



Reserve Currencies and the Dollar's Role in Containing Global Imbalances

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The stability of the international reserve currency's purchasing power is less a question of what serves as that currency and more a question of the international adjustment mechanism, as well as the compatibility of export-led development strategies with international payment balances. Export-led growth and free capital flows are the real causes of sustained international imbalances. The only way out of this predicament is to shift to domestic demand-led development strategies—and capital flows will have to be part of the solution.

In terms of the gold standard, the international balance-of-payments adjustment mechanism based on arbitrage failed to solve the problem. According to John Maynard Keynes, it was the level of domestic activity, not arbitrage, that acted as the mechanism of price adjustment. The asymmetry between surplus and deficit countries meant that the adjustment process reduced the global level of activity, primarily through lower output and employment. This implied that the stability of the international purchasing power of financial claims was preserved at the expense of the value of labor.

To restore equilibrium, Keynes recommended a clearing union, whereby the costs of adjustment would be borne equally by all countries, and by capital and labor. The Bretton Woods system instead resorted to managing the adjustment process. The imposition of par values for the US dollar or gold for current-account convertibility meant that deficits were constrained by the size of a country's foreign-exchange reserves and drawings from the International Monetary Fund (IMF). However, this system preserved the asymmetric adjustment under the gold standard because it placed no active constraint on the reserve balances of surplus countries or on the size of the US external imbalance (and prevented global full employment).

But as pointed out by Robert Triffin, there was a practical limit to accumulating dollars when the United States was unable to meet the outstanding claims in gold at parity. Triffin's paradox is that it is impossible to have the dollar as the source of global liquidity and to fix the dollar's value in terms of gold when there is a growing global economy that requires an expansion of international liquidity. An important corollary of this paradox is that the stability of the reserve currency's pur-

chasing power is linked to an adjustment mechanism that eliminates international imbalances; it has little to do with what actually serves as the international currency.

Resolving Triffin's paradox meant abandoning the fixed-rate system that provided the constraints on global imbalances and moving to floating exchange rates and unregulated international capital flows. Instead of IMF intervention and conditionality, a new, market-based adjustment mechanism came into play. Interest-rate differentials generated capital inflows, leading to higher foreign-exchange reserves and an appreciating exchange rate. This approach led to further deterioration in the external accounts and to exchange-rate appreciation, thus reinforcing investor belief in the stability of the process. The size of a country's deficit post-Bretton Woods is determined by the confidence of international investors that a country can continue to increase its foreign borrowing in order to meet its debt-service commitments—what Hyman P. Minsky would have called a "Ponzi" scheme.

When developing countries adopt a strategy supporting domestic industrialization by promoting net exports based on a competitive exchange rate, they forego any guarantee that the purchasing power of their external claims will remain stable. The successful pursuit of these policies requires a distortion of prices, exchange rates, or global demand, and of the purchasing power of the resulting surpluses. Changing the international currency is not a solution to the (declining) value of accumulated surpluses because the problem is caused by the absence of an international adjustment mechanism that is compatible with the full utilization of global resources. China's surpluses would have been eliminated if an automatic price-adjustment process based on exchange-rate flexibility had been in place. Due to the Triffin paradox, China cannot escape the dollar losses of its foreign-exchange reserves any more than central banks could under Bretton Woods.

For a more detailed discussion of this topic, go to www.levyinstitute.org/pubs/ppb_116.pdf.

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