An Essay on the Revived Bretton Woods System
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ABSTRACT

The economic emergence of a fixed exchange rate periphery in Asia has reestablished the United States as the center country in the Bretton Woods international monetary system. We argue that the normal evolution of the international monetary system involves the emergence of a periphery for which the development strategy is export-led growth supported by undervalued exchange rates, capital controls and official capital outflows in the form of accumulation of reserve asset claims on the center country. The success of this strategy in fostering economic growth allows the periphery to graduate to the center. Financial liberalization, in turn, requires floating exchange rates among the center countries. But there is a line of countries waiting to follow the Europe of the 1950s/60s and Asia today sufficient to keep the system intact for the foreseeable future.

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Let me be more positive: if I had an agreement with my tailor that whatever money I pay him returns to me the very same day as a loan, I would have no objection at all to ordering more suits from him.

Jacques Rueff (1965)

In this paper we explore the idea that the global system that has evolved and grown since the advent of Bretton Woods has maintained a single dynamic structure. In the Bretton Woods system of the 1950s, the US was the center region with essentially uncontrolled capital and goods markets. Europe and Japan, whose capital had been destroyed by the war, constituted the emerging periphery. The periphery countries chose a development strategy of undervalued currencies, controls on capital flows and trade, reserve accumulation, and the use of the center region as a financial intermediary that lent credibility to their own financial systems. In turn, the US lent long term to the periphery, generally through FDI.

Once the capital of these zones had been rebuilt and their institutions restored, the periphery graduated to the center. It had no further need for the fixed rate, controlled development strategy, especially when it perceived that the US, in performing its financial intermediation service, was reaping a large transfer payment. For an insightful and entertaining example of the French and US views see Rueff and Hirsch (1965).

Then and now the debate focused on the *willingness* of the periphery to accumulate claims on the center country. Triffin, for example, argued that the US could provide reserves for a growing world economy "but only if European governments and central banks were willing to abandon to the political, monetary, and banking authorities of the United States their sovereignty over the management and use of reserves ..... It is hard to see how they could be willing to underwrite blindly in this fashion future deficits of the United States irrespective of their amounts and of the multiple and variegated causes of their emergence and continuance." p.14.

More recent analysis of fixed rate systems, notably Helpman (1981) and Giovannini (1989), sets out the intertemporal restrictions on the center country and provides a good understanding of the welfare implications of rules of the game for adjustment and eventual repayment of debt. We are interested in a very asymmetric version of a fixed rate system in which, for some time period, periphery countries are willing to underwrite future deficits of the United States. Moreover, we do not think they do so blindly. McKinnon and Schnoble (2003) provide several arguments that would support a fixed rate regime for Asian countries. We emphasize the idea that it has been a successful development strategy to subordinate the objective of maximizing the value of reserve assets in order to subsidize and build a domestic capital

stock capable of competing in international markets. This is not a first best strategy. It would be better to have both an internationally competitive capital stock and reserves that were superior investments. But, if a country had to choose one or the other, a competitive capital stock may well be the better choice. It is clear that capital controls are necessary to keep residents of the periphery country from offsetting the government's second best international investment decisions. Nevertheless, with rising real wages in export industries this can be for a considerable interval a successful and politically sustainable development strategy.

When Europe's development strategy shifted toward free markets, financial controls were lifted and the fixed rate system soon collapsed into the floating regime of the 1970s. But in our view the system of freely floating exchange rates and open capital markets was itself only a transition *during which there was no important periphery*. To be more precise, there was no periphery for which a development strategy based on export-led growth was the dominant objective for economic policy.

During this "generalized floating" transition the communist countries were irrelevant to the international monetary system. Most other developing countries, particularly the newly decolonized states, flirted with socialism or systems of import substitution that closed them off from the center. This development strategy was inhospitable to trade and the importation of long-term foreign capital. It fostered a local production of goods that could not compete globally and therefore built an inefficient capital stock that would in the end have little global value. Just as in the communist countries, when these opened to world trade and capital flows, they discovered that their cumulated capital was fit only to be junked. That is, they were in the same real capital-poor position as the post-war European countries.

With the discrediting of the socialist model in the 1980s and then the collapse of communism in 1989-91, a new periphery was melded to the US-Europe-Japan center. These countries were newly willing to open their economies to trade and their capital markets to foreign capital.

These countries all were emerging from decades of being closed systems with decrepit capital stocks, repressed financial systems, and a quality of goods production that was not marketable in the center. The Washington Consensus encouraged them in a development strategy of joining the center directly by throwing open their capital markets immediately.

Others, mainly in Asia, chose the same periphery strategy as immediate post-war Europe and Japan, undervaluing the exchange rate, managing sizable foreign exchange interventions, imposing controls, accumulating reserves, and encouraging export-led growth by sending goods to the competitive center countries.

It is the striking success of this latter group that has today brought the structure of the international monetary system full circle to its essential Bretton Woods era form. The Europe-Japan of the 1950s was already large enough so that in our analyses we did not have a "small country" view of the periphery but rather recognized it as the driving force of the international monetary system. Now the Asian periphery has reached a similar weight: the dynamics of the international monetary system, reserve accumulation, net capital flows, and exchange rate movements, are driven by the development of these periphery countries. The emerging markets can no longer be treated as small countries, weightless with respect to the center. At some point, the current Asian periphery will reach a developmental stage when they also will join the center and float. But that point will not be reached for perhaps 10 more years and, most likely, there will be at that time another wave of countries, as India is now doing, ready to graduate to the periphery.

Eichengreen (1995) points out that "one of the more remarkable features of the last hundred years of international monetary experience is the regularity with which one regime (fixed and floating rates) has superseded the other." He sets out six explanations for this rotating dominance of exchange rate regimes. All are interesting and plausible and contribute to our understanding of the system. Our answer to this puzzle is that the system has not changed but the objectives for important blocs of countries within the system have changed over time. Fixed exchange rates and controlled financial markets work for twenty years and countries that follow this development strategy become an important periphery. These development policies are then overtaken by open financial markets and this, in turn, requires floating exchange rates. The Bretton Woods system does not evolve, it just occasionally reloads a periphery.

Bordo and Flandreau (2003) provide an excellent analysis of the link between financial development and the choice of exchange rate regime in the periphery. They also relate this choice to the debate on original sin, fear of floating and other recent topics related to economic policies in emerging markets. We are more concerned here about the effects of the periphery on the center.

For the most part, the reigning economic analysis of the system proceeds as if the periphery does not exist or is not important enough to affect the economies of the center countries. This is, we believe, a serious omission. To illustrate this point we focus below on the emerging current account deficit in the United States. In our framework, the US is once again the center country and, as such, plays by a different set of rules.

Where is the International Monetary System Driving Us?

The recent weakness of the dollar against the euro seems consistent with the idea that the large and rising expected US current account deficits will become more difficult to finance as the net international investment position of the United States deteriorates. But if investors were becoming reluctant to invest in the US they would have to be rewarded with rising returns. Yet yields and spreads have generally been falling in the US, not rising.

To explain this anomaly it is helpful to step back for a broad look at how the international monetary system has evolved. In general we know that the US current account would have to adjust if the international monetary system consisted of floating currencies and open capital markets. But we do not live in such a world. We have re-entered a Bretton Woods reality and have to relearn and understand the very different adjustment requirements for the center country in such a system.

The view of the world monetary order that we assemble here allows for strong conclusions about where current global supply surpluses will be focused and how various participants will adjust to a very large current account deficit in the center country. It especially allows us to understand what is going on in the emerging markets and Europe, which will face the most difficult macroeconomic challenges.

Trade Account vs. Capital Account Regions

There are now three principal economic and currency zones in the world. Because these are generally concentrated by geographic region, it is tempting to think in terms of East Asia-US-Europe. But to get at a truly global picture, it is more illuminating to characterize the zones functionally: The functional framework we develop includes a trade account region, Asia, a center country, the United States, and a capital account region, Europe, Canada and Latin America.

As a trade account region, exporting to the US is Asia's main concern. Exports mean growth. When their imports do not keep up, the official sectors are happy to buy US securities to finance the shortfall directly, without regard to the risk/return characteristics of the securities. Their appetite for such investments is, for all practical purposes, unlimited because their growth capacity is far from its limit. An alternative is to target imports of capital goods from the United States, which they would do if they came under commercial policy pressure.

In their currency policies members of a trade account region manage their exchange rates. While nominal exchange rates have moved by large amounts following the Asian crisis in 1997 and macro shocks to Japan in recent years, central banks have consistently intervened to limit appreciation of their currencies.

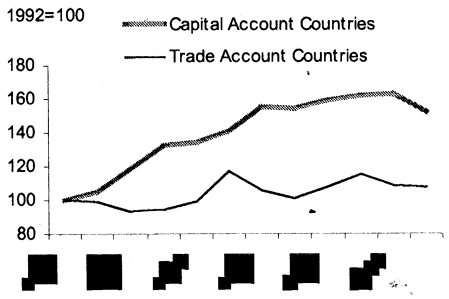
Europe, Canada, Australia, and now most of Latin America form, in contrast, a capital account region. Private investors in this region care about the risk/return of their international investment position and have recently become concerned about their US exposure.

In their currency policies members of a capital account region are floaters. Europe and Canada, for example, float against the USD; and the euro has fluctuated by 30% up and down against the USD since its introduction. Their governments stay out of international capital markets: there has been hardly any change in official reserves in this capital account region in the last decade.

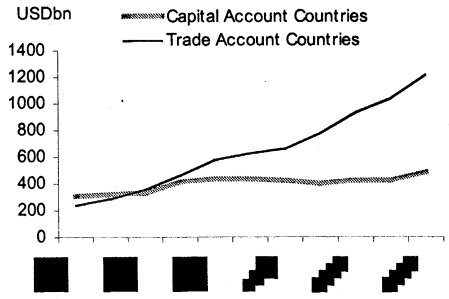
As for the third zone, the US is the center country and intermediary of the system. The US does not try to manage its exchange rate. It does not cumulate official reserves, so its investment motivations make it a capital account country. But its own growth motivations make it a trade account country also. It wants finance for its own growth and foreign savings help finance domestic capital formation. There have been complaints from US industry about the strong dollar, but overall the US has been happy to invest now, consume now, and let investors worry about its deteriorating international investment position.

The contrasting behavior of capital and trade account countries is summarized in the charts below. The first panel shows a trade weighted dollar exchange rate for each country group. The capital account countries show a substantial depreciation relative to the dollar from 1992 through the end of 2002, which has been partially reversed in the first half of 2003. Our interpretation of this is that, until recently, private investors in the capital account group pushed the dollar up and helped finance the US current account deficit. The trade account group's dollar rate has been essentially unchanged over the whole period. Private investors in the trade account group were not a factor on net; but, as shown in the second panel, official investors in the trade group helped finance the US current account deficit as reserves increased steadily reaching about $1.2 trillion in 2003. Projecting this behavior forward we would expect further strength in the capital account currencies, stability in the trade account currencies and accelerated accumulation of international reserves by the trade account central banks.

Trade Weighted Dollar Exchange Rates



International Reserves (USD bn)



Source: DB Global Markets Research, BEA

Differing Motivations for Financing the US Current Account Deficit

The US current account deficit (now about $500 bn, 4.7% of GDP) has been financed by official inflows from the trade account region and private inflows_from the capital account region. This has been especially so for the last 5 years, with the US current account deficit surging from $130 billion in 1997 to $300 billion in 1999 to $400 billion in both 2000 and 2001. This US current account growth has been the engine for growth for the rest of the world.

Asian countries in particular (China, Taiwan, HK, Singapore, Japan, Korea, Malaysia) manage their dollar exchange rates; and, as such, they float against the capital account region. Official capital exports finance growth-oriented trade surpluses. Policy is often affected through a system of exchange controls and administrative pricing. Some currencies are explicitly and rigidly fixed (RMB, HKD, MYR); others (JPY, KRW) "float" but still accumulate vast amounts of official reserves in USD.

Since mid-1998, the JPY has moved from 120 to 105 to 135 and now back around 116. This has coincided with increases of Japan's foreign exchange reserves of $92 billion in the last year alone (vs. overall capital exports of $116 billion) and of $275 billion since 1998. China accumulated reserves of $56 billion in 2001 and $74 billion in 2002. Taiwan accumulated reserves of $16 billion in 2001 and $40 billion in 2002. These three official sectors alone financed 42% of the $489 billion US current account deficit in 2002. In Asia as a whole, a single-minded emphasis on export growth has been supported by a virtually unlimited demand for US financial assets in the form of official reserves. The current account surplus of Asia in 2002 was about $200 billion. The increase in reserves was a bit over $200 billion.

Europe and, for now, Latin America constitute the bulk of the capital account region. European flows have been driven by private sector calculations for more than ten years. Private Latin American investors are now reversing capital flight, and their currencies have also been appreciating dramatically recently. Improving economic conditions in Latin America have clearly pulled funds into the region and limited

capital flight from the region. But the push of funds into Latin America to escape low yields and uncertainty in the US has also been an important factor. As in Europe and Canada private capital flows have pushed currencies up across the board. Brazil and Argentina have already given back some of the improvement in their competitive positions following large depreciations in 2002 and 2003, respectively.

Is This System Sustainable?

In spite of the growing US deficits, this system has been stable and sustainable. The current account structure and asset accumulation have been consistent with the trade account region's preferences for official investments in the US and, until early this year, the capital account region's preferences for private financial investments in the US. But as US debts cumulate, US willingness to repay both Asia and Europe comes more naturally onto the radar screen, so the system that was previously stable could run into trouble.

Normally, a private investor would require a much higher return than before to keep capital flowing to the US. This could happen in both of two ways. Yields in the US would have to rise and the dollar would depreciate sharply so that an expected subsequent appreciation would further boost the yield to foreign investors.

But our analysis of behavior of trade account countries suggests that Asia will displace Europe in sending exports to the US and will accept an even larger inflow of US securities. If so, yields in the US will not rise.

We see the start of this now in the form of euro appreciation. But trade account countries will resist appreciation. They will cumulate even more low-yielding US securities. A Europe that lets this happen will see its exports squeezed out and in the extreme may even start selling its claims on the US to be acquired by Asia as the capital account region avoids what it sees as the potential collapse of the system.

As evidence for this combination of European and Asian actions, US yields have generally fallen, stock prices risen, and spreads have contracted. This has happened even in the face of a sharp depreciation in dollar-euro and other capital account region currencies and a sharp rise in the US current account deficit. Asian exchange rates have hardly moved by comparison against the USD.

There is a rising volume of complaints in the US about the unfair trade advantages of Asia's undervalued currencies, aimed primarily at China, but curiously not at Japan whose goods are more directly competitive with manufactured goods in the US. Also, there have been claims that undervalued currencies inevitably lead to over-heating and inflation and so must be self-correcting. However, it will take a long time to get to such a point. For example, in China, M2 growth of 16% is consistent with price stability, and only recently has it risen to 20%, which will lead to inflation of about 5% in two year's time (0.5% right now). As interim measures, there is room to raise bank reserve requirements or domestic interest rates. To head off trade partner commercial policy, there may be a token revaluation of up to 3%, over the course of time, or a redirection of imports to the US. But support of growth is the primary motivation, with above 40% of the population yet to be absorbed from the farming sector. And even if this reserve of labor were gone, India is ready to graduate to the periphery with its vast supply of underemployed workers.

The Trade Account Region Is Underwriting the US in the Long Term

Asia's proclivity to hold US assets does not reflect an irrational affinity for the US. Asia would export anywhere if it could and happily finance any resulting imbalances. But the US is open; Europe is not. Europe could not absorb the flood of goods, given its structural problems and in the face of absorbing Eastern Europe as well. So Asia's exports go to the US, as does its finance—otherwise, a US, if faced with financing difficulties, might similarly tend toward more stringent commercial policy. Asian officials are unlikely to shift toward Euro assets because of the depressing effect this would have on trade with the US.

The irony here is that concern of investors in the capital account region about the risk/return in an increasingly indebted US is misplaced. The US is being underwritten by Asia for the foreseeable future.

The result is a bilateral US trade deficit with Asia and a balancing official bilateral capital inflow to the US from Asia. If Europeans and other capital account region countries want to sharply reduce their US assets, the euro and other capital account region currencies will appreciate much more. Then the US, but more probably Asia, will have to run trade surpluses with these countries roughly equal to the desired capital repatriation. With a multilateral current account balance, the extra official financing from Asia, in effect, will finance everyone else.

It is useful to fit other countries, e.g. Mexico, Canada, Australia, Russia, into this three-color map of the world economy. The first three are floaters against the USD, and therefore, for now are in the *capital account* zone. As a result, their currencies will tend to appreciate; and their exports to the US will be displaced by Asia. Russia is and will be an oil exporter.

More generally, emerging markets now have a choice: they can join Asia in the trade account region or Europe in the capital account region. If they follow the Asian model, they will do whatever it takes to limit exchange rate changes relative to the dollar and to keep their currencies undervalued to spur exports. The two tools available are controls and taxes on capital inflows and intervention in the foreign exchange markets to peg an undervalued currency.

Conclusions

If European investors, looking objectively at growing US debt alone, prudentially limit their US positions and demand better risk/return characteristics before supplying more capital to the US, the euro will appreciate dramatically. Local savings will stay in Europe, depressing yields there. Asia will grow even faster as it displaces European goods in the US; Europe will grow even more slowly. Yields in the US will not be forced up even as the US current account deficit grows; the dollar falls against the euro and private capital inflows from Europe and other capital account countries fall off.

Other emerging market countries will have to choose which way to go. In Latin America, those impatient for growth through exports will favor free trade, fixed, undervalued rates with the dollar, intervention and capital controls; in short, the Asian model of development. In contrast, central bankers and the IMF favor floating rates and capital mobility and therefore the capital account region, in short, the European model. As converging countries, emerging market countries in Europe must naturally follow the euro. Emerging markets in Asia are not likely to miss this opportunity to displace their rivals in US markets.

We used to have a view that 1) there was a system (Bretton Woods) that evaporated thirty years ago into no system at all and 2) now a semi-system has emerged anew. But, in fact, the system has been the same throughout, just manifesting itself in different forms because the original emerging markets (Europe and Japan) developed and did not need the center's intermediation any more. There was no one to replace these countries for two decades. But with the collapse of socialism came a new litter of emerging markets, and the background system that is the incubator of such economies has reanimated itself.

So we can anticipate some issues that were familiar 50 years ago returning to center stage of the economics of international finance. Can the center survive with two reserve currencies? As the dollar replaced sterling as the preferred reserve currency, will the euro replace the dollar? How long can trade account countries insulate their domestic financial markets through capital controls? Does the system benefit and entrench the economic and gêo-political power of the center country (i.e. the DeGaulle-Rueff view)? Does the center country balance sheet make it a liquidity-providing bank to the periphery, borrowing short term and lending long, and validating domestic banking systems (i.e. the Despres-Kindelberger-Salant view)? Is the IMF the manager of a fixed rate system after all? Will the SDR ever be more than a currency basket?

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