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Eichengreen, Barry, *Global Imbalances and the Lessons of Bretton Woods*, MIT Press, 2007, ISBN-13:978-0-262-05084-5, pp 1-187.

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The international monetary system, with its often implicit rules of the game governing how nations interact, continually evolves through time. Nevertheless, history remains particularly important for understanding today's huge global imbalances. Economists have failed rather dismally to construct convincing theoretical models of why the international dollar standard has led to seemingly endless U.S. current account deficits that are sustained by the seemingly endless willingness of the rest of the world to acquire liquid dollar assets.

In his engaging and often insightful book, Barry Eichengreen draws parallels with the last major period of dollar pre-dominance during the Bretton Woods of fixed dollar exchange rates, beginning in 1950 until its breakdown with the Nixon shock in 1971, and with sterling's predominance before 1914. He also carefully points out the differences between these two periods and the present one—often with illustrative data and summary figures. The book is divided into four chapters:

1. Global Imbalances and the Lessons of Bretton Woods
2. The Anatomy of the Gold Pool
3. How to Exit a Currency Peg: Japan and the End of the Bretton Woods Period (with Mariko Hatase)
4. Sterling's Past, Dollar's Future

Eichengreen notes that, through most of the Bretton Woods period of fixed dollar exchange rates, the U.S. ran current account surpluses. He also makes the often-overlooked point that today's large current account deficits may well be endogenous to the way in which the dollar standard now works. When most new issues of treasury bonds can be easily lodged with foreign central banks, the U.S. federal government's borrowing constraint is softened. Fiscal deficits generate no political pain because interest rates stay low so as not to squeeze out domestic private borrowers. Nevertheless, Eichengreen remains fundamentally pessimistic over whether high U.S. deficits can continue without eventually triggering a run on the dollar that forces a fundamental change. But, being a good economic historian, he carefully qualifies any predictions.

As a reviewer, however, I would be remiss—not to say utterly boring—if I did not dissent from some of his historical analogies. He sees the ultimate failure of the London gold pool to prop up the fixed-rate dollar-gold exchange standard of the 1960s as a portent for the absence of collective foreign support during a crisis in the current phase of the dollar standard—sometimes called Bretton Woods II. He treats Japan's exit from the fixed-rate dollar standard in 1971 as “successful”, with useful lessons for China exiting

from its current pegged dollar exchange rate. And in several places he theorizes implicitly and incorrectly about the role of the exchange rate in the adjustment process. Let us discuss each issue in turn.

Analyzing the long-neglected London Gold Pool of the 1960s is the most novel part of the book. Under the Gold Pool, created in 1961, Belgium, France, Germany, Italy, the Netherlands, Switzerland, the United Kingdom and the United States agreed to regulate the London open-market price of gold to help the U.S. maintain its commitment, under the Bretton Woods Agreement of 1945, to sell gold to foreign central banks or other official institutions at \$35 per ounce.

Eichengreen explains why such a cartel-like pool was necessary. In the post-World War II era of very rapid economic growth, the demand for official exchange reserves also grew rapidly—and initially, in the 1950s, demand was largely satisfied by foreign governments voluntarily accumulating dollar bank accounts or U.S. Treasury bonds. However, by 1965 official dollar reserves owned by foreigners exceeded the U.S. government's gold stock, thus creating the famous Triffin dilemma. Any individual foreign government might prefer to hold on to its dollar reserves because they bore interest and were highly liquid for international transacting. However, if other governments bought gold from the U.S. Federal Reserve at \$35, and so exhausted the Fed's stock as to drive the U.S. off its gold convertibility commitment, the market price would jump above \$35. Unless the foreign government in question also joined the rush to buy gold, it could forgo capital gains on its existing gold stocks as well as on new purchases.

To mitigate this dilemma, Eichengreen characterizes the London Gold Pool as a collective agreement among central banks to constrain gold conversions by its European members. If the London free market price of gold tended to rise above \$35, as when newly mined gold was in unusually short supply, then, using the Bank of England as their agent, members of the gold pool would sell gold—with pro rata shares assigned more or less by economic size—to drive the open-market price back down again. And if “excess” gold appeared on the London market, which would threaten to drive the price below \$35, the Bank of England would buy gold and distribute it to the cartel members using the same pro rata shares. As long as confidence in the mechanism was sustained, the incentive of any cartel member—or other central banks outside the cartel—to “defect” by demanding gold from the U.S. Federal Reserve at \$35 per ounce was minimized.

But not eliminated. Each participating government could, outside the London market, still use dollars to buy gold at \$35 directly from the U.S. Federal Reserve Bank. And as dollar holdings of foreign governments continued to grow, they eventually did just that. Eichengreen clearly documents the gold rush that began in 1967 through 1 April 1968, when the gold pool was dissolved. By that time the U.S. gold stock had fallen to just \$11 billion, which was less than half of what it had been in 1950. Afterwards, the U.S. government became much more restrictive with official conversions, and the free-market price of gold rose well above \$35. This foreshadowed the complete closing of the

U.S. gold window in August 1971, when President Nixon also demanded that the dollar be devalued against the currencies of all the major industrial countries.

Eichengreen sees the ultimate failure of the Gold Pool to rescue the fixed rate dollar standard of the 1950s and 1960s as a harbinger of the fragility of the current version of the dollar standard. Emerging markets in Asia and Latin America peg—albeit softly—to the dollar while building up large stocks of dollar exchange reserves. “Still, the Gold Pool reminds us that governments seeking to prevent a fall in the currency issued by a country that is their principal export market face a problem of collective action.....and sustaining cooperation can be problematic” (page 71).

Against Eichengreen’s historical analogy, however, the dollar- gold exchange standard of the 1960s had flaws, both legal and conceptual, not present in today’s version of the dollar standard. First, from the Triffin dilemma, the American commitment to convert dollars into gold at \$35 per ounce gave speculators, including some central banks, a one-way bet that the future price of gold would be greater than \$35. In effect, gold became superior to the dollar as an international store of value. At best, the London Gold Pool could only defer an inevitable run on the dollar. In contrast, under today’s pure dollar standard, there is no obviously more fundamental store of value into which speculators can fly.

Second, accepted macroeconomic doctrine is different today. In the 1950s into the 1970s most economists suffered from the great Phillips curve delusion. If an economy systematically accepted more inflation, they believed that it would run with systematically lower unemployment. In practice, when inflation in the U.S. began edging up in the late 1960s, the U.S. government in general, and the Federal Reserve Bank in particular, was conceptually inhibited by fear of rising unemployment from taking decisive action to disinflate. Instead, to restore America’s international competitiveness, they called for the dollar to be devalued—to which President Nixon acquiesced in August of 1971 while continuing with an expansionary monetary policy. The great inflation of the 1970s, with high unemployment, is sad testimony to the effect of the Phillips fallacy on public policy.

After gold was virtually demonetized in 1968, the Phillips curve delusion also foreclosed the option of continuing with the system of fixed dollar exchange parities. For such a pure dollar standard to work without a gold base, confidence in the center’s commitment to price level stability is paramount—but not so in the inflationary 1970s.

Another aspect of the Philips curve delusion was the idea that each country might have a different preferred tradeoff between inflation and unemployment. If Britain preferred to run with high inflation and low unemployment, whereas Germany wanted to reduce inflation at all costs even if it meant living with higher unemployment, why should they be bound together under a regime of fixed exchange rates which inhibits them from carrying out their differing domestic policy objectives? Now when respectable central banks strive for price level stability, such arguments seem naïve. However, they didn’t seem so before the collapse of the Bretton Woods dollar parities.

The present form of the dollar standard—where countries in Asia and Latin America “softly” peg to the dollar to anchor their national price levels—has somewhat more robust doctrinal underpinnings than the fixed rate dollar standard of the 1950s and 1960s. (Europe and the small countries to its East that are more on a euro-centered regime.) The peripheral countries can now have more confidence that the center country is at least striving for price-level stability—even if it doesn’t always manage it. And if the U.S. does succeed in achieving virtual price stability in the dollar prices of tradable goods on a worldwide scale, then most peripheral countries are willing to take this as a norm for their domestic price-level targets. Indeed, because countries in Asia with large current account (saving) surpluses finance them by building up dollar claims domestically, they are loathe to permit exchange appreciations that would immediately impose large capital losses on the domestic holders of dollar assets, and eventually impose economy-wide deflation—as in Japan 20 years ago.

Thus Eichengreen’s view that, in the new millennium, collective action will be required to prop up the foreign exchange value of the dollar—and, in crisis situations, that such collective action is likely to be found wanting, given the ultimate failure of the London Gold Pool in the 1960s—is too pessimistic. As long as the U.S. Federal Reserve keeps the purchasing power of the dollar fairly stable, and the dollar is widely used in invoicing foreign trade and as a clearing currency among banks, each peripheral country in Asia and Latin America has incentives to stabilize its dollar exchange rate without acting collectively. Dollar exchange reserves remain attractive because there is no one-way bet on the future rise of the price of gold or any other more fundamental international asset. So the current pure dollar standard is *financially sustainable* although it may yet prove *politically unacceptable* in the United States itself.

The current threat to the dollar standard comes from political factions within the United States wanting to devalue the dollar, not from foreign governments threatening to withdraw their support for the dollar as Eichengreen would have it. Why should the United States with a virtually unlimited line of easy credit from the rest of the world find the current situation to be politically unacceptable? The problem is that the process of transferring resources from the rest of the world creates tensions within the American economy itself.

What is the transfer mechanism? In order to transfer real resources from the rest of the world (apart from surplus-saving oil-producing emirates) to cover America’s saving deficiency, the U.S. runs very large trade deficits in manufactures from surplus-saving industrial economies such as China, Japan, smaller ones in East Asia, and Germany. This real transfer of manufactures needed to cover the shortfall in American saving speeds the contraction in employment in U.S. manufacturing beyond the natural rate of decline experienced by other mature industrial economies.

The upshot is a protectionist backlash in the United States, particularly by members of Congress with manufacturing constituencies. Instead of blaming America’s own deficient saving, which makes foreign borrowing necessary, American politicians

incorrectly blame “unfair” foreign trading practices—undervalued currencies, substandard labor practices, dumping of subsidized exports in American markets, and so on. Rather than any general collapse in America’s credit line with the rest of the world as Eichengreen would have it, this protectionist backlash in the United States is the serious threat to the world economy in general, and to the dollar standard in particular.

Currently, this backlash is taking the form of U.S. Congressmen fashioning legislation to force China—and perhaps even Japan again—to appreciate its currency. However, contrary to a widely held belief within the economics profession, devaluing the dollar is itself no panacea for correcting the savings (trade) imbalances across countries. Unlike what the old and familiar elasticities model of the balance of trade would suggest, having creditor countries like Japan or China appreciate against the dollar would have no predictable effect on their trade surpluses. In effect, their savings surpluses (or the American saving deficiency) need not be corrected if the dollar is devalued. But at several points in his book, Eichengreen theorizes (implicitly) that appreciations of the Asian currencies are necessary and inevitable to reduce their export surpluses .

Although failing to “correct” global trade imbalances, any such major change in the dollar’s nominal exchange rate could create serious *monetary* imbalances in the world economy: deflation in the appreciating countries or inflation in the United States. The tradeoff between the two is somewhat arbitrary, but the effect of nominal exchange rate changes on the “real” exchange rate eventually washes out.

Eichengreen spends a full chapter on what he considers to be Japan’s successful exit in 1971 from the Bretton Woods system of fixed dollar parities—with possible lessons for China at the present time. Both countries, Japan in the 1950s and 60s, and China 1994 to 2005, had been enormously successful by using fixed dollar exchange rates as anchors for their domestic monetary policies during parallel eras of extremely rapid economic growth and incompletely liberalized capital markets. But Eichengreen takes it as self-evident that exiting to an independent national monetary policy—for Japan then, and China now—is to be preferred. Because of outside American pressure, exiting is not (was not) a free choice in either case. But we can back cast historically to reexamine the consequences for Japan.

Japan suffered a loss of monetary control in 1971-73, along with the other industrial countries, because of a massive outflow of capital from the United States from anticipated depreciation of the dollar. Similarly, China faces large inflows of hot money at the present time. But for the rest of the 1970s, the upward “float” of the yen (there was another big forced appreciation in 1977-78) insulated Japan somewhat from the unwanted high inflation in the United States. However, because Japan had been forced into appreciating, this was a lucky accident.

The big problem for Japan came in the mid 1980s with the Plaza Accord which forced another big appreciation of the yen *after* the U.S. price level had been more or less stabilized. Expectations of further (forced) appreciations then contributed to the bubble economy of the late 1980s, and, by the mid-1990s, pushed short-term interest rates

toward zero, the dreaded liquidity trap. Strong deflationary pressure then developed as the bubbles burst and the yen continued to appreciate through 1995. The upshot was Japan's "lost decade" of 1992 to 2002, during which its trade surplus remained large despite the very high yen. So Japan's exit from the fixed exchange rate regime ultimately brought economic disaster.

What should the authorities have learned from this unfortunate episode? If credible, a system of stable nominal exchange rates against the center country's currency protects creditor countries on the periphery from being exposed to unwanted mercantile pressure to appreciate from the U.S.—which is in thrall to false theory that devaluing the dollar is the way to "correct" the U.S. trade deficit. Because repeated appreciations of the renminbi will fail to reduce China's (saving) current account surplus, China may eventually be forced down the same deflationary road as Japan was.

But my quibbles with some of Eichengreen's conclusions should not detract from the fact that this excellent book is a must read for economists and historians of how the international monetary system has evolved through time. The book is accessible to a wide variety of readers, and should be particularly valuable to young economists whose up-to-date technical training often obliterates historical perspective.