

Consumerism, Inequality, and Globalization¹

Abstract: This paper examines the following issues: To what extent are U.S. merchandise trade deficits explained by over-consumption (or under-saving) by U.S.A. consumers? Second, did the U.S. household sector become increasingly reliant on foreign saving to indulge its borrowing habits over the past decade? With respect to the former issue, the argument is made that the U.S. trade deficit was a predictable result of the relocation of manufacturing to low-wage countries by U.S.-based corporations, as well as the integration of culturally heterogeneous nations in a global trading system. In regard to the argument that trade deficits are explained by cross-national differences in saving rates, the claim is made that it is more accurate to state that variations in saving rates between countries originate from several of the same causes that produce trade imbalances (JEL E12, E21, F41).

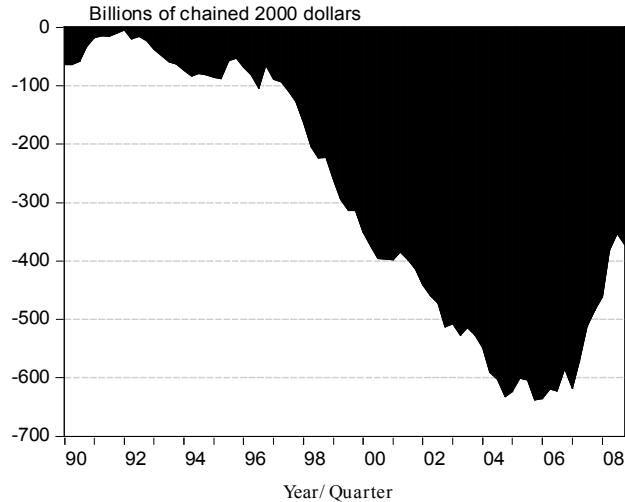
The term “globalization” is invoked in connection with a variety of phenomena. These include the expanding scale of international trade in merchandise and services, the removal of barriers to the transnational movement of resources and financial capital, as well as the relocation of production activity to so-called less developed countries (LDCs). This paper will be concerned first of all with appraising the view that persistent U.S. trade deficits are largely explained by “overconsumption” or, equivalently, a shortage of saving by U.S. households. The implications of globalization, and more specifically with what is commonly called the global dis-integration of production, for inequality and household saving within the industrialized nations, is also examined. The argument is made that rising economic inequality, the household debt surge, and the decline of household saving in the 1994-2007 period was closely connected to the far-reaching push by U.S.-based corporations to improve earnings by shifting production to LDCs.

I have argued elsewhere (see Brown 2007) that the surprising muscularity of the U.S. consumer is partly the result of financial innovations and practices that have effectively shifted the demand for household IOUs. Given that a substantial fraction of new securities backed by credit card, installment, student loan, home equity, or other consumer receivables are placed in foreign-owned portfolios, is it accurate to claim (as some have) that U.S. lifestyles are somehow underpinned or enabled by the comparatively stronger habits of thrift which prevail among

¹ Christopher Brown, Arkansas State University, P.O. Box 729, State university, AR 72467, cbrown@astate.edu. This paper is for presentation at the Association for Institutional Thought annual meeting, April 19, 2009 in Albuquerque. It is based on Chapter 7 of *Inequality, Consumer Credit, and the Saving Puzzle*, Cheltenham, UK: Edward Elgar, 2008, ISBN 978-1-84720-509-4.

the peoples of its major trading partners? A basic principle of Post Keynesian economics is that, so long as reserve production capacity and sophisticated financial institutions are present, income does not impose a hard constraint on spending. This must be true, or how could spending grow? Implicit in the view that deficit spending (negative saving) of the household sector in one nation is impossible without voluntary

Figure 1: Net Exports of the United States



Source: Bureau of Economic Analysis

abstinence in other nations is the belief that global effective demand is limited by global income. Our task is to explain why foreign saving *per se* has little to do with the pace of domestic credit expansion. At the same time, decisions with respect to the allocation of foreign portfolio capital (or accumulated saving) can and do have a significant impact on local credit conditions.

The transition of the United States to debtor nation status raises a number of concerns. There is considerable support for the view that, in the aftermath of a sustained run of capital account surpluses, the preference of foreign-based wealth controllers for dollar-denominated financial assets has assumed enlarged power to influence domestic credit (and economic) conditions. Thus a discussion of the potential fallout in the consumer credit industry arising from a flight from the dollar is in order.

Consumerism and the Trade Deficit

The issues of the causes, consequences, and sustainability of ballooning U.S. current account deficits (1) have produced a voluminous literature.² Olivier Blanchard recently wrote the following about the U.S. trade deficit:

I believe that there is now a broad consensus about the following proximate causes: first, low U.S. saving, reflecting primarily low private saving, but also budget deficits; second, high foreign saving, particularly for Asia; third, low foreign investment, in both Europe and Asia; and fourth, a strong preference for U.S. over foreign assets (Blanchard 2007, 198).

While Blanchard's comments imply that trade imbalances can be largely explained by cross-national differences in saving rates, we shall argue that it is more accurate to state that variations in saving rates between countries originate from several of the same causes that produce trade imbalances.³

The common use of goods as a system of communication about class is a salient feature of consumerist societies. Consumerism should be understood as a social or cultural accommodation to exigencies of big business and, indirectly, to the share and bondholding classes. Consumerism is a cultural manifestation of a particular form of material provisioning—one in which (private) capital (and other resources) may be withheld from use and the continuous recycling of income receipts for the purchase of producibles provides the best insurance against it. Its relative importance depends on a number of economic and non-economic factors. The strength of old habits and institutions in forestalling the movement to more unadulterated forms of consumerism will vary according to time and place. Thus at any given point in time the world consists of societies

² See, for example, Hubbard (2006), Roubini (2006), Mann (2002), Feenstra (2001), Cooper (2001), and Hervey, Merkel, and Loula (2000).

³ It is noteworthy that Blanchard failed to mention "currency misalignment." We can take it as a tacit acknowledgment by a responsible economist that a revaluation of the dollar is not likely to help the U.S. situation very much—even if trade theory textbooks tell us it should. After all, Treasury Secretary James Baker's "talk down the dollar" campaign of 1986-87, informed as it was by the view that currency realignment is the corrective for trade imbalances, proved wholly ineffective. The persistence of trade imbalances in the post-Bretton Woods era of flexible, market-determined exchange rates has driven home the reality that the Marshall-Lerner (upon which the Classical adjustment process rests) are rarely met in practice. The Marshall-Lerner principle states that for a change in the exchange rate to improve a country's balance of trade, the sum of the price elasticities of demand for exports and imports must exceed unity. If this condition is not met, then a devaluation of the domestic currency can actually cause an *increase* in the trade deficit. See Appleyard and Field (1986) for further explanation.

exhibiting lesser or greater degrees of consumerism, as measured by objective criteria such as the saving rate, per capita consumer debt, or cars per household. The integration of culturally heterogeneous societies in a global trading system raises a number of important questions. For example, do current trade regimes allow nations with poorly developed consumption sectors to “free ride” on those nations that do?

The constitution of a social unit capable of generating the kind of unflinching expenditure levels required to keep corporatism flourishing does not happen automatically, and should not be taken for granted. It requires first of all the emergence of institutions that facilitate a somewhat level distribution of liquid claims to goods across individuals, households, or social classes. The assertion that a robust market for mass-produced consumer items cannot emerge out of conditions of extreme income skewness will find no disconfirmation in the historical record. The onset of the American Age of Affluence (Galbraith 1958) was, not coincidentally, contemporaneous with the arrival of a bona fide middle class. It is certainly true that the shared prosperity of the 1950s and 60s was enabled by improvements in technology, infrastructure, business organization, and education. However, the appearance of a vast and prosperous middle class had its origins in social and political movements that aimed to alter the balance of power between labor and capital.

Institutionalists (and Post Keynesians) reject the standard (marginal productivity) theory of income distribution.⁴ Observed income disparities do *not*, according to the institutionalist view, arise from differential contributions to value at the margin of production.⁵ Rather, such disparities emerge from

⁴ See Peach (1994) and Brown (2005). The critiques of Pierra Sraffa (1951, 1960) and Joan Robinson (1953-1954) will be known to some readers. They showed that it was not possible to find an index number measuring capital *independent* of (or without prior knowledge of) the distribution of income between wages and profits. G.C. Harcourt noted that “such independence is necessary if we are to construct an iso-product curve showing the different quantities of labor and capital which produce a given level of national output The slope of this curve plays a key part in the determination of relative prices of capital and labor and therefore of factor rewards. However, the curve cannot be constructed and the slope measured unless the prices it is intended to determine are known beforehand” (Harcourt 1969, 371).

⁵ That is not to say that “market forces” are unimportant in establishing compensation levels for fast food cooks, nurses, machinists, football coaches, website designers, cotton farmers, or business executives. Markets are socially-approved, mutually-understood practices or working rules that regulate exchange. Yvngve Ramstad explained that “the ‘price mechanism’ is mentally inseparable from the *instituted* working rules of which it is but an active description. Indeed, without an understanding of the specific rules themselves, one cannot understand how the ‘mechanism’ functions” (Ramstad 2001, 258-259). Working rules “operate by placing certain limits or by opening up certain enlargements for the choices and powers of the individuals, who are parties to the transactions” (Commons 1924, 68).

institutionally-rooted asymmetries in the distribution of political and economic power. These asymmetries spring mainly from the concentration of control over property, as well as the nature of modern property rights.

Power is the capacity to give effect to the will and, importantly, to prevail against those with opposing wills. A contest of wills usually turns on which party is best positioned to sustain (actual or potential) injuries that other parties may inflict upon it. Property confers the privilege to *withhold*. With the rise of the public ownership, and the systematic replacement of markets with organizational hierarchies, property morphed into a shape quite unlike anything found in the writings of John Locke. Its domain is now coextensive with production systems, the continuous operation upon which a great number of jobs depend. Absentee ownership, vertical integration, horizontal consolidation—while these innovations may have been beneficial in terms of expanded production possibilities, they also delivered fearsome powers of coercion to the controllers of business enterprises (and, by extension, to the shareholder class) vis-à-vis labor. That the actual or potential loss of employment or livelihood is a potent despoiler of labor truculence has shown forth time and again. An equable, and macro-efficient, division of the material gains arising from the new methods of economic organization was only achieved after society took protective measures against the coercive powers of big business.

Social technologies such as collective bargaining, the closed shop, and legalized strikes are of equal importance to innovations such as continuous process manufacturing in explaining broad-based improvements in material welfare. Reforms of the working rules applicable to labor market transactions did, in many cases, eradicate the gross power disparities indicative of the wage bargain and thus were vital in making the fruits of modern capitalism obtainable for working people. These reforms were not achieved without a protracted and violent struggle, however. What is too often overlooked is the critical importance of labor legislation and unionism in bringing forth a macro-efficient division of income receipts—efficient in the sense of facilitating the return of income receipts to the expenditure stream.

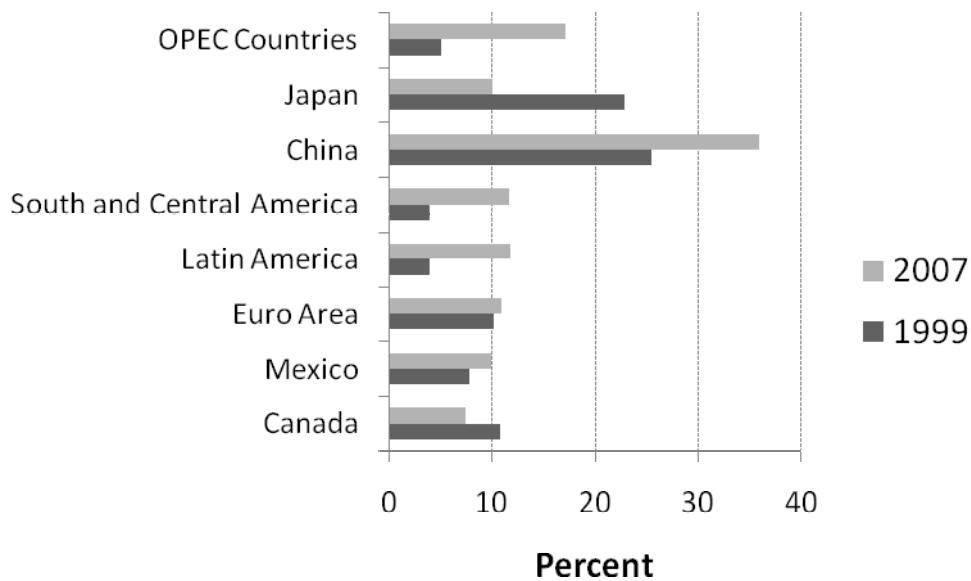
Trade deficits occur when agents affiliated with surplus nations withhold liquid claims to goods earned through exports from the purchase of foreign-made goods and services. Surplus nations such as Japan and China purchase dollar-denominated financial assets, an activity often described in financial press as “financing the U.S. trade deficit” (we will subsequently explain why this idea harbors a fundamental misunderstanding of trade deficits). What is often

missed is the fact that if surplus countries had exercised liquid claims to buy U.S. made goods, instead of dollar-denominated debt and equity, there would be no trade deficit to begin with. That is, the U.S. would not have experienced the kind of massive current account deficits seen in the new millennium if agents based in its principal trading partners had exhibited a greater preference for Chevrolets, Budweiser, Disney entertainment, and Arkansas long grain rice, and a lesser preference for Treasury bills, mortgage-backed securities, or Wal-Mart shares. Viewed in the framework of utility theory, foreign-based agents with the wherewithal to purchase U.S.-made goods and services evidently judge themselves better off by holding intangible, liquid assets instead. However, as Keynes was at pains to point out, a ravenous appetite for non-producible assets can exert a major drag on effective demand.

Blanchard (2007, 193) has noted that “[t]oday’s current account deficits are . . . quite different from their predecessors. The countries in deficit are rich countries.” The annualized U.S. current account deficit through the first three quarters of 2007 was \$803 billion—a record high both in absolute terms and as a percent of GDP. Figure 2 reveals that slightly less than 40 percent of the deficit in merchandise and services is accounted for by two less developed countries—China and Mexico. These nations are similar in important respects. Both feature extreme economic inequality, extensive poverty, vast reserve armies of cheap labor, and powerful, cohesive, authoritarian, and fabulously wealthy elite political castes. Moreover, both countries serve as low-cost manufacturing platforms for transnational corporations that realize the bulk of their revenues from sales in high income (developed) countries.

It is not a simple matter to conceptualize the circumstances under which the disposition of income receipts earned from export activity to purchase financial assets, as opposed to foreign-made goods or services, is welfare improving. This would seem to be particularly true in the case of impoverished nations where the use of hard currency to procure tangible things (like infrastructure or medicines) holds the potential to improve so many lives. Which begs the question: Why have trading partners such as China accumulated vast stores of dollar-denominated financial assets? There are at least four possible explanations: (1) to manage the lack of perfect coordination

Figure 2: Percent of U.S. Trade Deficit Accounted for by Selected Countries/Areas



between cash inflows and outflows arising from international transactions; (2) to protect the domestic currency against speculative attack; (3) a large share of national income has been allocated to a political/economic elite characterized by a high propensity to save and a strong preference for securities dominated in foreign currencies; and (4) government policy which leverages reserve holdings to gain power and influence, whether domestically or versus foreign governments.

With respect to point (1) above, Davidson has written that:

Once uncertainty and the impossibility of perfect coordination of cash inflows and outflows is recognized as inherent characteristics of all trading relations, it is obvious that an increase in international reserve holdings (liquidity) becomes a necessary condition for expanding trade (Davidson 2002, 166).

China's current account transactions with the U.S. increased about three-fold between 2000 and 2006 (from \$118 to \$344 billion), but its holding of U.S. securities multiplied nearly nine-fold (\$92 to \$809 billion) in the same period.⁶

⁶ The trade data are taken from the U.S. International Trade Commission. Data on Chinese dollar holdings are taken from the U.S. Treasury, Foreign Holdings of U.S. Long-Term Securities, March 31, 2000 and June 30, 2006.

Dollar reserves controlled by the State Administration of Foreign Exchange (the Chinese central bank) amounted to \$1,455 billion in October 2007. There is simply no basis for believing that the need for reserves to manage trade-related cash flow problems should rise more than proportionately to the scale of trade. As such, the main factors underpinning the dollar reserve buildup must fall into one or more of the other categories delineated above.

The “impossible trinity” pertains to the futility of attempts by nation-states to simultaneously maintain a fixed exchange rate, economic policy autonomy, and the free movement of foreign portfolio capital into and out of assets denominated in the home currency (capital mobility).⁷ It is possible to pursue any combination of two out of three objectives, however. Intent on attracting foreign investment, and in some cases bowing to pressure brought by the international agencies such as the International Monetary Fund (whose policy advice/dictates to client states followed the “Washington consensus”), many nations of the developing world refrained from imposing effective controls on (financial) capital mobility.⁸ This choice left some nations vulnerable to “capital flight” or the risk of a sudden exit of the global portfolio management community from the local currency. The devastating effects of “hot money” were felt in the case of the Mexican peso, which came under speculative attack in late 1994, and later during the Asian crisis of 1997-1998, which saw a precipitous decline in the values of the Korean won, the Malaysian ringgit, the Thai baht, and other currencies.⁹

The necessary conditions for capital flight are: (1) the absence of capital controls; and (2) extensive foreign ownership of domestic securities. If both conditions hold, it makes sense from a policy point of view to maintain large foreign currency reserves that can be deployed as needed to neutralize capital outflows. But neither conditions (1) nor (2) is met in the case of China. In fact, China “maintains extensive controls extensive control over portfolio investment, including equities, bonds, bank loans, currencies, commodities, and derivative instruments” (Hu 2005, 359). Moreover, China is interested in controlling hot money mainly because it threatens to drive to value of the renmibi *above* its longstanding government peg against the dollar (¥ 8.276-8.28 to \$1). Many have argued that the renmibi is artificially, and substantially, undervalued against the

⁷ Ostfeld and Taylor (1998) alternatively refer to it as the “open economy trilemma.” See Rodrik (2000) for a good explanation.

⁸ For a critique of the Washington consensus, see Stiglitz (2002).

⁹ Mexican President Zedillo’s decision to devalue the peso in October 1994 apparently provoked a run on peso denominated assets, The peso lost 40 percent of its value against the dollar in the first three months of 1995. The ringgit price of the U.S. dollar rose from 2.5 to 4.4 ringgets between July 1997 and February 1998. The won and baht suffered similar declines.

dollar, the pound, and the euro. Nearly everyone agrees that a relaxation of capital controls would, in the short term at least, cause a major *upward* revaluation of the Chinese currency. In summary, the argument that China must maintain immense dollar reserves as a safeguard against currency speculation does not stand up to scrutiny.

China, with its explosive income growth and vast population, would seem a potential gold mine for suppliers of consumer goods and services. But the efforts of U.S. based companies to find markets in China have up to now yielded mostly disappointment. China joined the World Trade Organization (WTO) in December 2001, so exporters are no longer required to deal through designated national trading companies. Daunting bureaucratic and logistical obstacles remain. U.S. trade officials bemoan difficulties encountered by U.S. firms in obtaining distribution licenses from Chinese government. There is also the well-publicized issue of intellectual property theft.¹⁰

Even if nontariff barriers were diminished and intellectual property rights were enforced, are lucrative Chinese consumer markets there to be tapped? Western businessmen regularly complain about the meager spending power of the Chinese consumer. The Chinese consumer faces a “hard” budget constraint due to the poor development of (formal) consumer lending institutions. The improvement in market robustness that might have been expected in light of sustained double-digit growth rates of real output has thus far not materialized. The lamentable fact about the Chinese economic boom is the limited extent to which the majority of its peoples have benefitted from it. In terms of forging a truly broad-based consumerism, the Chinese economic miracle has been a failure. The big winners are coteries of political officials, their families, or entrepreneurs possessed of the good *guanxi* necessary to thrive in the Chinese system. The income streams generated by China’s awesome manufacturing platform accrue in large share to a comparatively tiny, spectacularly rich, and parsimonious slice of society—a factor that goes some distance in explaining the inchoate status of its consumer markets.

Chinese officials must believe there are advantages in accumulating foreign credit balances; otherwise a larger share of these balances (accumulated through trade surpluses) would be spent for imports or foreign direct investment.

¹⁰ Dollar estimates of the loss of revenue by U.S. companies due to pirating vary. U.S. Trade representative Robert Portman estimated that U.S. losses from piracy of copyrighted materials ranged between \$2.5 billion and \$3.8 billion annually. In addition, U.S. Customs and Border Protection seized \$134 million of Chinese knockoffs of trademarked goods, such as brand-name batteries, pharmaceuticals and auto parts of such Chinese products at U.S. ports in 2004 (reported in Sparsshot 2005, p. 1) The Motion Picture Association claims that movie pirating in China costs the big studios to almost \$300 million a year (reported in Hernandez 2005, p. 1).

Ironically, the Communist party has metamorphosed into a twenty-first century *rentier*. The Chinese central bank is one of the largest single holders of U.S. Treasury securities (\$396 billion in September 2007). The party has lately sought to diversify its asset holdings away from Treasuries by constituting a sovereign wealth fund (an entity that aims to improve returns on foreign currency reserve holdings through the purchase of a range of assets including equities).¹¹

The Chinese regime has profited greatly by its open access to the great engine of effective demand that is the U.S. household sector. At the same time, China, by seeking a “resting place for savings other than reproducible assets” (Hahn 1977, 31) contributes to U.S. unemployment. The U.S. body politic should not allow this situation to continue indefinitely. A new set of trading rules should be evolved that make surplus countries responsible for correcting trade imbalances. Mechanisms should be developed which create incentives for creditor nations to disgorge of excessive foreign reserve balances.¹² Some will object that any action to force China to reduce its international reserves will have deleterious effects on U.S. securities prices and perhaps jeopardize the status of dollar as international reserve currency. Given the immense size of Chinese dollar holdings, these fears are well-founded. To avoid this possibility, no sanctions should be imposed on reserve balances accumulated prior to the date when the new rules become effective. It is difficult to envision how the majority of Chinese people are not made better off by a policy that puts constraints on the ability of its leaders to withhold the spending power that its people have earned.

Consumerism, for all its distastefulness, its harmful psychological, social, and environmental effects, does keep the factories humming and the malls flourishing. The view that U.S. trade deficits result from “overconsumption” fails to acknowledge that, if not for the overspent American, the gap between the world’s production possibilities and its actual production would be greater than it already is.¹³ That is, the U.S. consumer is doing the job that surplus countries

¹¹ See Sasso (2007).

¹² This recommendation borrows from the “trigger mechanism” proposal of Paul Davidson. Under his proposal, trading nations are organized into “clearing unions.” Surplus countries can spend excessive credits (that is, foreign reserves deemed excessive by clearing union members) in three ways (imports, direct foreign direct investment, or unilateral transfers) or else face a 100 percent tax on excessive reserve holdings, the proceeds of which would be used to adjust current account balances via a unilateral transfer to deficit countries. “The important thing is to make sure that continual oversaving by surplus nations in the form of international liquid reserves is not permitted to unleash depressionary forces and/or a building up of international debts so encumbering as to impoverish the global economy of the twenty-first century”(Davidson 2002, 234).

¹³ An *Economist* editorial recently blamed the U.S. trade deficit on “American profligacy” (*Economist*, May 19, 2007, 9).

are failing to do. At the same time, some of the institutions that make a vibrant consumerism sustainable have been severely eroded in the past three decades and stand in need of major repair.

Off-Shoring and Domestic Income Inequality

The increased openness of the U.S. economy (as measured by the increase in the sum of imports and exports relative to GDP) is a major factor in explaining structural changes of employment within the country—most importantly the loss (both in absolute terms and relative to total employment) of manufacturing jobs. Even the most ardent defenders of free trade do not dispute the fact that the flood of imported autos and parts, consumer electronics, machine tools, cameras, heating and cooling equipment, computers, apparel and shoes, toys, and other goods is implicated in the elimination of hundreds of thousands of well-paying domestic manufacturing jobs. And, as Blanchard (2007, 37) has noted: “Traditional concerns about the impact of trade on blue collar manufacturing industries have evolved to new concerns about the impact of off-shoring on high-tech services that have previously been considered less-susceptible.” United Airlines planes now receive routine maintenance in China. Indian software engineers do extensive work for Microsoft at wages far below those received by their counterparts in Redmond, WA. Tax preparers now face cut-throat competition from tax preparation outsourcing centers located in India.¹⁴

On the other side of the equation, growth of employment in export-related industries in the U.S. has grown substantially. Moreover, the record on total job creation in the U.S. is very good (especially when compared with European countries)—trade deficits notwithstanding. Enough jobs have been created to more than replace those lost due to trade. The question remains: How does the average quality of new jobs compare with those lost due to globalization/off-shoring? The evidence supports the view that, although globalization has created remunerative opportunities for many entrepreneurs and those owning a range of specialized skills, the overall effect of global economic integration on the quality of U.S. jobs has been negative. In fact, the evidence is consistent with the view that global economic integration has contributed mightily to the ‘hollowing out’ or loss of density of the U.S. distribution function.¹⁵

¹⁴ Other examples can be found in Thomas Friedman (2005).

¹⁵ A 1996 report of the council of economic Advisors conceded that “trade may have some adverse impact on wage inequality” (Council of Economic Advisors 1996, 232). A widely-cited empirical paper by Ravegna reported “significant effects of import penetration on both

The mushrooming U.S. trade deficit is partly the efflux of a transformation in the vertical structure of U.S.-based firms. The factors underpinning this transformation include: (1) a decrease in international shipping costs, largely due to the innovation of containerization¹⁶; (2) higher quality, cheaper telecommunications; (3) trade agreements which permit U.S. companies to export equipment and materials to offshore locations for manufacturing or assembly and then re-export products (typically back to the originating country) that are subject to tariffs only on the value-added component; (3) systems which tie the compensation of top corporate officials to share prices (“value-based” compensation) and thereby establish powerful incentives to reduce costs/improve margins through the relocation of production offshore; and (4) pressures on vendors reliant on dominant distribution channels such as Wal-Mart to conform to the “China price.”¹⁷

The global dis-integration of production by U.S. corporations is evidenced by the shifting composition of traded goods—specifically, the increased share of total trade flows accounted for by *intermediate* goods as well as the increase in imports of manufactured goods from developing countries. The growth of U.S. trade deficit is in good measure the manifestation of a broad-based drive by corporations to take cost out of supply chains by the relocation of production abroad—either through direct foreign investment or through partnerships with foreign-based manufacturers.¹⁸ Off-shoring (the practice of shifting of

employment and wages in manufacturing” (Ravegna 1992, 256). Bivens (2007) estimates that “In 2006, the impact of trade flows increased the inequality of earnings by roughly 7%, with the resulting loss to a representative household (two earners making the median wage and working the average amount of (household) hours each year) reaching more than \$2,000.” Also see Freeman (1995), Richardson (1995) and Wood (1998).

¹⁶ Containerization is a system of intermodal cargo transport using isocontainers that can be loaded intact into container ships, railroad cars, planes, and trucks. Herod (1998, 181) writes that “loading 11,000 tons of cargo might take a total of 10,585 [work] hours. Containerization allows for the same tonnage to be loaded with 546 work hours.”

¹⁷ Robert Scott (2007) writes that “Wal-Mart accounted for approximately 9.3% of total U.S. imports from China between 2001 and 2006. This estimate is based on widely reported statistics, including Wal-Mart’s own estimates of its imports from China. U.S. imports from China increased \$185 billion between 2001 and 2006. . . . Wal-Mart’s imports increased from \$9.5 billion in 2001 to \$26.7 billion in 2006, an increase of \$17.2 billion (181%) As they are a retailer and not a manufacturer, Wal-Mart exports only a negligible amount to China, accounting for at most 0.2% of total U.S. exports to China.”

¹⁸ A distinction is to be made between “market seeking” production relocation which “involves a replication of production capacity in the foreign location, presumably for sales there” and “efficiency seeking” offshoring, which means the shifting of activity offshore “with the aim of lowering costs” (Millberg 2004, 45).

manufacturing and service activities to foreign-based affiliates or unaffiliated firms) is economically efficient because the resulting cost saving (from lower wages, profit taxes, or reduced regulatory compliance costs) more than offset tariffs or transportation costs.

The relocation of production by U.S. firms to Mexican maquiladoras, Saipan, or China's Guangdong province has reshaped the personal distribution of domestic income by way of effects both direct and indirect. The permanent loss of good-paying jobs has shoved a significant fraction of the labor force away from the center of what was once a more densely compacted income distribution function (the statistical representation of the middle class). Job losers have frequently seen their economic status decline—even when they have found new employment. One study reported that during the 1980s and 90s, 65 percent of manufacturing workings displaced by trade were employed two years later. However, most took a pay cut. A quarter of these workers suffered pay losses of 30 percent or more.¹⁹ Concurrently, executive pay soared.²⁰

The validity of NAIRU hypothesis became increasingly tenuous through the 1990s as the unemployment rate fell well below levels that many of its advocates felt certain would trigger a price spiral, but no such development occurred.²¹ In fact, unit labor cost remained remarkably stable (1.4 percent average annual growth) as the unemployment rate fell from a peak of 7.8 percent in 1992 to 4.2 percent in 1999.²² One factor explaining this “nonconformity” is obviously strong productivity growth (private sector labor productivity grew at an impressive 2.31 percent annual rate between 1995-1999).²³ However, a significant factor restraining wage growth was a loss of job security experienced by workers in occupations vulnerable to cross-border relocation. In case after case, employees (both blue *and* white collar) have seen their bargaining power denuded—even when they have been able to retain their jobs. One report told of the experience of workers at Ford Motor's Focus assembly plant in Wayne Michigan. Ford built a sister plant (a virtual duplicate of its Wayne facility) to

¹⁹ See the *Economist*, January 20-26, 2007, 33.

²⁰ The *Economist* observed in a January 20, 2007 editorial that “[i]f you look back 20 years, the total pay of the typical top American manager has increased from roughly 40 times the average—the level for four decades—to 110 times the average now.”

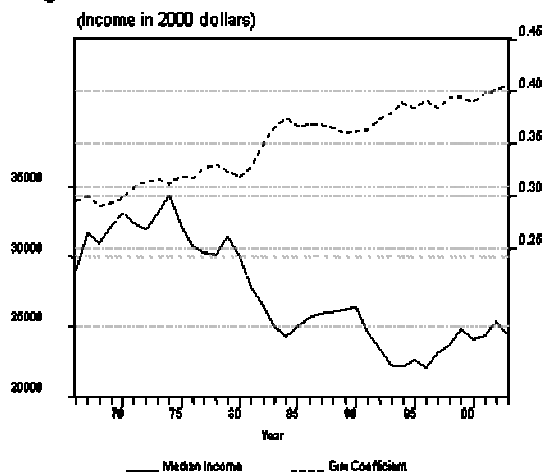
²¹ NAIRU is an acronym for “non-accelerating inflation rate of unemployment.” According to this hypothesis, the inflation rate will tend to accelerate when unemployment falls below a threshold, full-employment level—typically estimated in the range from 5.5 to 6.5 percent.

²² These figures are taken from the *Economic Report of the President*, 2007, Tables B-50 and B-42.

²³ This is according to the *Economic Report of the President*, 2001, Table 1-2.

assemble its Focus model in Hermosilla, Mexico (a maquiladora). With negotiations underway between Ford

Figure 3: Median Income, Gini Coefficient for Males, Ages 22-34



Source: Author's calculations from public use microdata

and the United Auto Workers, employees came to work one day to discover equipment taken from the plant shrink wrapped, stamped “Mexico” in large letters, and loaded on to rail road cars. This type of scenario has played out a countless number of times.

Collective bargaining can produce goods results, at least in terms of employee wages and benefits, when the employer is a dominant firm which enjoys considerable pricing power. A diminution of market power, suffered as a consequence of competition from cheap imports, narrows the discretion of management in the collective bargaining process. Marina Whitman (1999) has written persuasively on the importance of globalism in making the paternalistic corporation extinct.

The deleterious income distribution effects of trade are most evident in the case of young men. With the negative growth of manufacturing jobs, and remaining high-wage manufacturing jobs unavailable due to union seniority rules, a great many young men (especially those without post-secondary education or training) were been forced to settle for low paying service sector jobs. Figure 3 illustrates a “double movement” — a decline in median real incomes coupled with a surge in within-group inequality (as measured by the Gini ratio) for males aged 22-34 years.²⁴ Real median income for this group fell by about 13 percent between 1990 and 1997. A broad consensus formed among

²⁴ For a more detailed look at wage inequality in the U.S., see Gottschalk and Danziger (2005).

labor economists during the 1990s that rising wage inequality resulted from the effects of globalization on the “skill premium” — that is, the differential compensation received by those with more skill (usually measured by education).²⁵ The second wave of dislocations, usually attributed to improvements in worldwide telecommunications, has placed many highly trained workers at risk of job loss—not just telephone solicitors.

Viewed through the Schumpeterian lens, the relocation of production activity to LDC’s by transnational corporations is simply part of the process of creative destruction—a process that, if left unfettered, can bring forth amazing improvements in the quality of life for *all* people. The problem with this view is that it overlooks the vital importance of effective demand. Production relocation is not a strategy to increase profits through product innovation or by increased sales of existing products. Rather, it is an attempt by firms to raise profit margins by squeezing out labor costs. The fallout of such cost-cutting measures by a single firm—even a very large firm—for the economy-wide distribution of income are, of course, negligible. However, given the scale of production relocation or off-shoring by the U.S. business community at large, the cumulative effects are quite extensive.

The negative macroeconomic consequences (including negative effects on *profits*) of sharply rising income inequality failed to surface in the U.S. prior to recession that commenced in December 2007—that is, income inequality was not accompanied by an equivalent surge in consumption inequality. The reason for this is that households have borrowed more heavily than ever before to finance their consumption expenditures. The new, ruthless brand of shareholder capitalism has seriously undermined the viability of institutions that both protect against extreme economic inequality and limit the reliance on credit expansion for consumption growth. One (indirect) repercussion of the aggrandized power of employers is an unsustainable buildup of debt on household balance sheets.

Foreign Saving and Domestic Borrowing

²⁵ Freeman’s view are representative: “Since the U.S. imports that make heavy use of low-skilled labor, and exports goods that make heavy use of high-skilled labor, trade with developing countries reduces the relative demand for less-skilled labor in the U.S.” (Freeman 1995, 23). In contrast, Autor, Katz, and Krueger (1998) argued that computerization shifted the relative demand for college graduates and thus contributed strongly to the widening educational pay differentials.

The issue of the nature and economic significance of saving constitutes a main area of rupture separating Post Keynesianism from the dominant strains of macroeconomic analysis. The standard view holds that: (1) Saving materializes as an effect of acts of volitional abstinence by income recipients; (2) saving is a necessary pre-condition for investment; and (3) saving is the source of finance or “loanable funds.”

Post Keynesians, on the other hand, view saving is a *residual*. The capacity of banking system to provide *finance* (by expanding its liabilities) has, according to this view, nothing to do with the proportion of income saved (not spent) or the saving rate.²⁶ The production of non-consumables such as factories, durable equipment, bridges, or aircraft carriers, must necessarily result in the distribution of a residual income stream that is (at the aggregate level) just sufficient to provide long-term *funding* for non-consumables, a principle condensed in the statement ‘investment creates the saving to fund itself.’

Some have argued that massive U.S. current account deficits are *necessary*, and even welcome, given the insufficiency of domestic saving in relation to the financing or funding needs of domestic households, firms, and government units. Had U.S. investment been constrained by the domestic supply of saving since the great saving shortfall began around 1993, so the argument goes, the pace of capital accumulation actually achieved during the period would have been impossible. A trade deficit gives foreigners the wherewithal to purchase dollar-denominated financial assets—a fact that is reflected in the capital account surplus. Paul Krugman recently commented:

I think we would have more protectionism if it wasn't for the fact that at least the financial community is acutely aware on how much we depend on those treasury purchases by the [Chinese] central bank. We hate the Chinese trade deficit but we love the capital account deficit (quoted in Eliot 2005, 125)

Krugman's reasoning is built on an (implicit) assumption that merits close scrutiny. Specifically, Krugman's comments suggest that, if not for the trade deficit, the total stock of liquid assets available to purchase treasuries (or other dollar-denominated IOUs) would decrease. That is, trade deficits do not merely

²⁶ Keynes wrote that “Saving has no special efficacy, as compared with consumption in releasing cash and restoring liquidity. . . [T]here is, therefore, just as much reason for adding current consumption to the rate of increase of new bank money in reckoning the flow of cash available to provide new ‘finance,’ as there is for added saving” (Keynes 1973, 233).

alter the cross-national distribution of saving but contribute positively to its flow per unit of time. This idea is firmly rooted in the Classical view that aggregate saving is ultimately regulated by volitional abstinence of income recipients. Looked at in this light, trade imbalances act to redistribute income from low saving nations to high saving nations and thus facilitate a higher rate of new investment (or household or public sector borrowing) than could otherwise be achieved.

The standard view may be articulated by use of national income identities. Consider the following national income identity (truism):

$$S + T + M \equiv I + G + X \quad (1)$$

Equation (1) simply states that the sum of the “leakages” (income receipts not spent for final goods in domestic product market— comprised of saving (S), net taxes (T) and imports (M)) into the circular flow of national income and product are *necessarily* equal to the sum of “injections” (expenditures for final goods in domestic product markets other than consumption—including investment (I), Government expenditure minus transfers (G) and exports (X)) to the circular flow. The two sides of equation (7.1) must be equal because of the way in which the various artificial components of the equation are (heuristically) defined.²⁷ Given (1), the following must also be true by definition:

$$S + (M - X) + (T - G) \equiv I \quad (2)$$

Understood in the loanable funds context, there are three sources or pools of saving available to fund investment: private domestic saving (S), public saving ($T - G$) and foreign saving ($X - M$).²⁸ If the public sector is in deficit, it is best to rewrite (2) as follows:

$$S + (M - X) \equiv I + (G - T) \quad (3)$$

If saving is assumed to be determined independent of investment (including public investment), then, by equation (3), an increase in the public sector deficit *must* result in an equivalent decrease in private investment—that is, unless

²⁷ Davidson (2002, 137) reminds us that “[f]or the most part, aggregate income measures can have no meaning other than that assigned to them by aggregate accounting theory. The aggregate (social) accounts do measure conventionally existing items. Rather, they are a way of accounting for particular abstract theoretical concepts.”

²⁸ The loanable funds theory makes no distinction between *finance*—that is, the liquidity necessary to bridge the interval between the disbursement of factor costs and the receipt of income from the sale of output—and funding, defined as the need for capital goods buyers for an “investment fund” for the buyer to make payment to the seller on the delivery date” (Davison 1986, 103).

foreign saving comes to the rescue. The deductive basis of Krugman's statement should now be transparent. Given low domestic saving and surging public borrowing, a mushrooming trade deficit is required to generate a net increase in the stock of unexercised liquid claims to goods (measured by the left hand side of equation (3)) sufficient to absorb the greater flow of public sector IOUs without upsetting the complex of yields—otherwise, investment will be crowded out (and debt servicing costs will soar).

Having outlined the standard view of trade deficits, we must now explain why it is misguided. Aggregate saving is a residual—that is, its value is largely, though not completely, determined by the scale of factor payments distributed for the production of non-consumables.²⁹ Saving in excess of the value of goods produced in the current period but not available for consumption (non-consumables) can be properly called volitional or “discretionary.” Discretionary saving must be matched by (positive) unplanned inventory investment on the right hand side of equation (3).³⁰ Discretionary saving is equal to zero in macroeconomic (but not necessarily full-employment) equilibrium—and so is unplanned inventory investment. The important point is that, so long as producers of investment goods are successful in obtaining finance, and if they are able to gain disposal over real resources, we can be confident that sufficient saving will materialize to provide long-term funding. Moreover, that the capacity of the banking system to accommodate the financing needs of capital goods producers does not depend on the fraction of income saved—because saving, while it alters the distribution of bank deposits across balance sheets, it does not change their total quantity—at least not immediately.

From the principles explicated above we may deduce the following: Trade deficits have *no* direct effect on total saving per unit of time but *do* impinge on the distribution of new (net) liquid claims between domestic and foreign balance sheets. Krugman's position should be modified as follows: The U.S. capital account surplus is *not* a good thing; but at least those countries with negative capital account balances vis-à-vis the U.S. have exhibited a high preference for

²⁹ There is a qualification to this argument in the case of unplanned inventory investment. Production of many capital goods (aircraft, electrical generating equipment, e.g.) is done on a “for contract” basis so that the manufacturer is assured of a sale at the point in time when production begins. Production of consumer items, on the other hand, is mainly “for market” so that firms may, when demand forecasts are inaccurate, accumulate unwanted inventories. Total saving may therefore exceed the amount which is just sufficient to fund all new capital goods produced during the period—a disequilibrium situation that will bring about a change in the scale of output.

³⁰ Note that discretionary saving can also be negative, in which case there is a corresponding amount of unplanned inventory depletion.

dollar-denominated portfolio assets (such as treasuries). China is, for obvious reasons, a valued client of Wall Street. It therefore should come as no surprise that one of society's major power centers has deployed all of its political and opinion-shaping might to deflect criticism about the current state of the U.S.-China economic relations. The idea that trade deficits supply a remedy for a (phantom) domestic saving shortage persists because it serves a powerful vested (and narrow) interest—not because the idea rests on a sound intellectual footing.

Fallout of a Flight from the Dollar

One concern about the trade-induced buildup of external debt (or foreign ownership of dollar-denominated equity) is the possibility of a run on the dollar provoked by the exit of the international community of portfolio controllers from dollar-denominated securities. Discussion on this issue is apparently based on the view that, in terms of the comparative propensity to seek a fast exit from the dollar, a real difference exists between domestic and foreign-based portfolio controllers. The validity of this view is not questioned here. However, it should be pointed out that extensive foreign ownership of debt and equity issued in the home currency is *not* a necessary condition for capital flight. If capital controls are minimal, and if liquid securities markets exist, a quick exit from the domestic currency can develop even if foreign ownership is trivial. The main thing is that there exists a real possibility that portfolio controllers, whether foreign or domestic, will coalesce around the view that U.S. current account deficits are not sustainable and, as such, a major devaluation of the dollar against other major currencies (such as the renmibi, the euro, or the yen) is inevitable.

The worst-case scenario would be the loss of the dollar's post-1914 hegemonic status. Already the euro's share of known official foreign reserves had risen to 26.4 percent in the third quarter of 2006. The dollar's share of known official reserves fell to 63.8 per cent from 66.5 per cent in the same three months of 2006 ³¹, prompting the *Financial Times* to opine that

the primacy of the dollar is no longer to be taken for granted. Should wealth-holders (both foreign and domestic) come to doubt the determination of the Federal Reserve to preserve the dollar's domestic purchasing power, they might dump it, with devastating effects on its external value, long-term US interest rates and the US

³¹ This is according to the International Monetary Fund.

economy (*London Times*, December 27, 2007, 10).

The dollar's vulnerability was revealed on November 7, 2007 when its value spiked downward in reaction to public comments made by a pair of mid-level Chinese officials about the need to diversify China's \$1.4 trillion reserve portfolio away from dollars.³²

Taking into account the structure of the modern consumer credit industry, and in particular the dependence of consumer credit expansion on the capacity of underwriters to find a market for synthetic securities collateralized by household IOUs of all types, the fallout of a flight from the dollar could prove calamitous. Secondary markets for securities backed by consumer, student, and home equity loans are very thin and it takes little selling pressure for one-way markets to develop. The illiquidity of these instruments thus acts as a *de facto* capital control. The problem arises when underwriters attempt to place *new* issues in an environment in which the prices of old issues have reached rock bottom levels.

The subprime crisis furnishes a preview of what can be expected in the event of a full-fledged retreat from the dollar. The write-downs recently taken by Merrill Lynch, USB, Bear Stearns, Goldman Sachs, Barclay's Capital, Citigroup, and other underwriters happened because these firms were carrying large inventories of (subprime) collateralized mortgage obligations when the appetite for new issues abated. The result was the virtual disappearance of subprime lending. Underwriting of subprime mortgages simply stopped altogether. As of January 2008, the effects were being felt in the residential construction industry.

It stands to reason that a quasi-permanent change in the average preference for dollar-denominated securities has the potential to substantially alter the terms on which new, greenback-denominated asset backed securities (ABSs) can be placed. The result is likely to be a U.S. consumer credit crunch of some magnitude. Consumer credit is not so fungible as to be unaffected by the disappearance, in part or in whole, of the primary issue market for ABSs. If the pattern of previous consumer credit crunches (most conspicuously in spring and summer of 1980) is repeated, we can expect the captive finance affiliates such as Ford Motor Credit or Sears Holdings to move aggressively to stabilize the market. The capacity of these units to perform the lender of last resort function on behalf of their parent corporations will depend largely on the market for their

³² The *Economist* (2007) recently reported that "The dollar fell sharply on November 7th [2007] after mid-ranking Chinese officials, not actually responsible for foreign-exchange policy, made remarks that were seized upon by already jittery markets. A Chinese parliamentarian called for his country to diversify its reserves out of 'weak' currencies like the dollar and another official suggested that the dollar's status as a reserve currency was 'shaky'."

own IOUs –including commercial paper backed by consumer receivables. However, the effects of dollar flight are likely to be diffused across asset classes—even gilt-edged issues. The placement of new issues collateralized by household debt on reasonable terms—meaning on terms that would provide a decent profit margin for originators and underwriters—may entail an increased emphasis on credit quality. Thus, it is likely to be the case that individuals with credit scores in the middle and lower ranges will find consumer credit much harder to get, and more expensive, as compared with the halcyon era of 1993-2006.

Concluding Remarks

Wray (2008), Palley (2007) and others have noted the transition of the U.S. economy to “money manager capitalism” (or “financialization”), a crucial dimension of which is a sharp increase in the pace of private sector debt issuance relative to real output. Post Keynesian economists issued repeated warnings in the past decade that the spiraling growth of the private debt to output ratio could not be sustained indefinitely and that a major adjustment was imminent—warnings that looked prescient as the global economy slid into deep recession in the fall and winter of 2008-09.³³ As the process of balance sheet de-leveraging unfolded in classic, Minsky-like fashion, the search for lessons from the crisis gained momentum. A noisy chorus of voices pointed to the evils of debt and living above one’s means—a mindset that completely overlooks the dichotomy (and frequent divergence) between physical production possibilities and effective demand. It appears that the U.S. economy has evolved in a direction where the maintenance of full-employment necessitates that an increasing fraction of aggregate expenditure be debt-financed. I have argued that “debt dependency” is related to the inadequacy of distributive mechanisms in terms of generating aggregate expenditure (Brown 2007).

This paper has pursued the theme that globalism in its present incarnation is implicated in the rise in economic inequality in the U.S. in the past two decades and thus has exacerbated the problem of debt-dependency. The offshore relocation of production activity has destroyed thousands of high-paying manufacturing, technical, and service jobs and corroded the bargaining power of many others who have retained their jobs. Moreover, the tying together of rich and poor nations in a cross-national production system has diminished the macro-efficiency of global income distribution by allocating an increased share of income generated from production to entities (or countries) which have a

³³ For example, see Godley (1999), Parenteau (2006), and Papadimitrou, Zezza, and Hannsgen (2006).

comparatively low propensity to recycle export earnings for the purchase of tangible imported goods. As was discussed earlier, the use of export earnings to purchase non— producible assets contributes to the global insufficiency of effective demand.

The positions taken here do *not* add up to an unqualified case against trade or globalism generally. The objective has been to highlight some largely overlooked causes for skepticism toward claims that the removal of barriers to the cross-national movement of goods and services, economic and financial resources is unambiguously welfare-improving.³⁴ Advocates for labor standards in international trade agreements have hitherto focused on the need to achieve a more desirable tradeoff between cheap imported goods and the dislocations and upheavals associated with surging import penetration. The analysis above suggests that strong enforcement of fair labor standards—to the extent that such measures are effective in slowing/reversing the trend toward increased economic inequality—are indicated to preserve the great engine of global effective demand that is the U.S. household sector.

³⁴ Felipe and Vernengo (2002-3, 51, italics in original) label the position that free trade is mutually beneficial as the “*free-trade dogmatic interpretation*” of comparative advantage. They note that, even under conditions in which specialization according to comparative advantage leads to Pareto optimal *global* resource allocation, it is not necessarily the case that all sides will be better off: “The only thing that is true is that the welfare of one group [in a 2-country model] will improve; and that the group hurt can be more than compensated for by the group whose welfare has improved, for example, through unilateral transfers” (ibid, 52). Comparative advantage also rests on the assumption of full-employment—something that is rarely ever mentioned in textbook treatments of the subject.

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