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HIGHLIGHTS

THE FALLACY OF THE REVISED BRETTON WOODS HYPOTHESIS

Why Today's International Financial System Is Unsustainable

THOMAS I. PALLEY

Introduction

Dooley, Folkerts-Landau, and Garber, to whom I refer as DFG, suggest in a series of papers (2003, 2004a, 2004b) that today's international financial system has structural similarities with the Bretton Woods arrangement that held sway between 1946 and 1971. Export-led growth by developing countries figures heavily in their analysis, and the authors have done the economics profession a major service by reminding us that export-led growth can have significant international macroeconomic effects.[1]

This brief agrees with DFG's emphasis on export-led growth, but challenges their comparison of today's financial system and Bretton Woods. This brief also differs from DFG's conclusion that today's system is sustainable in the medium term, and I argue that the system is prone to crash. Other authors (Eichengreen 2004, Goldstein and Lardy 2005) have also argued that the system will crash, but they use different arguments, which focus on sustaining the financing of the U.S. trade deficit. I focus on the demand-side inadequacies of the current financial system and recommend a global system of managed exchange rates to replace the current system.

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The Revised Bretton Woods Hypothesis

The DFG hypothesis is that today's international financial system structurally resembles the post–World War II Bretton Woods system, which included fixed exchange rates and was, according to their analysis, a center-periphery system, where the United States was the center and war-ravaged Europe was the developing periphery. Within this framework, the United States proceeded to run progressively growing trade deficits with Europe that eventually caused a slow demise of the system.

DFG argue that today's global financial system still has the United States at the center of the system, but East Asia (especially China) has replaced Europe as the developing periphery. China has an explicitly fixed exchange rate vis-à-vis the U.S. dollar, while other East Asian economies actively manage their exchange rates to limit appreciation against the dollar. Additionally, the East Asia region is currently running huge trade surpluses with the United States.

The economic logic behind today's financial system is that East Asian economies are pursuing export-led growth because they lack robust domestic demand. Export success then serves to attract large-scale foreign direct investment (FDI) that creates jobs, builds manufacturing capacity, and transfers technology. Foreign investors finance this capital accumulation by providing the foreign exchange to purchase capital goods. They also transfer, install, and operate the installed capital. In this fashion, countries acquire jobs and a modern, internationally competitive, manufacturing sector.[2]

The price that the developing periphery must pay, however, is exports to the center. This arrangement explains why savings flow north from poor to rich countries. Since international competitiveness is the key to export-led growth, countries actively pursue policies aimed at maintaining undervalued exchange rates.

The Misplaced Analogy with Bretton Woods

DFG's analogy of the present international financial system with Bretton Woods rests on a number of similar macroeconomic patterns, including quasi-fixed exchange rates and persistent and growing U.S. trade deficits that are financed by the periphery. However, the analogy is wrong because it ignores the fundamentally different microeconomic regimes that characterize the two systems.

Three significant differences mark today's international financial system and Bretton Woods. First, today's trade deficits are the result of export-led growth predicated upon undervalued exchange rates. Bretton Woods was designed to prevent "beggar-thy-neighbor" trade, based on competitive devaluations that had afflicted the international economy during the Great Depression. Furthermore, the Bretton Woods system had formal provisions that allowed countries with structural trade deficits to devalue their currencies.

Second, under today's financial system, multinational corporations are establishing state-of-the-art export platforms in China, where production is exported back to the center (the United States). This arrangement contrasts with the European situation in the 1950s and 1960s, when American multinationals established production facilities in Europe to supply the European market.

Third, the growing U.S. trade deficits in the 1960s were driven by full employment in the United States, along with higher wages, a growing manufacturing sector, and increasing manufacturing employment (robust and stable aggregate demand). These deficits contrast with current U.S. trade deficits, which are driven by debt-financed consumption spending (supported by a housing price bubble), and imports are displacing U.S. manufacturing (undermining the income and aggregate demand process).

Why the Current Financial Regime Will Fail

DFG maintain that the current financial system is sustainable because the current arrangement suits both U.S. and East Asian interests—particularly the Chinese. The steady flow of imports that constitutes the U.S. trade deficit provides cheap consumption goods that lower consumer prices and contain inflation, enabling the Fed to hold the line on interest rates despite reduced unemployment rates. In addition, East Asian countries contribute to the favorable interest-rate environment by recycling their trade surpluses into U.S. Treasury bonds, as part of their strategy to maintain undervalued currencies vis-à-vis the dollar.

East Asia benefits from exporting to the United States and East Asian governments are willing to continue accumulating U.S. financial assets, thus ensuring a steady stream of financing for the U.S. trade deficit at current interest and exchange rates. The driving force of financial investment decisions in East Asian countries is economic growth, not portfolio risk and return. The configuration of national economic interests is underwritten politically by U.S. multinational corporations, which lobby Washington against "protectionist" pressures that are generated by the U.S. trade deficit and deindustrialization in the United States. The fact that the dollar is no longer officially convertible into gold adds extra stability to the current system and avoids the weakness that brought down the original Bretton Woods system.[3]

A. The Current System Is Unstable

DFG's claim regarding the stability of the international financial system has been challenged by several authors. Eichengreen (2004) argues that the system will collapse because of inconsistencies between the system and the financial interests of individual countries, who have an incentive to diversify their reserve holdings, even though they benefit from the system as a whole. In effect, this is a classic cartel problem, because there are incentives to cheat the system.

Eichengreen's analysis raises two objections: (1) diversification does not necessarily kill the financial system; the dollar exchange rate will remain essentially unchanged, and (2) China could reap large capital gains on its holdings and also get a second wind for its export-led growth program—if Chinese wealth holders are allowed to exit their domestic system, thereby triggering a depreciation of the renminbi.[4]

The above scenario should be extremely troubling to U.S. policymakers who are concerned about the U.S. industrial base. Capital market openness, which is actively promoted by the U.S. Treasury, and renminbi depreciation are the diametric opposite of U.S. needs today. The U.S. Treasury's policy runs the risk of repeating the mistakes made with Japan in the early 1980s.

Goldstein and Lardy (2005) provide another criticism of DFG's sustainability claim. The principal focus of their analysis is the high cost to Chinese authorities of sterilizing monetary inflows into China. They believe that current measures to prevent exchange-rate appreciation are inadequate and that China will suffer from a combination of costly inflation and financial system distortions that misallocate and waste resources. Such costs, they say, will compel China to abandon its undervalued exchange rate. Their arguments against stability and unsustainability are also subject to important counterarguments.[5]

B. A New Explanation of Instability

DFG, Eichengreen, and Goldstein and Lardy all focus on the sustainability of financing the U.S. trade deficit. This brief argues that the international financial system is unsustainable and will crash; not for reasons of supply, but for reasons of demand.

An outline of the structure of U.S. borrowing from East Asia is shown in the figure. The key insight is that the process of financing export-led growth and the U.S. trade deficit is a two-part, intermediated transaction. One part involves a domestic transaction between U.S. banks and ultimate U.S. borrowers (consumers). The other part involves an international transaction between foreign governments and financial intermediaries (banks) in the U.S. financial markets. The system can break down in either the international or domestic credit markets. Attention so far has focused exclusively on the international credit market and the possible withdrawal of financing by foreign lenders. The real reason the system is unsustainable, however, may lie with the domestic credit market.[6]

The system is dependent on continuation of the U.S. consumption boom, yet circumstances could end that boom: the Fed may overshoot its interest rate–tightening campaign and trigger recession; local U.S. banks may tighten lending standards and reduce lending; and consumers may reduce spending voluntarily. The bottom line is that the global financial system is vulnerable to a crash that originates from within the United

The Structure of U.S.–East Asia Borrowing

States, and East Asian economies can do little about it. Indeed, the competitive pressures unleashed by export-led growth and outsourcing form part of the constellation of forces contributing to a possible crash by undermining U.S. jobs and wages.

What Happens If the U.S. Economy Sinks into Recession?

In the event that the United States falls into a consumer-led recession, East Asia is likely to be affected significantly via reduced exports, lower employment, and reduced FDI. These results would contrast with the effects of the 2001 U.S. recession, which was investment led and left U.S. consumption spending intact and East Asia relatively unscathed.

The United States will find it difficult to escape a consumer-led recession. The budget U-turn option is no longer available and interest rate cuts by the Fed will likely be much less effective than in the past. Europe and Japan will be adversely affected by a U.S. recession and East Asian countries will continue to restrict the appreciation of their currencies against the dollar, so the dollar may not fall very much. The prognosis, therefore, is a prolonged economic slump.

Wanted: A New Global Financial Architecture

The current international financial system is a product of recent events that were spurred by the East Asian financial crisis in 1997. East Asian countries were forced to accept the currency devaluations imposed by the panicking financial markets, but have subsequently benefited from the impact of devaluation on exports. The accumulation of official reserves has not been driven by a desire for collateral in order to underwrite FDI, but rather a desire to protect against the possibility of future capital flight.

The system is a product of state policy responses to unwelcome market developments, rather than a product of optimizing markets, and it is problematic on a global scale for reasons discussed in Blecker (2000) and Palley (2003). In particular, the system promotes global deflation by emphasizing exports excessively; this focus hollows out the income and aggregate demand–generation process in the United States via deindustrialization and outsourcing.

Destabilizing capital mobility was the main problem behind the East Asian financial crisis, while exchange rates are the main problem behind today's global financial imbalances. A new financial system needs to manage both capital mobility and exchange rates, and both the periphery and the center need to change.

There have been many proposals for redesigning the global financial architecture. Blecker (1999), Griffith-Jones and Kimmis (1999), and Palley (1999) provide solutions for governing and improving the quality of capital flows. The obvious solution to the problem of gross trade imbalances, which would create a more stable system of managed exchange rates, is a system with a crawling band target zone, as proposed by Williamson (1985, 1999), Bergsten et al. (1999), Grieve-Smith (1999), and Weller and Singleton (2002). A sensible candidate regarding the target exchange rate is the notion of fundamental equilibrium exchange rates proposed by Williamson (1994). His basic notion is that participating countries select a set of exchange rates consistent with their targeted current account and GDP outcomes.[7]

Finally, there needs to be agreement about the rules of intervention in order to protect the target exchange rate. The onus of exchange rate intervention needs to be reversed. The country with the stronger currency (where the central bank's exchange rate is appreciating) should be responsible for preventing appreciation, rather than the country with the weaker currency being responsible for preventing depreciation.

Conclusion: Beyond Policy Passivity

Today's global financial system is a haphazard and suboptimal creation. Whereas East Asian policymakers strategically manipulate their exchange rates, U.S. policymakers reject intervention on the grounds that the market knows what is best, so the exchange rate should be left alone. This asymmetry between economies has allowed East Asia to pursue neomercantilist policies that have contributed to massive global financial imbalances.

The mentality of U.S. policy is at odds with reason and the evidence. Theoretical reasons abound for the belief that foreign exchange markets are prone to herd behavior. Strong empirical evidence also indicates that exchange rates depart from theoretically warranted equilibrium levels, whether or not they are defined as purchasing power parity or as exchange rates consistent with sustainable current account deficits. From the standpoint of realpolitik, it is unwise for any country to be outgamed by another.

East Asian policymakers are correct in their belief that they can improve economic outcomes through exchange rate intervention. As Williamson (1999) observes, policymakers who use theory to devise and manage sensible exchange rates do better than those who employ unregulated, floating exchange rates. The problem is that East Asian countries have been intervening in an uncooperative manner, which risks an outcome that could be disastrous for the current international financial system.

Notes

1. Blecker (2000) and Palley (2003) have explored the global macroeconomic inconsistencies of export-led growth.
2. DFG emphasize the connection between exports, foreign direct investment (FDI), and growth. Goldstein and Lardy (2005) have rightly criticized them for overemphasizing the contribution of FDI to China's growth. However, that said, FDI is a critical component of China's capital and technology accumulation strategy. More important, the link that should be emphasized is between exports and industrial investment in general, with exports spurring both FDI and domestic manufacturing investment. Exports provide the classic "vent for surplus" in China's economy. China's entrepreneurial tradition makes it highly efficient at organizing capital accumulation. However, China has not yet put in place a domestic consumption market that can absorb its production. I emphasize this point in Palley (2006a).
3. In the face of large gold conversions, especially by France, President Nixon suspended the right of countries to convert official dollar reserves into gold on August 15, 1971.
4. Chinese wealth holders will want to diversify for standard economic reasons, as well as political reasons resulting from concerns about rule of law in China and the potential for future political instability.
5. These arguments are developed in greater detail in Palley (2006a).
6. These arguments are developed in two of my policy briefs: Palley (2006b) and Palley (2005).
7. Operationally for the single-country case, this is done as follows: The first step is to empirically estimate a current account equation of the form $CA = \alpha_0 + \alpha_1 Y + \alpha_2 e + \alpha_X X$, where CA = current account, Y = GDP, e = exchange rate, and X = vector of exogenous variables. The equation is then solved to yield the fundamental equilibrium exchange rate (e^*) consistent with the target current account (CA^*), target GDP (Y^*), and given levels of exogenous variables: $e^* = -\alpha_0/\alpha_2 - \alpha_1 Y^*/\alpha_2 + CA^*/\alpha_2 - \alpha_X X/\alpha_2$. In a multicountry exchange rate system, these equations must be estimated and solved simultaneously across countries to ensure a consistent set of exchange rates. It is necessary for countries to agree on a consistent set of national current account targets, since all countries cannot run trade surpluses.

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About the Author

Thomas I. Palley is an economist living in Washington, D.C. He was formerly chief economist with the U.S.–China Economic and Security Review Commission. Prior to joining the commission, he was director of the Open Society Institute's Globalization Reform Project and assistant director of public policy at the AFL–CIO. He is the founder of Economics for Democratic and Open Societies, which seeks to stimulate public discussion about the kinds of economic arrangements and conditions needed to promote democracy and open societies.

Palley has published in numerous journals, including the *Atlantic Monthly*, *American Prospect*, and *Nation* magazines. He is the author of *Plenty of Nothing: The Downsizing of the American Dream and the Case for Structural Keynesianism* (Princeton University Press 1998) and *Post Keynesian Economics* (Macmillan Press 1996). Some recent policy articles include "External Contradictions of the Chinese Development Model," *Journal of Contemporary China*, February 2006; "The Questionable Legacy of Alan Greenspan," *Challenge*, November–December 2005; "The Economic Case for International Labor Standards," *Cambridge Journal of Economics*, January 2004; and "Asset Price Bubbles and the Case for Asset-Based Reserve Requirements," *Challenge*, May–June 2003.

Palley holds a B.A. degree in modern history and economics from Oxford University and an M.A. in international relations and Ph.D. in economics from Yale University.

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