Global Imbalances and Power Imbalances

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Abstract

We discuss the conditions under which global imbalances, such as China being a large foreign creditor and the United States being a large foreign debtor, might also generate power imbalances. We highlight possible theoretical channels and empirical measures that the future literature could investigate in a full treatment of this topic.

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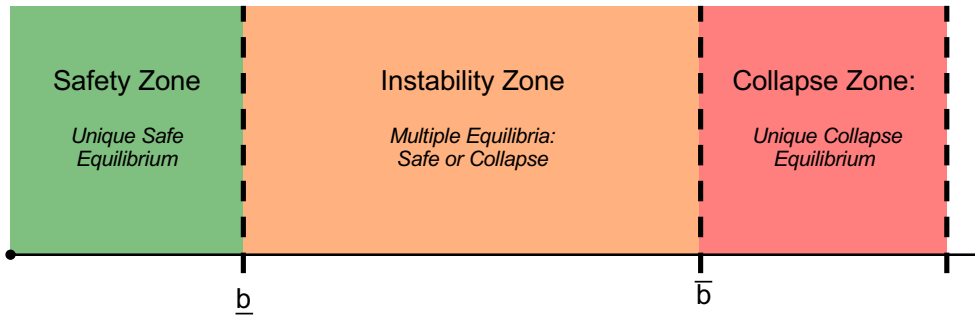
Geoeconomic pressure has returned to the forefront of the global policy agenda. Countries such as the United States and China are using the trade and finance relationships of their economies with the rest of the world to exert power to achieve economic or geopolitical goals. Contrary to competition between the U.S. and Russia during the Cold War, the current competition between the U.S. and China is taking place in a world in which the two great powers' economies are highly interdependent. In this short paper, we focus on a prominent economic relationship between the two great powers: the U.S. is a large external borrower, and China is a large external lender. In particular, we focus on Chinese holdings of U.S. bonds.

To what extent are these imbalances likely to also affect the power relationship between the U.S. and China? Geopolitical analysts have often speculated that China might generate leverage over the U.S. by threatening to "dump" its holdings of U.S. Treasuries. Yet, one could instead think that the debtor has the power, since it could threaten not to repay the debt. We sketch here considerations that a full model should address and connect them to relevant historical examples.

A crucial element is to assess how much of a loss China could inflict on the US through its (potentially off equilibrium) threat to dump U.S. bonds. This is the logic of geoeconomic power as the gap between the value of the inside and outside option of the target put forward by Clayton, Maggiori and Schreger (2023, 2024), and is key to determining how much China could extract from the U.S. in the form of a political or economic concession. If Chinese liquidations simply led to a change in who owns the U.S. bonds with limited impact on prices (i.e., U.S. borrowing costs), then the answer is that China would have no power over the U.S. arising from the global imbalances. If instead China could trigger a large and potentially persistent spike in U.S. borrowing costs, then China would have power over the U.S. and could extract some concessions from a threat to dump the bonds.

We take as background a model, like Farhi and Maggiori (2018), with three different regions of U.S. debt levels (see Figure 2). At low levels of debt below $\underline{b}$, in the Safety Zone, there is a unique equilibrium and the debt is safe. At intermediate debt levels (between $\underline{b}$ and $\bar{b}$), in the Instability Zone, there are multiple equilibria. If investors expect the debt to be safe, then because interest rates are low the U.S. prefers to repay the debt, thus fulfilling investors' expectations that the debt is safe. If instead investors expect the debt to be risky, then because interest rates are high the U.S. prefers to default/depreciate, thus fulfilling investors' expectations that the debt is risky. The multiplicity arises from a Calvo (1988) mechanism, but one could think of a rollover crisis à la Cole and Kehoe (2000). Finally, there is a Collapse Zone where the debt is so high (above $\bar{b}$) that the only equilibrium features default/depreciation. Our interest is to compare plausible power dynamics in the Safety and Instability zones.

Figure 1: Instability in Borrower Debt Market



1 Global Imbalances, Investor Substitution, and Self Fulfilling Crises

Suppose debt levels were low enough to be in the the Safety Zone. Let us conjecture that China carried out its threat to dump its holdings of US Treasuries or not show up as a buyer of new debt. The effect on U.S. borrowing costs would depend on the presence of alternative investors that could step in as buyers of the debt. The elasticity of bond prices to such flows has been the subject of much recent empirical macro-finance literature (e.g. Choi, Kirpalani and Perez (2025) and Jiang, Richmond and Zhang (2024)). Our conjecture is that for very safe and liquid debt, the price impact would be very limited. The U.S. could buy back the debt and re-issue it to new investors while pocketing a few basis points caused by China's fire-sale of the bonds. In this scenario, China has no power and attempts to fire-sell might even provide a mild gain to the U.S. However, as the U.S. reaches much higher levels of debt (i.e. in the Instability Zone) and the risks of a run surface, more considerations are at play.

First, high debt levels and the presence of default/depreciation risk might change the price elasticity to flows. The U.S. might now struggle to find alternative investors without offering a substantial price discount on the bonds (i.e., a higher interest rate). This is pure price pressure for a given level of riskiness of the bonds coming from the liquidity and depth of the market.

Second, China, as a large player, might be acting as a coordination device in a speculative attack on U.S. debt, along the lines of the second generation of currency crises models (Obstfeld (1986)). Through the lens of Figure 2, China carrying out its threat might cause a shift in the equilibrium selected from Safe to Collapse. The presence of multiplicity and shifts between equilibria could potentially amplify an originally much smaller price impact of China's fire selling of the bonds.

In this scenario, a power imbalance arises out of the global imbalances. China's threat to dump U.S. Treasuries allows it to threaten losses to the U.S. and extract concessions in return, in the tradition of geoeconomic power as the gap between the inside and outside option of the target

(Clayton, Maggiori and Schreger (2023, 2024)). Those papers focused on balanced trade and basic financial services (e.g. custody of assets and payments). The mechanisms discussed here arise from unbalanced trade, i.e. non-zero net foreign assets, and the elasticities of demand for bonds and other financial assets instead of those for goods.[1]

2 Retaliation, Asymmetric Costs, and Credibility

For a creditor, intentionally causing a debtor to suffer a run and not repay leads to losses. China would suffer a direct loss on its U.S. debt holdings. China could potentially also suffer indirect costs, including not only losses on the rest of its portfolio as other asset prices collapse due to a U.S. crisis, but also potential spillovers to its domestic economy as global demand slumps. Additionally, the U.S. might attempt to retaliate against China using its own asset holdings in China or other economic relationships.

It is also possible to imagine benefits to China of carrying out its threat. In a dynamic setting, one could imagine China engaging in a form of predatory reputation building. If China wants to build a reputation as a safe asset provider that can compete with the U.S. in a multipolar international monetary system, it might be willing to sustain short-term losses on its holdings of U.S. debt in order to cause a U.S. debt crisis that lowers the reputation of the U.S. as a safe asset provider.[2]

Ultimately, asymmetric costs – if the U.S. losses were much higher than the costs to China – might be enough to sustain the power imbalance and make the threats of China credible.

3 An Historical Precedent

The scenarios highlighted above are extreme concerns about crises that occur very rarely and are hard to predict. History, however, offers useful guidance and a closely related historical precedent with the U.K. facing a potential run and financial crisis, and the U.S. using the crisis to extract a political concession (see Kunz (1991), Kirshner (1997), Klug and Smith (1999), and Boughton (2001) for a fuller treatment).

In 1956 the British, French, and Israeli governments launched an invasion of Egypt with the aim of re-gaining control of the Suez Canal. The Canal, an important waterway for global commerce and a geopolitical point of tension, had been recently nationalized by Egyptian president Gamal Abdel Nasser.

The U.S. foreign policy under President Eisenhower tried to balance the interest of closely aligned nations such as Britain, France, and Israel with the aim of bringing Nasser's Egypt into the

[1] Threats to dump foreign asset holdings are one of many tools in the geoeconomics toolkit (see Baldwin (1985) and Clayton, Maggiori and Schreger (2025) for other tools).

[2] For models of dynamic reputation building as a safe asset provider, see Clayton et al. (2025) and Clayton et al. (2024).

U.S. sphere of influence and away from the U.S.S.R.. The Eisenhower Administration decided to put pressure on Britain, France, and Israel to withdraw from the Canal.

Britain in particular was facing a drainage of its foreign exchange reserves with the potential of a rapid acceleration of foreign liquidations, a run on the pound, and a consequent balance of payments crisis. Faced with a possible run, Britain appealed to the IMF for assistance via emergency liquidity, but the assistance was stalled by U.S. pressure on the IMF itself. In addition, there were concerns that the U.S. might attempt to liquidate some of its holdings of British bonds. These threats were deemed serious and credible by Britain's Chancellor of the Exchequer Macmillan who reported to Prime Minister Eden that Britain would suffer severely if the run occurred.[3] Macmillan's view of the U.S. threats was important in inducing the British government to agree to a ceasefire and eventual agreement to withdraw the troops that left the Canal under Egypt's control.

Figure 2 shows the drainage of Bank of England reserves in the period between July 1956 and December of the same year. The Suez Canal was nationalized by Egypt in July, and the hostilities escalated during the second part of October and November. Britain was defending a pound peg at 2.8 against the dollar, and had set a level of acceptable official reserves to be above 2 billion dollars. In November, British reserves were being drained and dipping below the self-declared critical level, and the pound was facing selling pressure on global markets.

The period of maximum tension was the second half of November and the first week of December. The approval of an IMF emergency lending package for Britain was held up by the U.S. administration resistance. Britain feared liquidation of its bonds by Arab countries, and potentially other western official reserves holders, forcing the Bank of England to use its official reserves to defend the pound peg. British officials worried that the news that official reserves had dropped below the self-declared floor of 2bn dollars could trigger private investors sales in expectation of a peg adjustment.

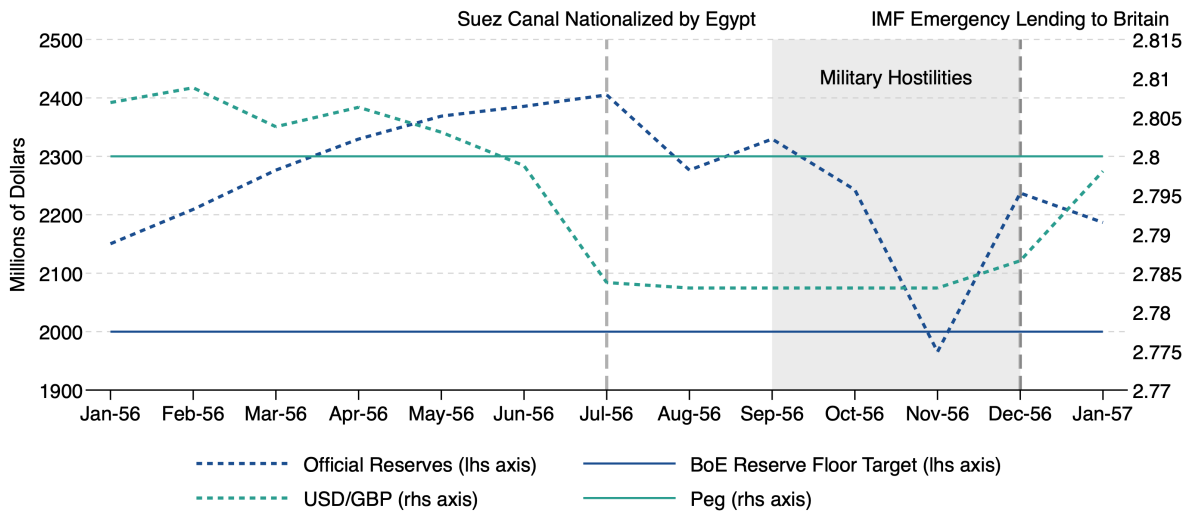
Faced with the mounting pressure, the British government gave in to the U.S. foreign policy demands and by mid December the IMF had approved and publicized emergency liquidity facilities, thus replenishing Britain's reserve position.[4] The crisis was averted by Britain providing a major geopolitical concession to the U.S. administration.

This historical episode illustrates some of the mechanisms sketched above. Britain was in a vulnerable position to begin with that left it open to a self-fulfilling crisis. Had Britain been in a stronger financial and fiscal position, it could have more easily withstood the pressure or found alternative buyers for its debt at a minor discount. The U.S. exploited this potential financial weakness in Britain and allegedly threatened to withhold IMF emergency lending and fire-sell some its bond holdings, thus potentially coordinating all investors expectations that a run on the pound

[3]Like all averted crises, there have been ex-post debates of the extent to which Britain was truly likely to face a run on the pound and whether Macmillan knowingly or unknowingly exaggerated the likely economic repercussions (Kunz (1991); Kirshner (1997)).

[4]For more detailed accounts of the financial statecraft during the crisis see: Klug and Smith (1999) and Boughton (2001).

Figure 2: British Financial Dynamics During the Suez Crisis



Notes: Britain official reserves and target floor on reserves (left scale, in dollar millions) and Dollar per British Pound exchange rate and peg level (exchange rate quoted in London, right scale). End of month from January 1956 to January 1957. Source: Bank of England Statistical Abstract 1970.

could be successful. The costs were probably asymmetric, with the cost of a crisis for the British economy outweighing the financial losses that the U.S. would have had to sustain.

4 Conclusion

In this short paper we sketched how global imbalances with some countries being large debtors to others could result into power imbalances. The mechanisms rely on fire-sales of bond holdings that can precipitate a financial crisis, akin to a bank run or rollover crisis, and prompt amplification via coordinating expectations and actions of other global investors. We think of these mechanisms in the context of China being a large creditor to the United states at present, but also related to U.S. financial threats to the U.K. during the Suez crisis in 1956-57. One could think of other likely scenarios, for example the U.S. weaponizing its emergency lending (e.g., the Fed swap lines) to other countries in the next financial crisis, much like it did to Britain in 1957. We suggest it is worthwhile for the future literature to fully model the forces highlighted here and to quantify the relevant elasticities in bond markets.

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