# Global Imbalances and the Lessons of Bretton Woods

## A review essay

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A major feature of the contemporary world economy relates to the large global economic imbalances that exist, with current account balance of payments deficits in some countries, most notably the United States, and surpluses in others, most notably China and other Asian economies. An important question is whether these imbalances should be a cause for concern. Are the imbalances sustainable or will they lead to a global economic crisis involving precipitous adjustment with large and rapid exchange rate changes and widespread and deep economic recession? In answering this question it may be helpful to try and draw lessons from history. After all, global economic imbalances are not a completely new phenomenon.

One point of view is that the contemporary situation is, in principle, little different from the situation under the Bretton Woods international monetary system. Here again some countries, such as the US, had current account deficits while others, such as West Germany and Japan, had surpluses. The surplus countries acquired reserves rather than see their exchange rates appreciate in nominal terms; the Bretton Woods system was indeed based on pegged exchange rates. The surplus countries were content to have undervalued exchange rates as a way of stimulating exports. They stood ready to provide the finance necessary to support deficits elsewhere in the world and, in particular, in the US. The system survived for as long as the US deficit was not too large and there remained confidence in the dollar. As the deficit increased and confidence evaporated in the early 1970s, it collapsed.

Moving forward to the 2000s, some economists have argued that the situation shares many of the same characteristics. The most influential analysis has been by Dooley, Folkerts-Landau and Garber (2003) who coined the label Bretton Woods II (BWII) to suggest that we are now in a new Bretton Woods type regime. This BWII label

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has attracted wide attention in the financial community as well as in academia. In this view the US again exhibits deficient saving while it is now Asia that exhibits excess saving. Asian countries have been content to provide finance to the US to cover its current account deficit and have built up their ownership of US assets. All players in the game seem to have got much what they wanted and the imbalances have been sustained. It would not be in the interests of Asian economies to sell their US assets in bulk since this would drive down the value of the dollar and their remaining dollar-denominated assets. For this reason the US deficit is seen as being of little concern. How close is the analogy between the Bretton Woods system and what we have today? Is it as close as the BWII advocates suggest?

In his recent book, *Global Imbalances and the Lessons of Bretton Woods*, Barry Eichengreen examines this question as well as exploring the failure of the Bretton Woods system and the lessons that emerge from it. Eichengreen argues that the comparison between the Bretton Woods era and the 2000s is rather unhelpful and that similarities are tenuous and "not long for this world". Is he right?

Modern international economics emphasizes that there is nothing sacrosanct about having balance in the trade or current accounts. In real terms it is imbalances in these accounts that redistribute capital from where it is abundant to where it is scarce. Traditionally it has been thought that this would generally involve capital flowing from wealthy to poorer countries. Wealthier countries were assumed to be able to save more and to exhibit declining marginal productivity of capital while developing countries have lower savings rates and higher returns to capital. A large part of the current pattern of capital flows conflicts with this traditional view. Contrary to the predictions of Marxist and some early Keynesian economists, consumption functions have tended to shift upwards over time with continued economic growth and increases in wealth. Contrary to the secular stagnation hypothesis, richer countries have shown little systematic tendency to generate excess saving. While Japan does fit this model to some extent, over recent years the United States has shown just the opposite tendency, consuming far beyond its means. In contrast to initial economic analysis, secure property rights, political stability, and generally strong financial markets have been found to provide key incentives for investment. Technological advances and the advantages of clustering for many types of economic activity have meant that the marginal productivity of investment has remained high in advanced economies.

At the same time, rapid economic growth and structural change, combined with considerable uncertainty and weak systems of social security have contributed to high savings rates in a number of developing countries, especially China. With relatively ill-developed domestic financial markets and limited opportunities to find an outlet for saving domestically, international capital has overall flowed

'uphill' from poorer to richer countries. But will this pattern continue as the BWII school argues, or is it indeed "not long for this world" as Eichengreen believes?

As uncertainties are reduced and stronger national social security policies are put in place we can expect Chinese savings rates to fall somewhat. But it is likely to be a slow process. Such considerations suggest that there is little need to eliminate the US current account deficit over the next decade. Elements of BWII may be around for a good while. However, this does not offer assurance that continued deficits of the current size will be sustainable. A medium-term deficit of two or three percent of GDP may be indefinitely sustainable while a continuation at five or six percent might end in crisis. The fact that, in recent years, private capital flows into the US have fallen short of financing the full current account deficit offers strong evidence of the need to bring about global adjustment.

Formal econometric models are of little help in predicting how long large financial inflows into the US will continue because these flows depend so crucially upon confidence factors which are far from fully understood. Experience with emerging economies has demonstrated that market confidence can turn very quickly and that large capital flow reversals can result. Thus we should not allow the continued sizeable capital inflows into the US to lull us into a false sense of security.

To what extent can foreign governments be relied upon to offset any rapid fall of net private capital flows into the US? In the BWII view such behaviour is driven in large part by the desires of many large dollar holders, especially in Asia, to maintain export-led growth and development strategies. As a result, these governments are seen as being willing to accumulate huge quantities of dollars in order to limit the appreciation of their currencies. Eichengreen argues (p. 6) that this view "confuse[s] the incentives that confronted individual countries under the original Bretton Woods system with the incentives that now confront groups of countries. [It] imagines the existence of a cohesive bloc of countries called *the periphery* that are ready and able to act in their collective interest". He goes on to document the much greater diversity of the major dollar holders today than of the large industrial country dollar holders under Bretton Woods, and notes that there is a much more viable alternative to the dollar today in the form of the euro. He also argues that developing countries are learning the limitations of mercantilist growth policies and, as a result, claims that their concerns with avoiding appreciation will be much less than according to the BWII view. He therefore concludes that the current situation only vaguely resembles Bretton Woods.

Our own view lies somewhere between that of the BWII school and Eichengreen. While we agree with Eichengreen that Asian policy makers have learned from history and see much less attraction to long-term undervaluation to stimulate exports, there are also shorter-run considerations that make appreciation unattractive—

specifically that it can generate adjustment costs that place strong political pressures on governments, even non-democratic ones such as China. Our reading of recent experience is that Chinese officials are probably sincere when they state that they would be happy to see a much smaller current account surplus. What has led to only a limited willingness to allow appreciation of the renminbi is concern about the social unrest that they believe would be generated by those who would be hurt in the short run by substantial appreciation. In this view, it is the typical aversion to the political costs of short-run adjustment rather than long-run mercantilist objectives that has been the more important cause of the recent reserve accumulations in Asia. (Substantial accumulations after the Asian crisis were quite justified as prudent protection against crises, but reserve holdings have grown far beyond what is needed on these grounds; see Bird and Mandilaras, 2005, for a brief discussion.)

We share Eichengreen's view that there is, at present, quite limited willingness among the major dollar holders to prioritize collective over individual interests. However, our view of the Bretton Woods regime is that such willingness was also quite limited for the major dollar holders of that era. While many accounts focus primarily on specific coordination efforts, of which there were quite a few, analysis by one of us some years ago (Officer and Willett, 1969) focused on self-interested behaviour within the context of strategic interdependence. According to this analysis, the limited number of large dollar holders recognized that major conversions of dollars into gold ran a substantial risk that this would stimulate a stampede by the other large dollar holders causing a major crisis. As a result, they had incentives to avoid making dollar conversions in the last years of Bretton Woods, while smaller dollar holders were still free to make use of the official convertibility of the dollar into gold.

For countries such as China and Korea today we see the situation as being quite similar. Both countries have many more reserves than conventional models of reserve adequacy show they need and, while published data is lacking, both are also likely to hold a much higher proportion of dollars in their reserves than would make sense on portfolio management grounds. Both countries have some scope for diversifying reserves without triggering a run on the dollar, but large sales of dollars for euros could carry a substantial risk of generating a crisis from which they, as well as many others, would lose. Thus, just as under Bretton Woods, such concerns with crisis avoidance by large dollar holders provide a systemically stabilizing element.

However, the strength of this stabilizing element is far from infinite. In the context of Bretton Woods, it was sufficient to allow US payments deficits to continue for as long as their size was moderate. The regime broke down after the huge increase in government expenditure associated with the Vietnam war. This, along with its monetary accommodation, generated

substantial overheating of the US economy and a large escalation in the size of the US payments deficit. Except for the overheating of the US economy, we see a similar type of situation today. As long as private capital inflows cover most of the US current account deficit, we expect that desires for reserve diversification will remain sufficiently muted that a crisis will be avoided. A sudden stop of capital inflows, however, would be extremely likely to provoke a severe crisis. (For more discussion of the possibility of a dollar crisis, see Bird, 2006.) The chances of a sudden stop diminish if progress is made towards reducing the size of the current account deficit and on getting government finances under control.

The depreciation of the dollar since 2002 and the slowdown in the US economy seem to be contributing to a reduction in imbalances. The question is whether these developments will be sufficient, on their own, to reduce the US deficit to a more comfortably sustainable level or whether further policy action will be required to raise savings in the US and consumption elsewhere in the world. A pessimistic scenario could be painted in which vulnerability to crisis is the principal similarity between the old Bretton Woods system and the contemporary global economic situation.

Optimist or pessimist, there is much to be learned by a careful reading of Eichengreen's thoughtful analysis. It maintains the high standards that have come to be associated with his name.

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