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The Political Economy of U.S. – Led Internationalization: Germany, Japan and China

Introduction

The attempt to re-establish the hegemony of the dollar at the beginning of the 1980s, ended the possibility of the U.S. collaborating with other industrialized countries in order to develop a monetary alternative to the weakened dollar[1]. The U.S. strategy to discipline its allies and rivals' currencies was a reaction against the Japanese and Germany extraordinary industrial success and the associated challenge to the role of the dollar as the key international currency[2]. This offensive was part of an enlarged effort carried out by the United States and England to discipline unions, dismantle the welfare state and the "excesses" of democracy that characterized "social keynesianism" in industrialized countries.

Dollar diplomacy was part of a wide imperialist offensive, aimed to diminish and restrict the protective mechanisms that previously regulated

[1] This policy was followed up by a strong military offensive through an enlarged military budget required for military responses against the Soviet Union and guerrillas in Latin America and Afghanistan. For details see Tavares (1997), Medeiros & Serrano (1999) and Serrano (2002).
[2] Parboni (1981) and Serrano, in this book.

the exposure of national economies to the global economy. The most notable amongst them was the "monetary protection" fully accepted by the Bretton Woods system. Financial globalization, achieved through either shocks or gradual change, implies free trade in financial assets between residents and non residents, and can be seen as the triumph of the interests of the "5% minority" as the moneyed classes were referred to by Dexter White, the U.S. official at Bretton Woods. Both he and Keynes considered accommodating these interests as being in contradiction with the interests of the majority of national populations[3].

The financial globalization process reinforced, from the beginning of the 1980s, the presence of the US dollar in the world economy, confirming it as being the international monetary standard[4]. The high share of dollar goods in international trade and the high share of dollars stocks[5] in financial markets clearly established the demand for dollar holdings[6].

The role of the dollar in the world economy created a unique macroeconomic independence for the United States. As the issuer of the

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[3] See Parboni (1982).
[4] Serrano (2002), Helleiner (1994), Gowan (1999).
[5] See Schulmeister (2000) and Pollard (1997).
[6] Consider the following analysis based on by Pollard (1997), who has used and elaborated IMF data: 1) the rate of dollar internationalization, which is the relation between world exports denominated in dollars and U.S. exports, experienced a minor reduction from 4.5 in 1980 to 3.9 in 1995 but still does not have competitors (the yen reached 0.6 and the euro, lacking the exact information should be around 1.0; 2) taking the dollar to be financial currency, one observes through the 1990s an expansion of certificates denominated in dollars (from 41.1% in 1993 to 48.7% in 2000) though during the last three years there has been a boom for operations in euros, especially the money market; 3) in world currency markets the domination of the dollar is amazing. In 1998, the dollar was used in 87% of all currency transactions. This share is much higher than the participation of the dollar in trade and debt emissions, denoting the special role as the currency used by third countries in the current operations and the dollars adoption as the official currency in certain developing countries; 4) take note that in the most recent data, the use of the dollar by governments as the international currency. Considering all countries, dollar reserves totaled nearly 70% of total reserves; from 1990 till today, there has been an increase in this regard, especially between industrialized countries. Among developing countries, there is no rival to the dollar, exceeding four times the share of the yen, or five times the share of the euro. With regards to the composition of long-term debt, the share of the dollar fell from 49.8% in 1989 to 41.2% in 1990, but then rose to 56% in 1999.

world currency and independently regulating its rate of interest, (Serrano, 2002; McKinnon & Ohno, 1997). The high and persistent current account deficits of the U.S., observed during recent decades, are financed in its own currency and the corresponding surplus of the rest of the world, highly concentrated in Japan and China, is transformed into dollar-denominated reserves.

In addition to macroeconomic autonomy, the importance of being the issuer of the world currency and being able to extend the reach of the U.S. empire, as occurred for England during the 19th century and for the US since Bretton Woods, is that globalization has fostered a strong link between U.S. residents with foreign-held wealth (i.e., U.S. company stocks and foreign investment) and the U.S. domestic economy. As a result, the U.S. has been able to incur current account deficits and operate as the bank of the world. Overall, the current situation allows the American economy to benefit from cheap imports from Asia, giving birth to a new international division of labor, at the same time that the dominance of the dollar provides a formidable leverage for its international firms to expand their financial position in the world market. A global economy based on the dollar is the basis of the American supremacy centered on its large domestic market and the technological forces of its firms. These factors are all interconnected.

Since the inception in the 1980s of this new monetary standard based on a floating dollar, the world economy has exhibited two distinct patterns. One general pattern is that of low economic growth due to the persistent Japanese recession and the low growth of Germany and Western Europe. The second patterns is that of high growth in Asian countries that are integrated into the division of labor led by the US[7].

The literature about the connections between the American hegemonic policies and the Japanese stagnation is not new and has evolved

[7] World Development Indicators, CD-ROM, World Bank, 2003.

in recent years. Several studies have pointed out a macroeconomic similarity between Japan and Germany, despite the fact that for the latter, the creation of the euro has been considered the main causal factor for low growth in Europe. The main focus of this chapter is to examine for Japan and Germany several explanations and hypotheses about these connections. The focus on China, in the last part of the chapter is aimed to describe a new reality, where a large economy inserted into a US – dominated international division of labor has built a dynamic regional economy with a strong degree of independence.

The most general macroeconomic issue regarding financial liberalization for countries that do not emit dollars, is the reduction of governments' ability to regulate their economic policy autonomously. By severing financial and currency demand from trade, financial liberalization exposes countries to a greater external vulnerability and foreign debt. For firms, financial fragility associated with capital liberalization means a position of currency mismatch in their accounts. As a consequence, with the monetary standard being a floating dollar and without capital controls, the efforts to control the effects of exchange volatility upon the economy and firms, has led governments to pursue economic policies obsessed with inflation though aggressive monetary and budget policies.

Financial liberalization introduces a potentially new conflict between national economies and capital or private wealth. This process takes place through the "internationalization of national capital", that on the one hand improves national residents rights to own foreign assets regulated by a foreign commercial code enforced by a foreign government. On the other hand this process provides non-residents rights regarding ownership of national assets, regulated by a national code enforced by the national state, though resulting in the "internationalization of the internal market". In a financially open economy, the exchange rate, and the trade and investment

rules produce different effects for “foreign wealth of national residents”, compared to “foreign wealth of non-residents”. These property and political dimensions present, alongside macroeconomic questions, the issue of power between nation states and the propertied classes. In this sense, positive results of globalization are not simply general outcomes of sound finance, but particular results of a combination of interests between nation states and both national and foreign capitalists.

The conflict of interests between the national economy and private national capital is very old. Even in a regulated Bretton Wood system, the possibility of this conflict was a reality observed by Rowthorn (1980) in his analysis of the British economy during the 1970s. The great international expansion of large British enterprises was accompanied by a stagnant national economy, widening the conflicts between private English capital and the British economy.

Rowthorn observed that the internalization of British firms during the post war was very strong at the same time that domestic economic policy was unable to achieve strong growth of the British economy. As a result, it generated a situation in which many large British firms carried out much of their business in *areas where the state played a minimal role and with limited influence, hardly even offering them protection*. Thus, these companies and British capitalism in general became *extremely vulnerable to reprisals*. So, to the extent that the British economy was more integrated with global capitalism or the world economy, and the extent to which the British state was absent, large British firms became more vulnerable, and the potential benefits diminished, as a result of unrestricted national aggressive development (Rowthorn, 1980:63, *Italics added).*

This conflict should not be confused with the existing conflict between vertically integrated sectors in the global production chain led by multinational companies and domestic sectors. This deals with another kind

of political and institutional conflict between national states and the property rights of global capital within a capital exporting country. The crucial aspect is that the wealth of residents is expressed in a foreign currency and their property rights are guaranteed by a foreign country and as a consequence, there is an asset vulnerability to external reprisals. We can consider "conflictive internationalization" to be a pattern of internationalization, whereby the nation state looses control and the capacity to promote wealth generation for both private capital and the national economy.

Thus, the dissolution of "monetary territories" in a monetary system led by the U.S., creates two articulated problems: macroeconomic policy subordinated to external constraints; and a conflict of interests among fractions of capital, and the vulnerability to exertions of power, independently of nation states. Under these conditions, low growth and economic stagnation, must be seen as a consequence of the external constraints that restrict domestic economic policy.

In the case of European countries, where Germany is seen as the dominant economy, the external macroeconomic growth constraint is the main restriction to a higher rate of growth, which will be discussed later in this chapter. However, Germany, in spite of its external deficit, has had a strong economic performance in recent years and Japan with its large current account surplus should not be perceived as having macroeconomic limitations due to balance of payment problems. In the Japanese case, financial vulnerability among its largest firms, constitutes the primary reason, according to many analysts, for its recession and low growth. As argued in the next section, the reluctance in promoting an expansive fiscal policy has been the main cause for its weak performance. Yet, this reluctance and to a greater or lesser degree, the efficacy of the fiscal and monetary policies implemented, has to be seen in a broad context, taking

into account the role of the Japanese state with different fractions of capital and its role in promoting private investment.

The English post war experience, was a classical balance of payment constraint accompanied by a successful internationalization of capital, supported by U.S. leadership and the British state. In contrast, the case of Japan involved greater conflict in the internationalization process, since it occurred in a different macroeconomic and geopolitical context. Japan was not a minor partner, but a defeated power, whose economic growth was stimulated in part by U.S. policy during the Cold War period, thus contributing to the creation of a competitive and highly developed industrial system. As a consequence of financial liberalization, and after the sharp increase in the value of the yen in 1985 – both imposed by US pressure- a meteoric internationalization took place generating similarly drastic asset and currency imbalances. From an internally oriented capitalism, Japan transformed itself into a major international investor by the end of the decade. However, this internationalization was not accompanied by the state playing an aggressive role at the international level or through the domination of its currency at a regional level. This process opened up a conflict between the large Japanese multinationals, the "Japan Inc." and the Japanese domestic economy. Their structural balance of payment surpluses brought about a permanent pressure for the yen to increase in value with subsequent impacts for both investment and economic growth. Japan's decline occurred just as fast as its rise to the world scene, after its process of internationalization, as a consequence of the crisis at the beginning of the 90s. This decade brought about important changes for Japanese capitalism. As a response to changes of control mechanisms and commercial rules, (internal deregulation and liberalization), capital inflows (mainly foreign direct investment (FDI) outnumbered capital outflows, changing a historical pattern observed previously and thus generating serious internal conflicts. In

1997, when the US strongly opposed the Japanese initiative to build a regional monetary system, centered around the yen and given the Japanese government's reluctance to practice expansionary fiscal and monetary policies, there seems to have been a fear of international reprisals due to "conflictive internationalization[8]". As a result, the Japanese influence on Asian economic development has diminished, and witnessed a greater role exercised by China.

Germany, just as Japan, is constrained or limited by internal policies, but in a different way than Japan. Growth is limited by the internal political conflict between the defense of the mark and the interests of large German capital (TNCs) and a regional policy with gradual social inclusion and the shift to reduce national disparities. The latter, was a result of newly established priorities after German unification and the absorption of the former East Germany.

The europeanization of Germany since WWII is the result of the importance of the German mark as the European currency, establishing a new historical reality, very distinct from the English "conflictive internationalization". Asserting itself as the strongest economy in Western Europe, Germany has employed its own currency. Benefiting from the expansion of the European market, which is substantially protected from the rest of the world, but notably disputed over by large TNCs. For this reason, financial liberalization, in contrast with what occurred in Japan, did not result in serious imbalances with regards to regulating capitals and the local economy. The EEC had a pan-European strategy, which was crucial to the interests of German capitalism, as well as to the interests of other Western European countries. And the latter were always concerned about the threat of an isolated Germany. Due to the political limits imposed on the German

[8] McKinnon & Scnabl (2003) christened the expression "conflictive virtue" in describing modern Japanese and Chinese balance of payment problems. The meaning we are using is very different and it will be explored further along in this chapter.

state after WWII, Germany's strategy was essentially a shared strategy, and in this sense, it coincided with the other main European countries, historically committed to maintaining the nation state in the context of a unified Europe. However, the European Monetary Union, which is how the EMU is currently referred to[9], was formed with distinct interests and strategies, in which there was no voice for organized labor. The unification of Germany established in 1990, required an extraordinary financial and fiscal effort. Such pressure led to a change in Germany's insertion in the world economy, transforming it into a net borrower of foreign resources and causing, through its monetary policy, a violent shock for the European Monetary System (EMS). Politically, its unification was perceived as a swing to the East in detriment to its compromise with Western Europe. The subsequent steps after the Treaty of Maastricht (1992) were in the direction of accelerating the process of economic integration through the monetary union, resulting in a rather strong bias towards recession for the European economies as a whole.

The meteoric expansion of Chinese exports in recent decades, worked well with, as in the case of Japan historically, the U.S. zone of influence and an orientation towards the U.S. economy. Initially promoted by the U.S. for geopolitical reasons, and later on due to commercial conflicts with Japan, the Chinese economy came to constitute a strong complementarity with the U.S. As in the case of Japan, the growth of net exports resulted in an increased net balance for both current account and reserves, making them the two main international lenders worldwide. But in contrast to Japan and Germany, China inserted itself in an economic order dominated by the US, but with greater autonomy with respect to its economic policies and its ability of achieving high growth. The control over

[9] In this regard, see Kregel (2000). The creation of the Economic Monetary Union (EMU) was the original and official expression to which the European Union corresponded.

economic policy and the autonomy in strategic decision-making implies greater control over capital flows and the extent of financial liberalization. Though foreign institutional regulation has been growing since China joined the World Trade Organization (WTO), China has maintained a sufficient degree of autonomy so as to also reduce their vulnerability to arbitrary trade pressure by the US. Such a situation has allowed China to maintain its exchange rate and growth regime and to be able to resist U.S. pressure. Their internal market is currently being fought over by capitals from across the globe, making its internationalization a formidable area of international capitalist expansion. On the other hand, due to its expansion and high level of imports, it is becoming a magnet for the growth of Asian economies, exercising a positive growth effect, similar to the role, which Germany played within Europe. We will now consider these claims in more detail in the three sections following this introduction.

Japan and Conflictive Internationalization

After decades of high growth between 1950 and 1970, followed by growth rates of 4.1% registered in the mid-1980s, Japan had a growth rate of just 1.3% in the 1990s, in its greatest recession since WWII (World Bank, 2003). Due to their high and persistent trade surplus and current account balances during the last decade, Japan was a major source of deflationary tendencies within the world economy. After the bursting of the speculative bubble and financial collapse of 1991, the main explanations for low Japanese growth has been the accumulation of financial losses by large banks and real estate corporations with high debt equity ratios. This has reduced the availability of credit, and is seen as the principal obstacle to investment growth, and thus general economic growth. Yet, it should have

been evident for Japan, which didn't have external constraints to growth that the economic policies practiced through the 1990s were insufficiently expansive from the fiscal and monetary sides, and thus caused a contraction of private investment.

For McKinnon & Ohno (1997) the "currency mismatch" also constituted a financial vulnerability and thus an important factor in understanding the Japanese crises, though these authors seek to situate this factor within the general macroeconomic and geopolitical context. According to these authors, as Japan came to have large current account surpluses from the 1980s on – almost the same size as the U.S. deficit – with increasing U.S. trade pressure for trade adjustments during the 1980s, a "permanently overvalued yen syndrome" was established and came to be accepted by Japanese capitalists as well as the Bank of Japan. In a recent piece on China, though containing many references to Japan, McKinnon & Scnabl (2003), sought to generalize the argument that the excess of dollars held, as much by private citizens as by the government, in the form of reserves in a country that hasn't allowed its currency to float on world markets, led to the syndrome of "conflictive virtue". Why should the virtue of a structural surplus in the balance of payments, which allows these countries autonomy for growth without external constraints, be considered a conflict?

In the case of Japan[10], McKinnon & Ohno (1997) stress the existence of two main weaknesses regarding the variations of the exchange rate. The first is with respect to internal prices. It derives from: 1) the dominance of the dollar as the denomination of Japanese exports and imports; 2) the strong dependence of Japan on U.S. imports; 3) the absence of a regional agreement regarding exchange rates; and 4) the movement of

[10] These authors also consider that this syndrome corresponds to China as well. A similarly critical analysis can be found in the last section of this chapter.

many Asian currencies in line with the dollar. This is a weakness due to the significant dependence on trade with the U.S. and with the dollar as the currency in which prices are denominated (unit of account), the vehicle (means of exchange with third countries, particularly in Asia) and as the exchange anchor (unit of account between sovereign currencies) for Asian currencies.

This weakness which accompanied Japanese industrialization does not prevent Japan from asserting itself as an industrial power or increasing its role in the world economy, but there is a price to pay in the form of being more "vulnerable to reprisals", resulting from U.S. pressure, as evidenced by the events of financial liberalization in 1980, the Plazza agreement in 1985, and during the Asian crisis of 1997[11].

But there is yet a second weakness, which is financial and due to Japan becoming a lender in dollars, not in yen. This implies that the dollar is the principal currency in which financial assets are denominated and also the main currency in which reserves are held. It can be argued, that this aspect constitutes a novel situation for a creditor nation, contrasting Japan with England during the 19th century and the U.S. during the 20th century "making loans in their own currency". In the latter cases, domestic lenders-institutions or individuals- avoid any kind of risk of shifts due to the devaluation of the domestic currency with respect to the international currency, as is the case for Japan today[12].

The uniqueness of Japan is thus having become a strong creditor country without its currency being the international currency[13]. It is this

[11] See Medeiros (2001).

[12] Additionally, the continued existence of fixed exchange rates allowed England and later on the U.S. with their currencies tied to gold, to avoid the risk of an indirect exchange rate change. This risk occurs when the devaluation of a lending country's currency is compromised by the ability of borrowers of that country to pay back their loans.

[13] Japan is in the historically unusual situation of being a dominant creditor country whose currency is still surprisingly little used to denominate either current account or capital account transactions... (McKinnon & Scnabl, 2003: 103).

second weakness that constitutes a syndrome of "conflictive virtue". A country, which is unable to lend in its own currency, as has been the case historically for Japan, cumulatively generates a "currency mismatch" which the above-mentioned authors refer to as the syndrome of conflictive virtue[14]. Given the existence of a dollar glut, there is permanent pressure for increasing the value of the yen. In one sense because it corresponds to investor's expectations, and secondly because it is argued for based on U.S. trade pressure[15]. These two factors have combined with economic reasons (the fear of the appreciation of the local currency) and policies (the trade pressures of the U.S. on the Japanese government to support a stronger yen).

McKinnon & Ohno (1997); McKinnon (2003) were not focusing on the internationalization of Japanese capital, nor the conflict between fractions of internationalized capitals and those turning toward their internal domestic market due to financial liberalization. Sticking to a strictly macroeconomic framework and the rivalries between nation states is insufficient to assess what is meant by "vulnerable to reprisals". This does not just lead to external conflicts but also to internal conflicts due to financial liberalization in which the domestic economy. English capitalism did not experience any dollar glut whatsoever, but rather, their deficits in current account, led to a restrictive economic policy, subordinated to external constraints, though favorable to internationalized sectors. Japanese capitalism with significant foreign reserves, did not however, exercise a compatibly expansive policy, due to the fear that it would not be sustainable.

[14] Any international creditor country that cannot lend in its own currency cumulates a currency mismatch that we call the syndrome of conflictive virtue (ibid: 15).

[15] 1) As the stock of dollar claims accumulates, domestic holders of dollar assets worry more about a self-sustaining run on the domestic currency forcing an appreciation. 2) Foreigners start complaining that the country's continuing trade surpluses are unfair and the result of having an undervalued currency (ibid: 15).

The interpretation of McKinnon & Ohno regarding the "permanently overvalued yen" syndrome situates Japan in a virtual liquidity trap and a trajectory of low growth and external fragility, is quite compelling. The basic idea is that the persistent overvaluation of the yen depresses investment and demand for credit, and that the high level of foreign reserves leads to the expectation that the value of the yen will continue to be high. Since the liabilities of Japanese financial institutions are denominated in yen and the assets in yen and dollars, the variation of the exchange rate increases the risk of holding dollars. In such circumstances, rates of interest on bonds denominated in yen should be consistently lower then those rates for bonds denominated in dollars (whose nominal yield will be devalued with an anticipated drop in the value of the dollar) reflecting the existence, in the case of Japanese bonds of a negative risk premium. If the nominal rate of interest in the U.S. in high, there is room for maneuver for the Bank of Japan; however, when the U.S. rate of interest is low, as in the 1990s and the yen overvalued (as in the first half of the decade), the Central Bank of Japan becomes unable to reduce the real rate of interest. As a result, the effort to reduce the nominal rate of interest in such a way, endogenously, responding to external pressure and reducing the conversion of dollars to yen, keeping the overvalued exchange rate, brings the simultaneous movement of nominal rates of interests to zero and the increase in foreign exchange reserves. As the overvaluation leads to the devaluation of prices and a positive real rate of interest, the reduction of domestic investment and an increase in the trade balance, there is a reinforcing of the syndrome.

In researching the autonomous sources of demand for growth, McKinnon & Ohno limited themselves to examine external and internal accounts. Therefore, no matter what, given these circumstances, the fiscal policy cannot be counter-cyclical. It is possible that this omission in the analysis of McKinnon & Ohno is due to the increase of Japan's public

deficit during the last decade. However, the government expenditure is a key variable, along with exports, in understanding growth in Japan, which was very low. In fact, as stressed by Ahearne *et al* (2002), the fiscal stimulus in the 1990s was not a result of the government budget[16]. In this manner, the growth of the public deficit, at the beginning of the decade was the result of supplementary fiscal packages based on public work projects and principally from a temporary reduction of income taxes. The main inference to be derived from this, is that compared to recessive situations in other countries, and mainly in the U.S., the Japanese fiscal policy was not sufficiently expansive so as to combat deflation and a recession[17]. On the other hand, one result could have been an increase in net exports through the 1990s, or alternatively, a clear deceleration of Japanese exports resulting in a reduction in their participation worldwide. During this same decade, the difference between the rates of growth of U.S. exports and Japanese exports was greater than the difference between the rates of growth of the two economies.

With regards to the Bank of Japan being caught with the dollar glut it is important to point out that the crisis of 1991 was provoked by their decision to bring an end to the speculative bubble at the end of the 1980s, using the policy of a high rate of interest and the tightening of fiscal policy (Pigeon, 2000). In 1994, with a nominal rate of interest close to zero, there was room for a more expansive fiscal policy. Why wasn't this pursued? The main explanations in Japan refer more to the fear of the Bank of Japan, than

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[16] The dominant fiscal concern in Japan was with the ageing of the population and the future impact on public spending.

[17] According to Posen (2003: 7) "Since 1990, however, macroeconomic policy in Japan has been on balance contractionary and has worked to deepen rather than offset the post-bubble recession. The popular but incorrect perception of Japanese fiscal policy is that the government has been on a public-works spending binge. Properly measured, however, the Japanese government has provided little added stimulus as the economy has contracted. Over 80% of the increase in Japanese public debt is due to tax revenue shrinking with the economy.

to the financing of the government debt, which could call into question its credibility and impact the rate of inflation. This monetarist orientation within Japan's economic policy defines an entire decade, culminating in the new law of the Bank of Japan in 1998 (Pigeon, 2000). From the second half of the 1990s till the present, the main economic discussion was the debate between the Bank of Japan, the minister of finance, and the financial regulation agencies, as to who was most responsible, and when, for the policy of austerity and promoting neoliberal reforms.

Let's consider these issues in perspective. Japan industrialized under the domination of the dollar, and in the same way, the regionalization of Japan in Asia during the 1970s operated essentially with the dollar. Thus, the internationalization of the yen definitely didn't find a greater stimulus during the 1970s and much less in the international conditions established at the beginning of the 1980s, marked by the rule of the dollar and the U.S. as the dominant world power. The free convertibility of the yen in the middle of period when the strength of the dollar was growing, did not lead to the internationalization of the yen, but rather to a reduction in its autonomy with respect to the dollar. As a result, the financial liberalization in Japan, once Japan passed the Foreign Exchange and Trade Control Law in 1980, and interest rates were liberalized, produced a major discontinuity in the financial system characterized by speculative tendencies, overborrowing and overlending. This occurred when the Central Bank maintained strict control over domestic credit and also with significant capital controls. These mechanisms facilitated and allowed for the successful expansion of "Japan, inc.", the highly-competitive export-oriented industrial complex, but with the rest of the domestic economy being much less competitive, subsidized and having the support of the dominant political party, namely, the Democratic Labor Party (PLD).

Financial liberalization and the rapid internationalization of the financial system had as a counterpart, the meteoric expansion of financial activity with investments denominated in dollars, and internally the expansion of bank loans to the real estate sector which has come to be an important escape valve given the significant decline in the demand for credit on the part of large corporations and domestic investments due to the sudden increase in the value of the yen in 1985 (Teixeira, 1999 and Posen, 2003).

After financial liberalization, foreign loans by Japanese banks are essentially in foreign currencies, mainly dollars. Thus, the dollar is the main currency vehicle for exchange operations in Japan. As McKinnon & Ohno note, between 1981-1990, Japan transformed itself from a major international investor with long term capital flows greater than their current account surpluses. The imbalance was covered over by short term dollar deposits in Japanese banks attracted by the financial liberalization and the increased value of Japanese stocks and real estate. Since 1985, Japan played the role of a major intermediary by borrowing in the short run and then investing in the long run, thus having extraordinary repercussions with respect to levels of direct investment in Asian economies, similar to that of England and the U.S. The essential difference is the importance, in the case of Japan, that such investment was in dollars, not in the local currency.

This position of intermediary was undoing at the beginning of the 1990s. With the financial crisis of 1991 and after that, of 1995 when the U.S. Treasury Secretary, Robert Rubin, announced the policy of a strong dollar, direct investments contracted significantly, to the point where applications in the short run for U.S. bonds, became the main counterbalance to the current account surplus. This movement of the exchange rate between the yen and the dollar had a significant impact in Asia. As the main Asian currencies followed the dollar, the devaluation of

the yen caused a decline in Japanese investments in the region and increased its competition with other countries. The decline in economic growth and Japanese imports was an important factor in understanding the Asian crisis of 1997[18]. As a result, with the stagnation of the Japanese economy, the exports of the Association of South East Asian Nations (ASEAN) to Japan declined substantially. The conditions created as of 1995, whereby Japan had a trade surplus with the majority of ASEAN countries, given its low level of imports from the region and the declining level of foreign investment, led to a deflationary impact for the region as a whole. Given the U.S. vetoing of the Japanese proposal to create a stabilization fund, as a response to the Asian crisis of 1997, the influence of the yen continued to be limited.

With regards to foreign investment, it is important to consider that while exporters integrated with a dynamic industrial state, the large Japanese firms showed themselves to be major engines of growth and technical change. The internationalization of productive Japanese capital since the 1980s, did not have continued support from the state, promoting its interests, nor was the yen the dominant international currency. In a strict sense, the internationalization of productive Japanese capital was the result of U.S. trade pressure on the Japanese economy, and not a process guided independently by Japanese firms, and even less by the Japanese state. This characteristic became quite evident in the 1990s. According to Peter Nolan (2001), in the last ten years, Japanese capital located outside Japan lost position as an entrepreneurial revolution took place in the U.S. and Europe. Mergers such as Daimler and Chrysler, Sandoz and Ciba, Mobil and Exxon, Amoco and BP, left Japanese companies relatively parochial and under scaled. In the last ten years, the value of Japanese firms, according to the

[18] According to Sakakibara & Yamakawa (2002), at the beginning of the 1990s, the share of Japanese investment within the Association of South East Asian Nations (ASEAN) was 19%; by the end of the decade, its share had contracted to only 10-11%.

stock market, dropped dramatically in relation to large Western firms, thus reducing their level of investment and control of international markets. On the other hand, the high levels of Japanese investment in R&D were disproportionately channeled toward sectors technologically less dynamic, increasing the differences with U.S. firms in high tech sectors. The central thesis of Nolan, is that the diversification and the typical conglomerates of Japan (like that of South Korea) were extremely successful in the regulated context of Asian capitalism, but revealed themselves, with the liberalization of the 1980s and 1990s, to be quite weak when faced with global competition. So, for example, alongside the highly profitable activities in the core business of the *keiretsus*, there always exists a high number of activities, whose existence depends on the high level of market growth and special loans obtained within their own group. Such an articulation among firms within and between sectors of different segments with different degrees of productivity was, as previously argued, an essential characteristic for the growth of Japan after WWII, reflecting a particular economic form. The process now underway, of the dismantling of the *keiretsus*, and above all else, bank mergers and corporate restructuring, reveals the weakness of Japanese industrial arrangements in relation to U.S. and European firms[19]. In general, the Japanese firms are still at the early stages of setting up vertically integrated supply chains and networks worldwide.

This is an important aspect for understanding the rapid internationalization of the domestic Japanese market, which took place during the 1990s. More than just effective FDI stock, relatively small when considering the primary destination for FDI, namely, the U.S. and China. It is readily recognized that the rapid change in Japan's international position given that FDI going into Japan is occurring at a much faster rate than the

[19] Thus, for example, with Nissan taking control of Renault, the system of local suppliers was dismantled opening the market for large producers of auto parts (TNCs).

FDI that Japan is investing outside the country. The reforms of the Commercial Code, introduced at the beginning of the 1990s, preceded the wave of mergers and acquisitions, which took place throughout the decade. Corporate restructuring was carried out in the spirit of the traditional structure of *keiretsus*, with financial intermediation by the Japanese banks, typical for Japan, and can be argued to be responsible for the paralisation of the Japanese economy. The revision of the Commercial Code and the introduction of a new Telecommunications Law, strongly influenced by the U.S. Chamber of Commerce in Japan (Francis, 2003), led to a rapid process of mergers and acquisitions, especially in the banking, insurance, telecommunications and auto sectors (Francis, 2003)[20]. The deregulation in the U.S. and in Europe was mainly an attack on unions, thereby limiting their influence to strategic sectors. The deregulation in Japan, aimed mainly for the internationalization of productive domestic sectors and segments that had continued to be integrated with large Japanese firms. Without a state or the yen being the dominant international currency, the competitive force of Japanese firms in foreign markets was inferior to that of large U.S. and European competitors, and the opening of the domestic market was carried out from a regulatory framework constructed according to norms and interests of the U.S. Given the fact that Japan does not have the power nor willingness to practice an aggressive fiscal policy, that it remains a prisoner to globalization outside of its control, and is thus paralyzed because of a dollar glut.

In these conditions, the positive contribution that Japan exercised in the development of Asia as the supplier of capital goods, articulator of a regional division of labor, and most notably, providing the institutional

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[20] In this wave of mergers and acquisitions, it is worth noting that the purchase of land lines of Japan Telecom by British Telecom in 1999, afterwards acquired by Vodafone and recently by Ripplewood, was an investment fund with U.S. capital and Japanese banks. Such transformations, in a certain way, reflect the U.S. pressure on the Japanese state, and are the basis of changes of Japanese capitalism.

framework for developing countries, has clearly been reduced. As will be seen later on, China has come to occupy this space in part, and for Japan, China is becoming the main source of growth. Now let us turn to consider the case of Germany.

Germany, the Euro, the Deflationary Bias and Realpolitik

The low growth experienced by the main Western European economies since the 1980s must be explained starting with Germany and the process of macroeconomic convergence among the main economies of Western Europe established by the Maastricht Treaty of 1992 and consolidated with a common currency in 2002. Such a process is taking place within a given global macroeconomic context, marked by the neoliberal transformations led by the U.S. in defense of the dollar. This period is also shaped by the conjuncture of the following events: the collapse of socialism in Eastern Europe, the unification of Germany, the containment of unions and the triumph of a conservative perspective in the area of economic policies, and the acceleration of the project for the unification of Europe.

Historically, Germany has played a central role with respect to the development of the European economy. This contrast with Japan, whose economic dependence on the U.S. market was always very high, and only as of the 1980s did they build a regional network. While in the case of Germany, intra-regional trade was built up historically, as it was fundamental for their interests of expansion and at the same time, the catalyst for European growth.

In an even more accentuated form than Japan, German exports constituted, historically, the prime motor for their growth. Led by the

machines and equipment sector, Germany benefited substantially from the arms race, by specializing in the production of precision equipment, and machines and equipment used for the production of armaments[21]. German exports were directed to a large extent toward Western Europe, but were articulated with the expansion of a dynamic domestic market, though because of its size, limited exports from other European countries[22]. German leadership derives from the fact that no other country in isolation can affect, through its internal demand, Germany's growth. In contrast, Germany, by expanding or contracting, leads to the expansion or contraction of the other countries, thus establishing it as the "main engine of economic growth for Europe". From a political point of view, as noted by Milward (1992), the rescue of the European nation state in the post-war period had as a key characteristic, the political recognition of the impossibility of an exclusively national German project[23]. German elites have perceived, since

[21] Michael Kalecki (1955) observed that, with the U.S. machinery sector dedicated to arms production, the machine sector of Germany found ample space internationally for its exports.

[22] In the 1990s, Germany continued to be the dominant economy for Europe. As a result, German output accounts for 23 percent of the European Union's GDP and 32 percent of the eurozone´s GDP. The Benelux countries sell over $ 90 billion in goods and services to Germany every year, making it the engine of west European growth. From the strategically emerging Eastern Europe, Germany takes in 8 percent of Russian exports, 19 percent of Turkish exports, and 31 percent of the exports from the EU accession countries-primarily Poland, Hungary, and the Czech Republic – which is over 11 percent of the annual GDP of these NATO members. (Posen, 2003: 4).

[23] The rescue of the nation-state from this collapse, which appeared to mark the end of its long domination of European history, is the most salient aspect of Europe's post-war history. The development of the European Community, the process of European integration, was, (…) a part of that post-war rescue of the European nation-state, because the new political consensus on which this rescue was built required the process of integration, and the surrender of limited areas of national sovereignty to the supranation." (Milward, 1992: 4). The basis of the rescue of the nation-state was an economic one, and it follows that the Europeanization of its rescue also had to be economic. The interdependence of European states was, however, by no means purely economic. The single greatest problem of interdependence was political, the future of Germany (…) No European rescue of the nation-state was of any validity, unless it also offered a solution to this new problem. Therefore, although the European rescue of the nation-state was necessarily an economic one, it is the point where that economic rescue intersected with the problem of Germany's future in Europe that the common policies of the European Community developed (Milward, 1992: 45).

the post-war reconstruction that their national interests are better served through the discourse and practice of being part of Europe, as historically laid out in the Treaty of Rome. This practice, which many refer to as soft hegemony or hegemony by stealth, or even semi-sovereignty, results in an effort to construct a unified economic space where German political and economic interests are exercised without political confrontations and subordinated to the leadership of the U.S. in the area of security and defense for Europe. The importance in the formation of the European Economic Union (EEU) and the irrelevance in NATO translate the limits and ambitions of Germany in the context created by the Cold War[24].

It is important to recognize that the unified Bundesbank, historically operated with a autonomy with respect to its policy tools but accommodated to government interests for economic policy, as established by the German state led by Adenauer (Bibow, 2004). Thus, up until the 1970s, Germany provided, through its growth, a significant stimulus to other countries of the EEU, and especially France, building up a dynamic common market. As a result of its significant regional integration and Europe's geopolitical role in the post-WWII period, the German mark was clearly seen as the dominant regional currency and Germany as the center of economic relations for the EEC, in clear contrast to the reduced role of the yen as a regional currency and as Japan as the central motor of Asia's economy.

With the crisis of the Bretton Woods system, and as a reaction to conflicts over income distribution, inflation and exchange rate instability of the 1970s, the economic policy position adopted by the Bundesbank, centered around the German mark, entered into crisis. There was a collision

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[24] This would be the general direction and political base which Germany accepts, at the end of the 1990s, opening a space for their currency, the main currency of Europe, in exchange for the European currency.

with Keynesian economic policies previously adopted[25]. Even when Schmidt was prime minister from 1974-1982, the German government began to have a conservative policy with respect to social spending, as there were increases in the public deficit, unemployment and also political pressures. At the same time, this strategy was accompanied by a growing autonomy of German policy, simultaneously establishing cooperation agreements with the Soviet Union and especially East Germany (GDR) and the strategic alliance with the U.S. regarding military matters[26]. In this way, the refusal to bolster the economy, despite U.S. pressure and the defense of a strong mark as an alternative to the weakened dollar, reflects the desire to contain the inflationary pressures due to the rise in the price of oil and wages, which was also convenient for the interests of German nationalists. As a result of the German mark becoming stronger in relation to the dollar in the second half of the 1970s, other currencies followed in the same direction as determined by German policy. In the EMS, finally instituted in 1978, Germany, due to its higher productivity, came to have a large trade surplus with other European countries, generating a significant surplus for its current account. This surplus combined with low growth led to capital outflows, mainly FDI. Although this movement fit with national objectives, it interrupted a regional macroeconomic expansion, as had been developed since World War II. German economic policy also had another aim: the reduction of migration pressures. The post-WWII German "miracle" was built upon a strong flow of immigrants into Germany, mostly coming from Turkey, Spain, Italy and Greece. The policy of attracting workers was directly promoted by the German state and was responsible for the entry of almost a million Turkish guest-workers between 1961 and 1973 (Eryilmaz,

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[25] The fall of Karl Schiller, the powerful German prime minister in 1972, came about after the public confrontation with respect to the policy defended by the Bundesbank.
[26] The process which afterwards brought the installation of Pershing missiles into Germany in 1982.

2002) employed in construction, metalworking, mining, and textiles. These workers, attracted by high growth, and socially isolated from German politics, were essentially functional for the control of unions and the regulation of capital-labor relations in corporative Germany. In 1973, the offer for guest workers came to an end and German social policies changed, discouraging immigrants and the demographic expansion of poor foreign working-class families. Nevertheless, the migration continued, and more than one million Turkish immigrants arrived in Germany during the 1970s. The growing hostility towards immigrants and the existence of ghettoization, put pressure on public policy, and laid the groundwork for a hardening of attitudes in public policy during the 1980s, thus contributing to the conservative changes in German society.

In this manner, these transformations, which were already present in the German economy and society during the 1970s came to have serious repercussions in the formation of the European Union. Thus, instead of the "Keynesian-expansive" approach which marked the European regionalization process since the Treaty of Rome, the opposite approach of regional convergence begun in the 1980s, had as a central element, the search for a convergence of rates of exchange in terms of the EMS, with the German mark clearly being the main currency for European trade and financial integration. Countries with weaker balance of payments (Italy, Spain, but also France) were obligated to maintain parity within fixed limits with the EMS; to increase rates of interests in order to attract capital in the short run, which was seen as necessary for the financing of the external deficit, thus reproducing the classical restriction on the balance of payments for economic growth.

Recognizing this monetary arrangement and the implicit macroeconomic options, a shock was inevitable, especially in countries with greater external restrictions, especially given the presence of unions and

moving from a broad welfare State to the abandonment of the policy of full employment, which characterized Europe in the post war period. The stabilization of exchange rates imposed a discipline on unions and a change of direction of economic policy. In the majority of European countries, this process generated a shift in income distribution, dislocating unions from their militant or combative positions and shifts in economic policy, which previously defended wages and social expenditure given high levels of unemployment.

With the conservative victory of Reagan[27] and the extraordinary increase in the rate of interest in the U.S., the 1980s pushed Western Europe to reinforce the neoliberal strategy with a swing to orthodox economic policies, based on the affirmation of the German mark as the main currency for commercial and financial integration. At the beginning of the 1980s, continental Europe didn't have a Thatcher or a Reagan, and the confrontation between workers was not so direct, but was more indirect, as reflected in unemployment and its effect on wages. In Germany, with the arrival of the center-right government of Kohl, upward redistribution of income, more than anything, led to a shift, reducing expenditure aimed for direct transfers of income and a return to market rhetoric. This was accompanied by a struggle over the rigidity of the labor market, considered responsible for the unemployment at the beginning of the decade.

Right after the interest rate shock, Germany achieved an economic recuperation. Considering Germany's high productivity compared to other European countries, the devaluation of the dollar in 1985, allowed Germany to achieve a high trade surplus, based mainly on its trade within Europe. It increased, on the other hand, its role as foreign investor and net exporter of capital, especially in Europe. It is this context in which "Germany became

[27] For an interpretation of the distributive conflict in this period, see the chapter by Serrano in this book.

the anchor of Europe" (Halevi, 1997) and initiatives such as the Single European Act of 1986, which removed major controls on capital and labor flows in the countries of the EEU, and thus led to the project for a single currency as approved in Maastricht in 1992. A project essentially centered on the construction of a single monetary territory, but nevertheless was politically attractive for weaker nation states since they could argue that decisions made which had negative implications for workers were because of external forces related to the EEU.

For these reasons, the process of international insertion for Germany hardly could be described as a form of subordinate internationalization, and consequently, susceptible to the "vulnerability of reprisals" as Rowthorn (1980) observed for England, and as we presented for the case of Japan above. The approach taken by Germany was not followed because of the fear of reprisals on the part of the U.S. or for other structural weaknesses reflected in the balance of payments, and even less could it be considered a direct result due to the project of European integration along the lines established by the Treaty of Rome. It has to do with a strategy guided by the geopolitical insertion of Germany and for the internal political and ideological currents.

The 1990s were demarcated by two central movements: the reconstruction of a unified Germany, clearly the most significant economic and political result for Germany today and secondly the implementation of the monetary union in Europe. These two processes mutually conditioned, and in a certain way, synthesized the strategic question of frontiers to the west and to the east for Germany since WWII. With the fall of the Berlin Wall and the unification of Germany, the regionalism formed, according to the project of Bonn, included, alongside the strategy of the 1980s (expansion of direct investment, industrial restructuring), searching for a

degree of maneuver, in the form of financing the costs of integration and the industrial reconstruction of the East.

The path chosen for the absorption of East Germany was the immediate monetary integration "from above" with an approximate parity of 1:1[28] between the West German mark and the East German mark, and the unification of all social welfare programs. These new expenditures, such as the creation of a Fund aimed at providing for infrastructure and for a reconstruction program, implied a major transfer- close to 50% of West Germany's GDP- an unprecedented transfer since the Marshall Plan. These resources allowed East Germany to have a surplus of imports (this is, an aggregate influx greater than their GDP) and nearly 46% of GDP (Sinn & Westermann, 2001).

The funds destined for the former East Germany were obtained, for the most part, through issuing of public debt, whose expansion was stimulated through the increase in the German interest rate. With the transfers and internal expenditures for the expansion, the external situation completely changed; from an economy with a net surplus for their current account, Germany came to have a current account deficit during the 1990s[29]. As a result, Germany, which had a reduced inflow of portfolio investment, began to capture in the short run, a much larger share of foreign direct investment[30].

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[28] This parity was defended by Kohl's Christian Democratic Union (CDU) against the position of the Bundesbank (that defended a exchange of 1:2) in a moment that revealed to the public, just how independent the Central Bank was. The main concern of the CDU was the migratory boom that would have supposedly occurred (in 1989 alone, more than 133,000 people migrated from East to West Germany) if wages were converted at a different rate that the one-to-one parity.

[29] After having high current account surpluses in the 1980s, as of 1991, two years after unification, Germany started to have a deficit in their current account, and this continues to the present.

[30] It is worth emphasizing that such a change never occurred for Japan, which kept its position as a net creditor (and notably, while experiencing the dollar glut). In a way this is similar to the Japanese experience, but for different reasons. Germany had a recessive fiscal

With the devaluation of the mark in relation to the dollar during the second half of the decade, the deficit in transactions declined only to increase again afterwards, causing a strong contraction of aggregate demand. The German monetary policy at the beginning of the decade and the fiscal policy at the end of the decade, are the main causes of Germany's stagnation and subsequently that of Europe as well. Let us consider these two phases.

Between 1990 and 1992, German fiscal policy allowed for a significant increase in public expenditure, which was necessary for the integration of East Germany. Their exports stayed at the same level, but their imports experienced notable growth[31]. As a result of this change European countries benefited enormously by increasing their exports to Germany. As a way of financing new government spending in the macroeconomic policy framework established in Maastricht, the Bundesbank increased the rate of interest for the mark[32]. This decision had devastating effects for Europe, which continued into the 1990s, since the European monetary system is centered around the German mark.

The increase in the German rate of interest (reaching 6%) also countered inflation, which intensified slightly during these years, due to the increase in taxes and prices, necessary for the unification process and the increase in wages in the eastern part of the country, in line with the policy of leveling wages as defended by the German unions. The sharp increase in

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policy at the end of the decade, so as to accommodate the goals of the Maastricht treaty, limiting its current account deficit in order to maintain the stability of the mark.

[31] Structural changes were also important for the deteriorization of Germany's current account balance, as the strong penetration of Asian imports due to Germany and Europe being behind in the electronics industry.

[32] From 1989 to 1991, the German government deliberately relied upon borrowing to take almost the whole unification's fiscal brunt. By 1991, an overall budget deficit of DM 85 billion…had replaced a budget that was balanced in 1989. Starting in 1992 and under mounting pressure from the Bundesbank, the government began to introduce a series of new fiscal measures aimed at cutting its borrowing requirements. Between 1992 and 1995 a cumulative fiscal tightening occurred that was far in excess of initial borrowing requirement (Bibow, 2001: 13).

interest rates caused a crisis in Italy's financial situation, forcing the devaluation of the lira in 1992 and therefore forcing Italy to exit from the EMS. This decision led to a wave of ruptures, with the devaluation of the lira, the Irish pound, the Swedish crown, the Spanish peseta and the Portuguese escudo. According to Halevi (1997), the threat of a possible devaluation in France could have undermined competition with Germany, in a serious way. According to this author, this was the rationale for Germany in defense of the objectives of Maastricht (1992), and the creation of the euro with its very restrictive criteria established in the Pact of Growth and Solidarity in 1997. On the other hand, the fear of devaluations in order to remain competitive, which could have undermined European integration, which was in the process of establishing the basis of a significant European agreement regarding the rather restrictive rules, whose informal maintenance revealed themselves as the basis for a break in 1992. In order to convince unions of the need to reduce pressure for wage increases- despite the real losses due to devaluations during the 1990s – the European governments argued for the establishment of the monetary union. Fulfilling the Maastricht criteria, functioned as the anchor against union pressures, through the creation of a new "monetary constitution", which had been previously demanded by the director of the Bank of Italy at the beginning of the 1980s (Stirati & Levrero, 2003).

In the geopolitical plane, this also confirmed another fear, that the unification of Germany strengthened the drive that prioritized a horizontal expansion toward the East, subordinating the vertical integration of Western Europe. The deepening of the economic convergence, established at Maastricht, centered around monetary convergence and the introduction of a single currency constituted, in a certain way, a response to this fear[33].

[33] See the response by Prey (1995). According to Edourd Balladur, the French prime minister, the dilemma of the Maastricht Treaty for France is the following: the rejection of

German unification encouraged European states to accelerate the process of integration at the expense of accepting very restrictive fiscal and monetary policies.

Thus, after the wave of devaluations in 1992, the following years were marked by two processes. On the one hand, as a result of trying to adapt to the restrictive criteria of Maastricht, and the adjustments it brought, in the case of Germany, they entered their worst recession since WWII and with recessionary effects throughout Europe. On the other hand, there was the expansion of the European Union, with the entries of Sweden, Austria, Finland (forming the 15 of Europe) followed by the agreement for the entries of Poland, Hungary, the Czech Republic and the Baltic countries.

The conditions created at Maastricht for the Monetary and Economic Union[34] preceding the adoption of the euro and consolidated in the Pact of Stability and Growth (1997) based on the goals for the fiscal deficit (a cap of 3% of GDP), debt (a cap of 60% of GDP), inflation (not to exceed 1.5% above the weighted average of the three members with the lowest rates of inflation) and interest rates (rates on public debt in the range of 2% of the three states with the best performance in the EMU). This created a destabilizing bias in the following sense. The worse a recession the greater the possibility of not achieving the goal of 3% for the deficit bringing a cut in expenditure and deepening the recession.[35] In such circumstances,

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the treaty will not give France more liberty; it will simply allow the bigger Germany to act as it desires, without taking heed of its neighbors or its partners, without being constrained by any set of common European rules in its role as military, economic, financial and monetary power in the center of the continent (Prey, 1995: 20).

[34] Kregel (2000) notes that this is a correct specification for the EMU and not the European Monetary Union as it is commonly referred to.

[35] Cui (2004) observed that the goal of 3% for the deficit corresponds to the defense of the golden rule for fiscal policy, in that the indebtedness can not exceed the budget expenses for investment. This recommendation is expressed in the German Constitution. Three percent corresponds, on average, to the percentage of GDP spent on public investment for the countries of Western Europe.

insistently defended by Germany, reveals the deflationary bias in Europe (Graziani, 2000).

It is evident that a downturn occurring simultaneously for a group of countries that are economically integrated will produce multiplicative reciprocal effects. The drop in global demand in any country produces a contraction of imports; this automatically implies a drop in exports for other countries and from there, a contraction in general demand, adding to the depressive effects, derived from the government policies already adopted. Thus, as European countries attempt to adhere to the Treaty of Maastricht, without intending to, they effectively add to a growing tendency for recession (Graziani, 2000: 178).

Thus, there is a general question regarding the creation of a single currency in Europe, since this results in governments forsaking their monetary sovereignty, implying a loss of their capacity to independently set their rate of interest, deferring to the supra-national Central Bank (which is independent of participating governments). The later sets guidelines according to the classic model attributed to the Bundesbank, without however, having created in this same plan, a Treasury and central government that are able to finance sub-regional disequilibria[36].

As a result, the funds which had been allocated for integration and the structural funds generated for the European Budget for countries with lower income per capita, though very important for the original recipients, Spain, Portugal, Greece and Ireland, will no longer be continued or made available for newcomers. Thus, not allowing itself, the leveraging of these economies, nor the possibility of increasing such funds for investing in new

[36] Godley correctly observed that "If there is to be an active (collective) fiscal policy there would have to be political institutions and guiding principles which go far beyond those pertaining to a central bank. Mere coordination of budget balances could mean that an overly cautious stance in one part of EMU might impart an undesirable deflationary bias to the Community as a whole and even perhaps to the rest of the world as well. "(Godley, 1991:8).

member countries. The attempt to emphasize monetary and fiscal policy disconnected from other economic processes is a reflection of the proposition defended by Germany to reduce the functions of the Central Bank in order to control inflation and the concerns over unemployment and growth of national governments. This separation is an obstacle to economic growth in any European economy and if followed by Germany, impedes the growth of the other European countries. On the other hand, as observed by Halevi (1997) and Graziani (2000) with the prohibition of governments to finance the Central Bank, the need to resort to capital markets "generates a real stimulus for financial incomes" (Graziani, 2000) other than being strictly dependent on exogenous interest rates.

Thus, in contrast to regions of the same country, where a commercial deficit is entirely financed by the government, the rules of convergence are made with respect to the commercial deficit of each nation in the European Union requiring an adjustment to aggregate demand[37].

Under this deflationary bias only transfers, exports or foreign investment can arise as autonomous mechanisms of growth. In relation to exports, the central question is: if all of the European Union is simultaneously restricted by the containment of Germany, there is no possibility for export-led growth in Europe. The only "third markets" that are sufficiently big enough and growing at high rates, would be the U.S. However, for other structural and exchange rate reasons, this was not a sufficient catalyst to compensate the restrictive fiscal policy. Western Europe moved "from a high level of unemployment with high interest rates

[37] "… the fact that we could no longer run a balance of payments deficit would mean that any failure to sell exports on a sufficient scale would depress total demand and output even more rapidly and directly than at present." (ibid: 8)

observed in the 1980s to a high rate of unemployment with restrictive fiscal policies (Halevi, 1997) [38].

With the creation of the European Central Bank, Germany saw itself constrained to practice (until recent years when they openly decided not to comply with the established goals of Maastricht) a contentious fiscal policy, in order to comply with the criteria of the European Union. This policy of self-restriction[39] will have (and had) multiple meanings for Germany, and not only economic ones, but especially, geopolitical ones. This issue takes on a greater meaning, at the moment defined by the decision of the EU, in 2002, to admit the entry of new country members, eight from Central and Eastern Europe plus Cyprus and Malta- and accepting the seven countries of Central Europe into NATO, accelerating the horizontal expansion for a group of countries, that historically, corresponded to the periphery of Germany. The key question is, which formal macroeconomic conditions for entering the EU, will be required by new members, given the difficult process of transition (the conditions are similar to other countries with the difference that national currencies will continue to be used but with a range

[38] Ireland, in contrast to the rest of Europe, was an island of growth and dynamism during the 1990s. Undoubtedly, exports and foreign investment was the main motor of growth. But this is because something entirely outside the domain of the Irish government had to occur: the decline of the European information technology (IT) industry and a boom by U.S. and Asian countries. Taking into account the European protectionist barriers, the migration of U.S. IT companies to Ireland looking to return production of exports for the large European countries was an essential ingredient for the export dynamism led by U.S. companies. They also benefited from a cheap, well-educated work force, that spoke English, a clear competitive advantage in service activities, attending typical users of this technology. The Irish government which pursued this strategy without success during the 1970s, took advantage of structural funds and funds of cohesion provided by the European Union to create an adequate infrastructure for this industry.

[39] In relation to monetary policy, one can observe that a rate of inflation below the average of EU countries, a rate of interest in Germany fixed by the ECB (European Central Bank) is higher than that which the Bundesbank set, using the same criteria as the ECB. As Posen (pointed out: "Since European monetary unification at the start of 1999, (...) German monetary policy has been set by the European Central Bank, and German fiscal policy has been constrained by the eurozone´s Stability and Growth Pact. With the ECB replacing the Bundesbank, Germany has suffered from a centrally set monetary policy aimed at the euro zone in general, rather than set to its own needs. (Posen, 2003: 16).

of 15% with respect to the euro) that in the present conjuncture of low growth, anticipate high levels of unemployment and migratory pressures.

During the three first years of the new century, Germany and France decided not to comply with the fiscal deficit goals established at Maastricht and the sanctions established by the Solidarity and Growth Pact were not applied. Such a decision implies, in practice, the end of this pact. Such recognition of the impossibility of following the goals of convergence, without consequent economic and social damage, comes at a moment when the increased value of the euro in relation to the dollar reduces the competitiveness of European exports. The relaxing of these restrictions does not change, however, the European compromise for the EU economically led by Germany, based on the stability of the currency and in the disciplining of unions and weaker states.

The Centralization of Asia in China, Exchange Rate Policy, and Trade Flows

As a result of its dynamism rooted in accelerated industrialization, and its high level of trade, China currently constitutes a pole of world growth and particularly regional growth. Inserted into the trading area dominated by the dollar, China, as with other Asian countries tied to the U.S. market, came to build up large reserves of that currency. Maintaining capital controls and economic coordination mechanisms allowed China to preserve, after the Asian crisis of 1997, the stability of the yuan and its economic growth. This was possible through high growth of the internal market through an expansive fiscal policy. This capacity to practice an autonomous economic policy in spite of U.S. pressures with respect to the rate of exchange, is not only a unique moment for China, as has come to be

seen in the context of a new reality for the Asian regional economy. Let us consider this in greater detail.

While the "endaka"[40] lasted, China, in the same way as other countries of ASEAN, like Thailand, Malaysia, the Philippines and Indonesia, benefited from foreign investments, especially from Japan and the trade region and its associates by getting around the pressure of costs due to the highly-valued yen with respect to the dollar. A triangular dynamic was created between Japan, the main provider of capital goods for China and other ASEAN countries, and the groups of countries of ASEAN, alongside of South Korea and China, whose trade flow, especially intra-regionally grew at amazing rates, and the U.S. which was established as a clear net importer, namely as "consumers of the last resort" for regional manufacturing production.

This international division of labor, marked by the bilateral conflict between the U.S. and Japan and because of the high complementarity between the U.S. and Asian countries, producing cheap manufacturing goods, facilitated the growth of an extensive regional division of labor. This was carried out in large part through internal trade networks, especially for those countries with a lower level of development or a small internal market. As Sakakibara & Yamakawa (2002) noted, during the last 15 years, the intra-regional Asian trade was even more intense than that registered in the countries of the EU. China with its special zones, and trade regimes specifically designed to absorb capitals from Hong Kong, Taiwan and Japan, strongly participated in this movement. This dynamic, after generating amazing dynamism and allowing for synchronized growth and levels between countries at different stages of development, as described in the model of the "flying geese", entered into crisis in 1995.

[40] Japanese expression for the period marked by the strengthening of the value of the yen with respect to the dollar (especially between 1985-95).

The devaluation of the yen as of 1995, and the abrupt contraction of Japanese FDI linked to Asian exports for third markets (mainly the U.S.) produced a serious instability into the regional dynamic. As a result, since these countries had exchange regimes linked to the dollar, the increased value of the dollar in relation to the yen led to an increased value of the main Asian currencies with the exception of the Chinese yuan, which devalued in 1994. The greater competitive pressure for Japan in electronic sectors with a greater unit value (increased competition with South Korea), led to a drop in prices of semi-conductors and showed the degree of competitiveness of China in manufacturing and IT sectors. There was a shifting of exports from ASEAN to world markets, in particular to the U.S., due to the new currency alignment and, in Japan, due to the recession, which began in the second half of the 1990s. In relation to the U.S. market, China and Mexico (Medeiros, 2001) undermined the producers of ASEAN.

Another notable fact is that as of 1995, there was a decline in Japanese FDI and investments directly connected to exports. This fact, along with trade liberalization and financial deregulation, put into practice in the majority of ASEAN countries, at the beginning of the 90s, changed the structure of external finance with a strong increase in short term capital flows. A boom of short term loans, denominated in dollars, were destined for loans in local currencies for sectors turning toward their internal markets (primarily real estate). Thus, for the ASEAN-4 plus South Korea, it was clear that financial liberalization was the main cause of the liquidity crisis, at the end of 1997, intensely shaking up countries, such as Thailand, Malaysia, South Korea, the Philippines and Indonesia (Medeiros, 2001). As correctly emphasized by Sakakibara & Yamakawa (2002) this was a "crisis of capital account" and not a "crisis of current account" generated by a reversal of flows in economies that had their external liquidity weakened very quickly.

After the sudden recession and exchange rate collapse, these economies, with the exception of Indonesia, returned to their expansive trajectories after the strong recuperation of their exports and the recomposition, through the IMF, of their foreign exchange reserves. The factor immediately responsible for the growth of exports was the boom of the "new economy" in the U.S. and its impact on IT (Medeiros, 2001); with the collapse of the bubble occurring in 2000/2001 the Asian exports were affected, but regional exports expanded as a result of the growth of China. This transformation- based on the importance of internal demand- began to change the dynamic of Asian regional growth.

Consequently, the circumstances and regional dynamism was no longer similar to that experienced between 1985-1995. The scaled back role of Japan and the new role of China changed this dynamic. According to what was already observed, the retraction of Japan became evident through the weakening of its regional power and its currency. On the other hand, the instability between the dollar and the yen is evidently a permanent source of regional instability, which the stability of the yuan is attempting to counter. The contrast between Japan and China in the 1990s cannot be greater. If during the 1990s Japan experienced a dismantling of their regulation mechanisms under the supervision of the U.S., throughout this decade the Chinese government selected 120 entrepreneurial groups to form a national team for dealing with strategically important sectors[41].

The drive for Chinese industrialization always requires, as observed elsewhere (Medeiros, 1999), resolving the permanent challenge, due to a huge population and the lack of land and necessary raw materials, in order

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[41] In sectors that are fundamental for the "power, continued growth and the defense of a technologically advanced, modern, urban and industrial society". The selected sectors include electricity generation (8groups), carbon (3), automobiles (6), electronics (10), iron and steel (8), machinery (14), chemicals (7), construction material (6), transport (5), aerospace (6) and pharmaceutical (5) (Nolan, 2001: 18). This special team formed by state companies obtained special concessions, protective tariffs, and wide financial support from the four main Chinese state banks and from the Export-Import Bank.

to reach a level for sustained industrial production. The need for imports in China is huge. Their total consumption of iron ore (30% of world consumption in 2001), platinum (21%) and aluminum (15%) are in contrast with levels that are much more modest if one considers them in per capita terms. Along with oil and other commodities, the need for imports of machinery and equipment and sophisticated arms are putting intense pressure on the need for foreign exchange and thus demonstrate the importance of foreign markets for China's development strategy.

In this sense, it is necessary to observe the expansion of Chinese foreign trade and the configuration of a regional dynamic centered around China. This expansion is the result of China establishing itself as a "dual pole" in the world economy: the principal producer of cheap manufactured goods and the very large market for world production of machinery and equipment, high tech industries and raw materials. This dual pole, never exercised by Japan, has generated an important impact on the Asian region. As a reflection of this reality, China is in the process of expanding upon a set of political initiatives for the region. Let's consider the first aspect.

Since 1995, China has been substantially increasing its trade surplus with the U.S. and Europe, displacing, partially, exports from other Asian countries for those markets, and at the same time, increasing, in a significant way, its imports in Asia. As occurred for Japan previously, China is becoming more and more linked to the dynamic of U.S. imports (more than 20% of Chinese exports go to the U.S.). But in contrast to Japan, China has shown itself to also be a strong magnet for ASEAN exports. The Chinese imports from Asia have already been increasing since the 1980s, but have increased strongly as of 1995, especially as of 1997, becoming the motor of Asian growth (McKinnon & Scnabl, 2003), particularly important for South Korea and Taiwan. Their position as a net importer for ASEAN, is due on the other hand to the structural change in China, mainly in the IT industry,

and in the machinery and equipment sector, which have come to have growing importance in their composition of exports and the production geared towards their internal market.

The shifting of trade resulting from the acceleration of Chinese exports is closely tied to the shifting of foreign investment. Thus, China establishing itself as a pole of attraction for foreign investment, shifting investment flows from returning to other Asian countries. The large U.S., Japanese, and European multinationals, decided to consolidate, in China, a world manufacturing base for the production of consumer electronics[42]. Even more significant, for political reasons, has been the huge shifting of IT companies from Taiwan (world leaders for keyboards, monitors, and laptops) to China with major impacts for regional trade. The shifting of investments became evident, especially with regards to Japan. Thus, as Japan was scaling back foreign investment into ASEAN countries, such as Indonesia, Malaysia and Thailand, it was expanding it into China. China has therefore transformed into a pole of attraction for processing activities, but also, thanks to its internal market, a major destination for imports.

This double dimension means that the expansion of foreign investment into China is turned toward the foreign market as much as toward the internal Chinese market. On the other hand, the rapid shift of the volume of Chinese exports and their diversification is growing with the possibilities of industrialization in the region. In this way, in 1993, oils and lubricants corresponded to 32% of the exports from ASEAN to China, in 1999, machines and computers correspond to 20% and electronic equipment 18% (Hefeker & Nabor, 2002). In 1993, China was responsible for 11% of

[42] As Sakakibara & Yamakawa (2002: 44) observe: “China’s success is transforming the marketplace for Asia electronics industry. China now accounts for 30 percent of the region’s electronics exports, compared to only 14.3% in 1997. China’s gains have been most costly for Singapore, which saw its market share slump over the same period from 19.3 percent to 9.8 percent. Other countries, such as Malaysia, Taiwan, and Thailand, are also under pressure”.

electronic equipment exports to the ASEAN countries and 10% of computers and machine exports; by 1999 the proportions grew to 26.6% and 20% respectively. There is a new pattern developing, given the large difference between the volume of trade patterns for China within ASEAN – being more similar to the case of Germany within Europe- rather than that of Japan with the Asian region, a pattern of traditional vertical specialization.

It is this position of China within world and regional trade that allows us to understand why, facing the successive devaluations of the main Asian currencies, due to the crisis of 1997 (up to 50% in real terms), that China kept a fixed nominal exchange rate of the yuan to the dollar and put into place a significant program of investment and public works, in order to maintain economic growth through the expansion of internal demand (McKinnon & Scnabl, 2003).

Contrary to other Asian economies in which high trade flows became strongly dependent on the exchange rate variations and the behavior of foreign markets, China with a large internal market and in spite of its absolute size a smaller trade flow, thus establishing a dynamic rooted in internal policy. For this, they maintain strict control over their capital account for their balance of payments[43]; it must also be observed that starting from very reduced initial values, China began to establish itself as a regional investor (Sakakibara & Yamakawa, 2002).

It is in this context that the pressures from the U.S. and also from Japan opposed the exchange rate regime of China and the argument that China is keeping its real exchange rate artificially low. This pressure, and the fact that China is presented, just like Japan, as having a high trade

[43] The case of China reveals that the central issue for greater stability of growth in open economies is not the size of foreign trade reflected in the ratio of trade to GDP, but one's external solvency, which essentially depends on the relation between the balance of current transactions and the evolution of net external liabilities and exports (Medeiros & Serrano, 1999).

surplus with the U.S., substantial reserves basically denominated in dollars, and having registered low inflation in recent years, including deflation in 1999, brings McKinnon & Scnabl (2003) to extend to China the "conflictive virtue syndrome". Such a syndrome brings a constant pressure on the yuan to increase in value, as occurred historically with Japan.

However, with a notable difference, Japan is a net creditor whereas China is a net debtor country. The Japanese issue portrayed in the "conflictive virtue syndrome" is a low internationalization of their currency, causing them to be a creditor in dollars. The high external risk for Japan derives from the risk of an exchange rate shift and the pressure of the dollar glut with regards to exchange brings with it a deflationary pressure. The external position of China is completely different. China does not have a problem of solvency and their debt/export ratio is quite low compared to international standards. However, the strong expansion of foreign investment has been increasing its foreign liabilities[44]. The bilateral pressures from the U.S. and secondarily from Japan and the EU, in opposition to the Chinese exchange rate policy, must be seen in perspective. As the pressures of the U.S. regarding the trade balance with Japan were substantial and persistent, the high Chinese trade balance with the U.S. is also a factor of pressure, however with a major difference. In contrast to Japan, China is a large receiver of U.S. investment. With an investment stock of $70 billion from large U.S. multinationals, China has established itself as the developing country with the largest amount of income transferred to U.S. companies. The volume of sales of these corporations in China is incomparably greater than those realized in Japan. So, the U.S. pressure against the Chinese exchange rate policy is due to industries that

[44] Therefore, if considering the net external position of a country as the sum of net debt, net stocks of financial investments and net stocks of foreign investment, for China, as for the majority of developing countries, and in stark contrast with the Japanese economy, has a negative external position.

have less access to the Chinese market. But, more than anything, that which seems to differ significantly between the two economies is the commitment by the Chinese government to continue to have public expenditures and investments in state enterprises[45].

Regarding the rate of exchange of the yuan, it must be observed that by keeping a fixed ratio (quasi-) with the dollar since 1994, as various competing Asian countries devalued their currencies, including Japan, there was an increase in the value (and not a devaluation) of the yuan with respect to their Asian competitors. This meant a decline in exports from China to ASEAN countries, such that their main concentration of exports was even more with the U.S. This can also be seen in relation to the deceleration of growth of Japanese exports, which has occurred in recent years. In a strict sense, it is important to emphasize (Cui, 2004) that as a compensation for the devaluations of Asian competitors, Chinese exports outside the special processing zones were provided with a stimulus through the fiscal returns from exporters.

In relation to the dollar, the pattern of inflation in the US (China's main partner) must be taken into account and the inflation in China (same as the deflation in 1999) is practically the same. The impressive expansion of Chinese exports for this market didn't result in a real devaluation of the yuan with respect to the dollar, but reflects as already seen above, the shift of trade and the strategy of shifting operations by US multinationals. With regards to the yen, the deflation of prices in Japan caused a devaluation in real terms of their currency with respect to the yuan. In this manner, the pressure for a change in the Chinese exchange rate must be seen as pressure against the exchange centralization and the policy of buying reserves by the

[45] In the description by McKinnon & Scnabl (2003: 10): "...starting in March 1998, China took strong Keynesian measures to slow its internal deflation. Its New Deal encompassed a huge expansion of government expenditure on infrastructure and on mass residential housing. Since 1998 public works have increased by 20% per year. In 2001 as well in 2002, the (announced) stimulus package amounted $18 billion (150 billion RMB).

Chinese Central Bank, which prevents the yuan from increasing in value with the accumulation of capital flows. Maintaining the nominal stability of the yuan, and at the same time continuing the expansion of their internal market, through to the present moment, has been a form of increasing their trade and establishing themselves as a regional pole. The entry into the WTO and other regional agreements and the establishment of the yuan regionally, must be considered in this context.

The entry of China into the WTO in 2001 – the result of a long negotiation with the US taking place over 15 years – constituted a complex issue, the examination of which evidently goes beyond immediate economic calculations and issues. In spite of the arguments in favor, generally defined for academic Chinese economists based on statistical gains in international trade, in should be observed that the Chinese concessions for foreign trade, investment regime, government purchases, technology transfers, and competition regime were quite extensive and broad[46].

The impact on agriculture and subsequently on unemployment (estimates show that there are close to 200 million excess rural workers), on certain key industries (automobiles, chemicals, machines and equipment) and especially in services (banks, business services) will possibly be impacted significantly and will depend on the degree to which the Chinese economy will be able to keep high rates of growth. There is, however, an aspect of notable importance. As China is more and more dependent on the global economy for serving its needs of raw materials and capital goods, the

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[46] According to Nolan (2001:195): "China agreed to dismantle almost the entire range of mechanisms that has formed the core of industrial policy in the past two hundred years as a succession of countries has supported the growth of domestic large corporations. China has accepted that there will be enormous changes in its dealings with the global marketplace. Within the WTO it will be extremely difficult for China to limit access to its domestic market. (…) The US-China Agreement is the most detailed agreement yet signed by any country on its entry to the WTO. The US-China WTO Agreement in itself constitutes a massive program of economic system reform. Nine hundred Chinese laws will need to be changed and/or adapted for China to enter the WTO".

reduction in costs of imports and the free access to world markets for these products constitutes an important factor for its external competitiveness. On the other hand, as the domestic Chinese market has no equivalent, foreign firms investing in China that are seeking to sell within China, will still need to export. And thanks to the speed in which it is advancing technologically and the modernization of its infrastructure, it would be difficult for the export multiplier to collapse, as occurred in the case of Mexico. From the political point of view, the two main underlying trajectories in accordance with the WTO, were the attempt to reduce the US trade pressure and the strategy of politically isolating the initiatives for autonomy by Taiwan (Medeiros, 2001).

The new institutions created according to the rules of the WTO undeniably created, also in China, mechanisms that impede initiatives that have been developed by the Chinese state. However, the control of capital flows and consequently the yuan, keeping public enterprises, infrastructure and the search for state mechanisms for conglomeration and internationalization have, together with an active fiscal policy, preserved a significant degree of the Chinese government's initiative in maintaining control of their economy.

As a result of anticipated reduction in tariffs, China needs to increase its imports and possibly consolidate, even more, its position as a major destination of foreign investment in Asia. As seen previously, the shifting of the electronics industry from Taiwan to China is already a fact which China's entry into the WTO facilitated. In this sense, keeping the nominal rate of exchange stable and a favorable real rate for Chinese exports is of great strategic importance, as it is in the same way, looking to consolidate more and more of its development within the network of regional trade. As a result, with the reduction of Chinese tariffs, upon entering the WTO, Chinese imports are expected to increase, favoring the exports from

ASEAN. In the same year that China entered the WTO, 2001, an initiative was launched to establish a free trade area for the ASEAN countries within ten years (Xian, 2003). This seems to reinforce the Chinese strategy of consolidating its leadership among the ASEAN countries, and at the same time, building up the level of cooperation and agreements within the context of the ASEAN+3 (China, South Korea and Japan), including financial and monetary arrangements in such a way, so as to reduce the exchange rate risks in the region.

Implicit in this strategy is the decision, made at the 10th 5-year Plan (2001) to accelerate the development of the IT industry, going from regional cooperation and concentrating on the creation of adequate infrastructure for such a transition. Indisputably, this strategy is based upon the yuan (once again the importance of its stability), which, due to the weakness of the yen, can aspire to have a stronger position with respect to the dollar[47]. By a different path, China appears to be exercising a role in Asia today that is similar to that which Germany exercised in Western Europe in the golden age of capitalism under the Bretton Woods system, that of becoming the center of an expanding region. A center which however, doesn't possess a US military base leading its defense policy, a factor which implies a major difference in the geopolitical context and in the strategies of development, and that makes the Chinese state a permanent target for the imperial designs of the U.S.

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[47] The agreement between China and ASEAN to establish a FTA within 10 years increased the role of China in the region and spurred China's integration in the regional network not only economically but also politically, to the expense of Japan. This should increase mutual confidence between China and its neighbors and therefore stabilize bilateral relations and monetary cooperation (Hefeker & Nabor, 2002: 17).

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