

# The United States Empire of debt

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## INTRODUCTION [ABSTRACT]

The emergence of quite severe global balance of payments disequilibria over the past two decades threatens the very foundations of the international monetary and financial system. The very epicentre of this widening chasm can be readily identified in the burgeoning US current account deficits and net foreign debt, on the one hand, and the vast accumulation of current account surpluses and foreign exchange reserves by East Asia, on the other hand. Indeed, the greatest asymmetry in the global economy lies precisely in these growing imbalances across the Pacific. It is possible to evoke analogies between the decline of *Pax Britannica* as the foremost financial hegemon in the era preceding the First World War and the concomitant rise of the rival capitalist states of Germany and the USA (Harvey, 2003). The central question posed is whether the demise of *Pax Americana* signifies a phase of hegemonic transition to East Asia. What are the implications of the decline of the US dollar as the pre-eminent reserve currency and means of international payments? To what extent are the foreign holders of US dollar-denominated assets willing to bestow the exorbitant privileges of seigniorage enjoyed by the US monetary authorities? In the event of a sell-off of US dollar denominated assets and foreign central bank dollar reserves, will the US itself encounter a similar phase of debt-deflation to that which has gripped Japan in the 1990s?

## THE EXORBITANT PRIVILEGES OF US DOLLAR SEIGNIORAGE

In 2006, the US current account deficit reached perilous levels both in absolute terms at US \$811bn and as a percentage of GDP (6.12%). This compares to US\$200bn or 2.5 per cent of GDP in 1998, and US\$416bn (4% of GDP) in 2000. The most recent OECD projections show that the US current account deficit could rise to over 7.6 per cent of GDP in 2008. The US had incurred a cumulative current account deficit exceeding US\$4.5 trillion by 2003 (Iley & Lewis, 2007: 159). In the period 1997-2000, the US current account deficit had tripled as a result of both the dollar revaluation and the impact of the East Asian export recovery. The hollowing out of the US manufacturing base was further eroded as the manufacturing trade deficit increased by two and a half times and had accounted for about 70 per cent of the increase in the overall current account deficit during this period (Brenner, 2006: 307). Gross dollar-denominated financial assets owned by private foreigners stood at about US\$5.9 trillion in 2003 (Gray, 2004: 13). Dollar reserves accounted for about 73 per cent of total international reserves, or equivalent to around US\$1,751.4 billion by the end of 2002 (D'Arista, 2004: 500). According to Duncan (2003), between 1969 and 2003, international reserve assets expanded almost exponentially at around 20-fold. Since the demise of the post-war, fixed exchange rate system of Bretton Woods

in 1971, there has been an explosive growth of international central bank reserves, most of which are denominated in US dollars. The expansion of these reserves has mirrored the widening trade imbalances between the US and the rest of the world (Duncan, 2003: 13). Table 1 summarises global current account balances in the years 1997-2006.

Conversely, the East Asian economies, most notably China, have been accumulating quite large balance of payments surpluses and the build-up of substantial foreign exchange reserves. Indeed, in the aftermath of the East Asian financial crisis in 1997-98, the East Asian economies have restored their reserve positions and have amassed vast war chests of foreign exchange reserves in order to defend themselves against the possibility of another speculative attack on their respective currencies. The imposition of fixed and managed exchange rates have also offset the pressure for currency revaluations against the US dollar, which would inevitably undermine their export-led strategies of growth. Between 1999 and 2005, East Asian central banks (excluding Japan) have accumulated US\$1.25 trillion in reserves. A large share of these reserves are simply recycled through the purchase of US bonds and securities or re-invested in US dollar-denominated assets. "Since Bush took office, East Asian central banks have added to their Treasury holdings at a rate of nearly half a billion dollars a day, that is, about a third of the average US current account deficit. The funding of the deficit was thus left increasingly to the mercy of these banks" (Arrighi, 2005: 67).

**Table 1**  
**Global Current Account Balances, Selected Years,**  
**1997-2006 (US\$ billions)**

	<i>1997</i>	<i>2000</i>	<i>2006</i>	<i>2006-2000</i>	<i>% of US Change, 2000-06</i>
USA	-141	-416	-811	-395	N/A
Japan	97	120	170	50	12.7
Germany, Netherlands, Switzerland	41	5	263	258	65.3
Other developed countries	68	23	-139	-162	-41.0
China	34	21	239	218	55.2
Other developing Asia	-27	26	-12	-38	-9.6
Central and Eastern Europe	-21	-32	-89	-57	-14.4
CIS	-9	48	99	51	12.9
Middle East	11	70	212	142	35.9
Latin America	-67	-48	49	97	24.6
Africa	-6	7	20	13	3.3
Discrepancy	14	176	-1	-177	-44.8
Memo: Fuel Exporters	16	149	396	247	62.5

*Source:* Iley & Lewis, 2007: 185.

Since 2002, China's current account surpluses have increased quite sharply and now constitute the largest single nation component of the US current account deficit, surpassing even those of Japan (Table 3). These current account surpluses surged from only US\$68.7bn in 2004 to US \$158bn or 7.1 per cent of GDP in 2005. By 2006, China's bilateral trade surplus with the US was US\$235bn, which represented over a third of the total US trade deficit, making China by far the largest country component of the US trade deficit. Moreover, China is heavily dependent

upon the US market, with exports to the US accounting for 35 per cent of total Chinese exports in 2003, while only 4 per cent of US exports were destined to China. China's current account surpluses translate into an enormous accumulation of dollar reserves. Between December 2000 and December 2003, foreign exchange holdings of China's central bank more than doubled from \$US166 billion to \$US403 billion. In 2006, this figure had exceeded \$US1.2 trillion of which \$US600 billion was denominated in the US currency. In the absence of central bank sterilisation policies, the vast build-up of excess liquidity threatens to induce a phase of financial speculation in the real estate and equity markets reminiscent of the speculative boom which had preceded the East Asian financial crisis in 1997-98 (Lucarelli, 2002).

In order to maintain their competitive advantage, China is systematically intervening in the foreign exchange markets to keep its currency undervalued. China pegs its currency to the dollar and the yuan has traded, with small fluctuations, at about 8.28 per dollar since 1998. This situation has enormously strengthened China's competitive advantage, making the yuan undervalued by between 15 and 40 per cent according to most estimates. At the same time, the temptation of the Chinese central bank to diversify out of US dollar denominated bonds and securities threatens to trigger a crash in the US bond market, which would ultimately imperil China's major export market in the US in the event of a US recession (Taggart-Murphy, 2005: 61). US trade officials have argued that the under-valuation of the Chinese yuan has contributed to their trade deficit with China and has been a major factor in the hollowing out of the US manufacturing sector. Needless to say, these trade imbalances and currency disputes have the potential to trigger a phase of destabilising trade wars between China and the United States.

**Table 2**  
**Total Chinese Exports to the US (\$USbn) and as a Percent of Total Exports**  
**(1990-2003)**

Year	Total Exports to the US (\$USbn)	Percent of Total Exports
1990	2.3	8.5
1995	24.7	16.6
2000	52.2	20.9
2003	124.0	35.0

*Source:* Report to Congress of the US-China Economic & Security Review Commission, 2004, p. 56

The other major source of global surpluses have recently emanated from the non-OECD oil producers. Whereas East Asian surpluses are expected to exceed US\$700bn in 2006-07, the surpluses of the non-OECD oil producers are projected to be about US\$550bn in 2007 (Burrell, 2006). The cumulative surpluses of the oil exporters were estimated to be about US\$1.7 trillion between 2002 and 2007. This enormous expansion of petro-dollars has contributed to excess liquidity which has fuelled the equity boom over this period. However, these OPEC surpluses can be designated as cyclical in the sense that commodity prices tend to be highly dependent upon the vagaries of international trade cycles. By contrast, the East Asian surpluses are essentially structural and signify a profound shift in the international competitiveness of manufacturing in East Asia's favour (Glyn, 2006). Deindustrialisation in the US thus constitutes the rationalising dynamic of this shift in the productive centre of gravity to East Asia.

**Table 3**  
**US Balance of Goods Trade by Region for 2003**

	Balance(\$USbn)	% of Total
Total	-535	100%
North America –	95.0	17.8
Canada	-54.5	10.2
Mexico	-40.6	7.6
Western Europe –	101.3	18.9
Euro Area	-75.4	14.1
Pacific Rim –	-230.0	43.0
Japan	-66.0	12.3
China	-124.0	23.2
OPEC	-51.0	9.5
Rest of the World	-57.9	10.8

*Source:* Report to Congress of the US-China Economic & Security Review Commission, 2004, p. 57

US adjustment to the new realities of the global economy will involve some combination of further depreciation of the dollar, appreciation of the currencies of countries with the largest current account surpluses, and the rerouting of these surpluses from the financing of US deficits to the creation of demand elsewhere, especially in East Asia. This eventual adjustment may be “brutal”, through a dollar rout, or “smooth”. Either way, the adjustment will inevitably result in a further decrease of US command over world economic resources, a reduction of the weight and centrality of the US market in the global economy, and a diminished role for the dollar as international means of payment and reserve currency. (Arrighi, 2005: 70)

Consequently, this virtuous circle implies an increase in the net US external debt but, at the same time, makes East Asian holders of US dollar denominated assets quite vulnerable to a sudden depreciation of the US dollar (Schnabl, 2005: 161). US deficits have been estimated to have absorbed about two thirds of the combined global current account surpluses (Roubini & Setser, 2004: 26). Summers (2004) has described the current configuration as a “balance of financial terror”: “The term 'balance of financial terror' refers to a situation where we rely on the costs of others of not financing our current account deficit as assurance that financing will continue” (Summers, 2004: 8). In the event of a sudden dollar devaluation, the fallacy of composition would suggest that the incentive for individual central banks to diversify out of an over-reliance of US dollar denominated assets will intensify as the US continues to experience an ever-growing and cumulative stock of foreign debt, which in turn puts pressure on a substantial dollar devaluation. It follows that this logic could quite easily become self-fulfilling to the extent that if a growing number of central banks feel obliged to protect themselves against a falling US dollar by diversifying their reserve holdings, the whole system of dollar recycling could collapse with quite devastating consequences. There is a classical dilemma akin to the prisoner's dilemma in game theory: all central banks would be assured stability if no single central bank decided to diversify out of US dollar reserve assets, but as the risk of a dollar crisis increases, each central bank is impelled to insulate itself from incurring huge losses.

The broadest measure of a nation's financial balance sheet or the amount a nation's residents owe to the rest of the world is the net international investment position (NIIP). Since most US debt is denominated in US dollars and most US foreign assets are denominated in foreign currencies, the US net international investment position tends to increase in the event of an effective exchange rate depreciation. At the same time, the US acts as an international financial intermediary and enjoys relatively higher returns on its foreign investment than foreigners earn on their respective US investments (Papadimitriou, *et al*, 2006: 4). Over the past three decades, however, the United States' NIIP has deteriorated, which is reflected in the increase in net

foreign debt. In the 1970s, the net foreign debt was about one and a half times GDP. By 1985 it had doubled and by 2005, the total net foreign debt was estimated at three and a half times GDP, or around US\$44 trillion (Magdoff, 2006: 7). However, the NIIP of the US peaked in 1982 at over US\$329bn, or about 12 per cent of GDP. Since then, the NIIP has experienced a dramatic deterioration, estimated at minus 24 per cent of GDP, or equivalent to minus US\$2.65 trillion in 2003 (Gray, 2004: 13). The value of foreign owned US assets was estimated at US \$3.3 trillion or about 30 per cent of its GDP in 2005 and this share had doubled in the years 2001-05 (Ertuck, 2005: 1).

Despite the alarming deterioration in the US's NIIP, the net inflow of investment income has remained positive until 2005. This apparent anomaly suggests that the US continues to perform the role of foremost international financial intermediary as well as enjoying the exorbitant privileges bestowed by the pre-eminent role of the dollar as the major reserve asset and international means of payments. The US therefore continues to derive a profitable stream of income from its foreign assets which, to a large degree, compensates for its net liabilities abroad (Bibow, 2006: 19). There has also been a substantial increase in US assets held by foreigners, which has grown from only 2 per cent of the total value of the US credit market in the early 1970s to about 14 per cent in 2006. Similarly, the share of foreign ownership in US equities has increased from 7 per cent in the early 1990s to about 12 per cent in 2006 (Papadimitriou & Chilcote, *et al.*, 2006: 4).

A very high proportion of US assets abroad are held in equities. By the end of 2005, more than 55 per cent of the US stock of US\$10 trillion in overseas assets was in the form of corporate equities. In stark contrast, foreign claims on the US are concentrated in the US debt market. These financial claims were estimated at US\$12.7 trillion in 2006 (Iley & Lewis, 2007: 147-48). Even though the US is a net creditor in relation to foreign direct investment and the ownership of equities abroad, this is more than offset by their net liability position in the more interest-sensitive debt markets. This apparent dichotomy resembles the financial structure of a venture capitalist in the sense that the US's "portfolio" is highly leveraged with foreign liabilities over four times the size of net foreign debt and assets held abroad worth over three times net foreign debt (Iley & Lewis, 2007: 150). The bias towards the holding of debt and interest-bearing assets by foreigners reinforces the seigniorage privileges enjoyed by US financial markets and the pre-eminent role performed by the US dollar as both a store of international value and means of payments. As Gray (2004) has quite succinctly observed: "An international financial system in which the hegemon finances decreases in its international net worth (INW) by increasing its rate of dissaving (as non-residents acquire more and more dollar assets) is a case study in Ponzi finance" (Gray, 2004: 110).

A fall in the effective US exchange rate implies an improvement in US net investment income by increasing the dollar value of its overseas earnings. At the same time, the value of its stock of net foreign debt will diminish via the "valuation effect" of a dollar depreciation. In short, unlike the rest of the capitalist world, the US is capable of borrowing abroad in its own currency. The risk of a dollar depreciation is incurred almost entirely by the foreign holders of US dollar denominated assets. Between the beginning of 2002 and November 2007, the dollar had depreciated by 21 per cent on a trade weighted basis and more than 50 per cent against the euro (Godley *et al.*, 2007: 8). It is precisely because of the recent dollar depreciation since 2002 that the US has been able to prevent a major deterioration of its NIIP. This rather perverse logic has been possible because the investment income balance (the difference between what the US pays and what it earns from the rest of the world) has not deteriorated as much as one would expect from a country experiencing quite chronic and cumulative current account deficits. Consequently, the US has so far been able to finance these trade deficits without experiencing a major sell-off of US bonds and securities. Since almost all US foreign liabilities are denominated in its own currency and about 70 per cent of US foreign assets are in foreign currencies, a dollar depreciation represents a net transfer of wealth from the rest of the world. Indeed, a 10 per cent depreciation of the US dollar translates into a transfer of around 5 per cent

of US national income from abroad, which is sufficiently large enough to offset the US trade deficit itself (Iley & Lewis, 2007: 107). The extent to which the US can sustain this apparent enigma will ultimately depend upon the willingness of its international capitalist rivals to continue to finance the US current account deficits and the burgeoning foreign debt in the event of a major collapse of the US dollar (Halevi & Lucarelli, 2002).

In a nightmare scenario, the US would have to cut its current account deficit sharply to reduce the amount of new financing that it needs to attract from the rest of the world even as it is starting to lose the advantages of being a reserve currency. In such a scenario, the US would have to offer foreigners much more attractive returns – either higher interest rates or forms of borrowing that transfer the risk of further depreciation from US creditors to US borrowers – to convince foreigners to continue to hold their savings in the US. The US could face higher interest rates on its existing stock of debt even as it has to curtail its new borrowing. (Roubini & Setser, 2004: 44)

The received wisdom is that foreign holders of US dollar assets cannot continue to finance US external deficits indefinitely. Sooner or later, the United States will be compelled to make a painful structural adjustment by curtailing its domestic consumption spending on imports (Davidson, 2006: 479). This adjustment will inevitably impart a depressive impulse on those countries in East Asia, which have relied too much on an export-led strategy of growth and to which the American domestic market continues to act as a market of last resort. The impact of a US recession could lead to a dampening of effective demand and falling profitability in those sectors in East Asia most exposed to exports as an engine of growth. It is at this moment that the problem of “conflicted virtue” arises (McKinnon, 2005). In the event of a sudden and quite severe dollar depreciation, the foreign holders of US dollar-denominated assets will confront enormous losses. The appreciation of the domestic currency against the US dollar could induce a deflationary adjustment domestically and set in motion a depressive spiral of falling profitability and income. Under the more extreme cases, analogous to the Japanese experience of the 1990s, the onset of deflationary trap could lead to a collapse in investment and the level of effective demand. “Thus we have the syndrome of conflicted virtue for creditor economies, which is the mirror image or twin problem of original sin for debtor countries” (McKinnon, 2005: 7).

In order to prevent the appreciation of their domestic currency, which would threaten their international export competitiveness, East Asian central banks are forced to intervene through open market operations to buy excess US dollars. In the short run, these sterilisation policies mitigate the effects of successive dollar devaluations as the domestic monetary base expands in order to dampen domestic interest rates relative to US domestic rates. As long as the domestic interest rate remains above zero, a liquidity trap can be avoided. But the build-up of foreign exchange reserves could also induce the expansion of domestic credit and create the conditions for a speculative asset-price euphoria. This scenario can be described as an exemplar of a Minskian phase of a speculative financial mania leading to its eventual crash (Minsky, 1982). The bursting of the asset price bubble, in turn, sows the seeds for the onset of a phase of debt-deflation.

The real danger, however, could emerge in which an event or a confluence of events, hastens a flight from the dollar and precipitates a phase of severe financial turbulence in world markets and extreme volatility in global currency markets. In this Minskian drama, financial fragility could cause a series of cascading bankruptcies and financial defaults as holders of highly liquid US dollar denominated assets switch their portfolio preferences to non-US dollar assets (Gray, 1990: 283). This critical moment would signify the exhaustion of the dollar:

Exhaustion can come about for either of two reasons: the loss of confidence on the part of foreign lenders and their unwillingness to continue to hold or to increase their holdings of dollar-denominated assets: and, second, economic and political pressures in the US that

derive from the burden in the domestic economy of the duties of being the global locomotive (injecting aggregate demand into the global system by running current account deficits, thereby reducing aggregate demand for domestic capacity), may become intolerable. (Gray, 2004: 8)

As investors clamour to sell dollar-denominated assets, bond prices will fall and since interest rates move inversely with bond prices, rising interest rates could induce a recession in the US. Equally, a sharp dollar depreciation would tend to increase the price of imports and rekindle inflationary pressures, which could also act as a trigger in forcing the hand of the US Federal Reserve to hike up the official interest rate. International support for the dollar would evaporate as investors and hedge funds scramble for safer havens in other hard currencies or into gold or other precious metals. Balzac, the famous nineteenth century French novelist, once remarked that if the debtor was big enough then he or she has the ultimate power over the creditors. The real problem was to be a small debtor. It is still too premature to declare if the “Balzac effect” will cease to support the privileges of US dollar seigniorage. However, the exhaustion of the dollar cannot be too far away.

## CONCLUSION

The empire of debt signifies the final historical vestiges or the “autumn” phase of *Pax Americana*. The US economy is effectively caught in a debt trap. On the one hand, as the world's largest debtor nation, it is impelled to attract a net inflow of capital in order to finance its ever burgeoning and cumulative current account deficits. On the other hand, the US needs to ensure that the rate of return on US dollar assets are high enough to maintain this inflow of capital and prevent a loss of confidence in the US dollar. Since the demise of the Bretton Woods system since the early 1970s, the US has enjoyed the enormous benefits of international dollar seigniorage. But these financial privileges reflect the fact that the US has become a net *rentier* nation reminiscent of the decline of *Pax Britannica* during the inter-war years last century. Since 2000, the US's net international investment position has deteriorated quite dramatically but the immanent flight from US dollar assets has been temporarily postponed because the US continues to exploit its hegemonic position as the pre-eminent international financial intermediary. Sooner or later, however, this position will no longer be tenable and a deflationary process of internal adjustment will occur as the fall-out from the vast accumulation of private debt could precipitate a phase of quite severe debt-deflation, similar to the Japanese experience in the 1990s (Halevi & Lucarelli, 2002).

The logic of capitalist crises is precisely what Schumpeter describes as the gales of “creative destruction” or to paraphrase Marx, “the slaughtering of capital values”. Since the rise of neoliberalism from the early 1980s, the restoration of profitability has singularly failed to eventuate. The crisis in the US will invariably reverberate globally as the flight from US dollar assets intensifies inter-imperialist rivalries over markets, investment outlets and access to strategic raw materials. This phase of hegemonic transition could witness the centre of global economic gravity shifting to East Asia as China assumes the role of regional hegemon.

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