Research

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The Revived Bretton Woods System: Alive and Well

- The euro, up 50% since mid-2002, is still under inexorable upward pressure.
- The dollar, down 15% overall but only 4% against Asia, remains the dominant reserve currency.
- No large adjustments in US nominal or real interest rates, spreads, or current account deficits have occurred. Rates and spreads have actually declined while the deficit continues to widen.
- Japan is in the wings ready to resume intervention.
- Reserve diversification? No evidence and no incentive.
- Likely development is that the force of gravity pulls Europe into the managed rate system.

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Eighteen months ago, we forecast that the euro and currencies of other capital account countries would come under massive upward pressure against the dollar and trade account country currencies, as private investors reduced the share of their portfolios placed in dollars. We also suggested that the now "brutal" deflationary consequences of this would eventually force the ECB and other capital account countries to intervene in the markets to support the dollar. At the time, we saw these events as logical implications of incentives generated by the system. We did not argue that policy makers in these countries were predisposed to help finance US deficits. Rather, they would be forced to intervene by the threat of their own continued and worsening economic stagnation.

We also forecast that trade account countries would maintain their dollar pegs or tightly managed dollar exchange rates. The required intervention would, in turn, continue to provide cheap financing for US current account deficits. We did not argue that there would be no adjustment in their exchange rates but that gradual, managed appreciation would be consistent with the development and economic recovery programs in these countries. In particular, gradual appreciation would enhance the competitive position of the Asian dollar bloc relative to rapidly appreciating floating currencies.

We guessed that the US, the center and reserve currency country, would take no policy actions. In US markets, we forecast no adjustment in the US current account position and no rise in interest rates associated with a withdrawal of foreign savings from US credit markets. For sure, US rates would rise on the short end as the Fed tightened during the US recovery, but we did not foresee an extra push from the foreign sector. Indeed, the world's pushing of its excess savings into the US was keeping the cost of capital flat in the face of rapid growth.

Given the flurry of recent forecasts/reports of the demise of the dollar, the disappearing dollar, the last days of the dollar, in contrast with our analysis of the system, it seems the right time to evaluate our framework. This is especially timely because the relatively low yields and spreads in the generality of asset prices seem aligned with our view and not the conventional wisdom being expressed in the media.

Has the dollar crashed?

Clearly, the euro has soared, but the USD/EUR cross rate is not the value of the dollar. Since mid-2002 the euro has jumped from $0.90 to $1.35, a gain of about 50%. Other floating currencies have also appreciated significantly, though somewhat less. But the dollar value of foreign currencies weighted by US trade has appreciated by about 15% over this interval.

There is no doubt that pressure on the dollar has picked up since October, as the system is being tested once again, and that some Asian governments, particularly Japan, have stayed out of the market. Nevertheless, over this interval foreign exchange reserves have continued to grow, especially in Asia. More importantly, it seems likely to us that the MOF has changed strategy but not its underlying intent to manage the exchange rate through intervention. Rather than feeding speculative portfolios by leaning against the wind, the MOF may be inviting the market out on the limb so that they can saw it off with a large intervention.

China has reaffirmed its reliance on administrative controls for economic policy. They will not likely revalue soon and more generally will not cease their intervention.

An Asian dollar index that was unchanged since mid-2002 through September has appreciated since the beginning of October, but only by about 4%. There has been some mild exchange rate appreciation overall but this is hardly the collapse of the system. Korea has moved by 10% in November, but it has also resumed very large intervention, with an increase in reserves by $14.2 billion. Others have allowed smaller rate adjustments and have continued to manage their markets.

Have official reserves been shifted from dollars?

With a prospectively rising euro, it seemed clear to us that there was a substantial incentive for foreign governments to diversify their reserve portfolios when the Euro was at $0.90. In fact, their *failure* to diversify their positions 18 months ago and their continued pumping of their funds into the dollar were the main reasons we came to doubt that the conventional view of the system was adequate. Reserve managers do not behave like private sector fund managers benchmarked to a risk/return calculus—they have other macro motivations. And that puts them into a high stakes tug-of-war with private sector investors that ranges back and forth across the capital account.

Surely, if they did not diversify at $0.90, there is much less incentive at $1.35! Buying euros now invites the embarrassing prospect of losing at the far end of the currency swing. On a more formal level, there is no one fixing the USD/EUR exchange rate. There is no analogy between the current system and the dollar/gold exchange requirement of the original Bretton Woods System. In that part of the system, the US obligation to convert the dollar into gold at a fixed price created inherent instability. But there is now no one way bet because the US is not pegging the value of the euro. In the current system, as the dollar weakens relative to the euro the dollar becomes more, not less, attractive to official and private investors.

The question then shifts to whether much diversification has actually occurred. It is misleading to argue that IMF data on the currency composition of reserves suggests that official holders have significantly sold dollars. As the USD/EUR rate changes, the share of reserves denominated in dollars falls, even if there are no sales of dollars or purchases of euros by reserve managers. This shift occurs automatically through the revaluation of euro denominated reserves. Because reserve holdings are secret, the level and shifts in the currency composition of reserves have long been rich sources of speculation in foreign exchange markets. Nevertheless, the dollar always keeps its hold on being the principal destination for official foreign exchange.

We have discussed elsewhere that diversifying reserves and maintaining a peg are possible at the cost of having to accumulate even more reserves overall. This would have the effect of pumping the same amount of official sector capital into the US as before even in the presence of an attempt at diversification. So US interest rates would be unaffected even if official sector reserve managers started to diversify. So to determine whether there has been any meaningful diversification signaling a waning interest in the dollar, the natural question is:

Has there been any financial or economic adjustment in the US at all?

No effect on long term interest rates: they are flat for the year and down since mid-2002. At end-June 2002, 10-year Treasury real rates were a 3.7% on nominal notes and 3.07% on TIPS. The respective numbers in end-December 2003 were 2.35% and 1.95%. The current respective real rates are 0.97% and 1.64%. Long term real rates have fallen in the growth

phase of the US cycle! Spreads have not significantly widened and equity markets are up. Where is the unwillingness to finance the ballooning US deficits? Where is the expectation that it will end soon?

Non-oil import prices are falling relative to non-agricultural export prices even in the face of significant nominal appreciation of other currencies. Trade and current account deficits are growing.

Moreover, it is very hard to find any hint of a crisis in the non-price financial data. While the official statistics show that the US is a net debtor to the tune of $2.5 trillion, the US continues to earn more on its assets abroad than it pays on its liabilities. Net investment income earnings are positive and have actually increased in H1 2004 relative to H1 2003. In part, the official numbers are just wrong. The US has made a whopping capital gain on the dollar value of its foreign liabilities that is not captured in the statistics.

Will Europe join the managed rate system?

We viewed this as a pretty high risk forecast 18 months ago because we thought that Europe would take a lot of pain before overcoming ECB reluctance, but it now has become much more likely. Nearly every week brings new veiled threats of action from the political authorities or statements of anguish from ECB officials. These, along with reports of slowing in Japan, have somewhat reversed the sharp exchange rate movements of November. But Europe cannot afford to absorb even more deflationary pressure. When Japan and the rest of Asia resume massive sales of their currencies in the next market test of the system, the Europeans may be forced to join them in supporting the dollar and the US deficit as the euro floating regime comes to an end.

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