the degree to which ‘differential power’ can be gained in the world system.

As part of this process, Chapter 3 documents the fact that central banks and other financial market participants can (usually haphazardly) increase or reduce not only nominal but also real monetary wealth, and therefore real social power, independently of any initial changes in the production of GDP, perceived rates of return on investment, or other ‘real’ economic prospects. These types of wealth revaluations and transfers have occurred especially across the wide spaces of the global economy.

Also playing a role in this process, as confirmed by the author’s econometric work in Chapter 3 (updated since the first edition), is the ability of financial markets to ‘absorb’ money so that the money is not contemporaneously available to support the ‘real economy’. Perhaps this absorbed money-power is used at a later date to command production, consumption, or other social processes, or perhaps it is destroyed in an economic crisis before its title-holders can exert the differential power which it represents. Thus, claims on the social product can be revalued and transferred over time as well as space. Depending on the magnitudes of the revaluations and transfers of monetary wealth over (how much) time and space, serious real effects can be produced over time and space, i.e. monetary wealth is not neutral.

Based on these processes, and as demonstrated in case studies, this Second Edition shows that the US and the rest of the ‘hard-currency-core’ of the global economy benefit from what the author would call ‘money-mercantilism’ at the expense of the ‘soft-currency-periphery’. Because of the way that the international monetary system currently works with the US dollar as the dominant reserve currency, over time various monetary-wealth transfers from the periphery to the core have occurred independently of any other inherent instabilities in the global economy.

In present-day money-mercantilist US, economic growth might thus be significantly driven by a ‘thickening’ and ‘commodification’ of domestic markets as social agreements and institutions allow foreign and newly-created domestic monetary wealth to be spent domestically. Following this pattern, in the 1990s the US economy boomed ahead with unexpectedly great work-force participation and ‘stressed-out’ industriousness despite no obvious initiating increase in the inherent per-hour productivity of the average worker.