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The Bretton Woods System: Are We Experiencing a Revival? Symposium Summary

This Economic Letter *summarizes the papers presented at the symposium "Revived Bretton Woods System: A New Paradigm for Asian Development?" held at the Federal Reserve Bank of San Francisco on February 4, 2005, under the joint sponsorship of the Bank's Center for Pacific Basin Studies and the University of California at Berkeley's Clausen Center for International Economics. The papers are listed at the end and are available at http://www.frbsf.org/economics/conferences/0502/.*

At the center of this symposium was a presentation by Michael Dooley (University of California at Santa Cruz and Deutschebank) and Peter Garber (Deutschebank) based on their papers with David Folkerts-Landau (2003a, b, 2004). Dooley and Garber presented their views on the current international exchange rate system, the sustainability of global trade imbalances, and the implications for development by emerging markets, such as China. Other participants presented papers that questioned the bases of their arguments and the extent to which those arguments account for current developments.

A revival of Bretton Woods?

Dooley, Folkerts-Landau, and Garber (DFG 2003b) argue that the current international exchange rate system operates much like the Bretton Woods system of fixed exchange rates that prevailed for nearly a quarter of a century, from the end of World War II until the early 1970s. Under Bretton Woods, foreign currencies were pegged to the dollar at fixed parities, and the dollar was pegged to gold at $35 an ounce. The system was abandoned when foreign governments perceived that guarantees of currency conversion at fixed rates were no longer credible.

Although the current international exchange rate regime carries no guarantees of fixed parities in terms of gold or the dollar, DFG argue that many countries, particularly those in Asia, do limit exchange rate fluctuations against the dollar to varying degrees. For example, Japan often has conducted foreign exchange intervention—selling yen for dollars, which pushes the yen down against the dollar—in order to maintain its export competitiveness. As a result, Japan has been a net accumulator of dollar-denominated assets; indeed, it ranks first among official reserve holders of U.S. Treasury securities.

China's policy of keeping exchange rates low relative to the dollar is also related to a desire to boost exports. In addition, according to DFG, China has also been motivated by a desire to attract foreign direct investment by multinational firms as well as the technical expertise that usually comes with it. As a result, China also has been a net accumulator of dollar-denominated assets and is second only to Japan among official reserve holders of U.S. Treasury securities.

This result is surprising, however. Given that China is a rapidly growing developing country, one might expect it to be a net international borrower, as capital presumably enjoys a higher rate of return there than in the U.S. Naturally, this question also arises with other developing economies that may peg their exchange rates to varying degrees to the dollar. Whether this issue is a valid point or not, DFG (2004) have an answer. They argue that developing nations like China need to accumulate U.S. Treasury securities, because they provide a form of "collateral" against concerns about possible future expropriation of the assets of U.S. foreign direct investors.

This argument has implications for the U.S. trade deficit. The exchange rate policies discussed have

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been accompanied by large trade surpluses in most Asian countries vis-à-vis the U.S., as well as by a corresponding need by the U.S. to borrow to finance its purchases of net imports. This implies that, insofar as developing countries like China continue to accumulate these U.S. assets, the U.S. will see ongoing trade deficits.

Perhaps the biggest question facing DFG's world view is whether the current system is sustainable as the U.S. current account deficit continues to grow. DFG (2003a) argue that the system is sustainable in the near term (though their estimates of what the "near term" is varies from three to ten years or more) as long as Asian countries are willing to finance the growing U.S. current account deficit by purchasing additional U.S. securities.

Does China fit the story?

Several symposium participants questioned the merits and viability of a strategy of deliberate currency undervaluation by developing countries, particularly in the case of China.

For example, Nicholas Lardy (Institute of International Economics), in his paper with Morris Goldstein, pointed out that more than half of China's exports go to markets other than the U.S. or to countries with currencies not pegged to the dollar. Thus, a strategy of undervaluation by China to boost its exports should depend not just on the renminbi's exchange rate against the dollar but also on its effective rate against the currencies of all of its trading partners. In fact, between 1994 and 2001 the renminbi's real trade-weighted exchange rate (adjusted for inflation differences across countries) appreciated by 30% before falling by 13% since 2001. Lardy also disagreed with DFG's argument that the undervaluation contributed significantly to increasing foreign direct investment in China and the growth of China's capital stock. In his view, this argument ignores the fact that foreign direct investment in China has financed less than 5% of fixed asset investment over the past few years.

Barry Eichengreen (University of California at Berkeley) dismissed the purported role of U.S. assets as collateral that justify U.S. multinational firms' decisions to invest in China. For one thing, he argues that the timing is wrong: rising U.S. foreign direct investment in China began around 1992, whereas China's massive reserve accumulation came a decade later. In addition, he doubts that political conditions would support U.S. expropriation of Chinese claims, invalidating the collateral role these claims are purported to play. Finally, he points out that in recent years the U.S. has accounted for less than 10% of China's inward foreign direct investment.

Steven Kamin (Board of Governors) agreed with DFG that the authorities in developing economies other than China have been acting to maintain the competitiveness of their exports by limiting currency appreciation. However, he argues that the recent large current account surpluses in the region mainly reflect the special, ongoing effects of a decline in investment and domestic demand following the Asian financial crisis of 1997–1998. He attributes this fall in investment to factors such as the presence of considerable excess capacity after the crisis and the near collapse of domestic banking systems in the region. To be sure, immediately after the Asian financial crisis, the desire to rebuild foreign exchange reserves was another reason that authorities in the region intervened in foreign exchange markets to acquire dollar assets, but this motive has diminished in importance as reserves have grown. He believes that, over time, Asian investment spending will revive, that the authorities will be more comfortable in allowing their currencies to strengthen, and that their trade surpluses will narrow.

Will the system last?

Barry Eichengreen and Ted Truman (Institute of International Economics) argue that DFG make a false analogy between the current international foreign exchange system and Bretton Woods. In particular, they argue that the U.S. is now no longer a net saver with current account surpluses, as it was in the years immediately after World War II. In addition, domestic financial systems are more liberalized, capital accounts are more open, and exchange rates are more flexible, for both industrial and emerging market economies. These differences make it harder to sustain undervalued exchange rates indefinitely.

Nouriel Roubini (New York University) and Brad Setser (Roubini Global International) also questioned the sustainability of efforts to limit dollar appreciation, arguing that the scale of the financing required is increasing faster than the willingness of the world's central banks to build up their dollar reserves. In addition, the enormous reserve growth in these countries has become increasingly harder to sterilize fully, particularly in China, where the resulting increase in the money supply is fueling a lending boom and an asset-price bubble. Lardy and Roubini both suggest an earlier rather than a later end of China's peg to the dollar. Eichengreen argues that China has good reason to abandon its peg soon, while confidence is strong, capital is still flowing in, and reserves are still being accumulated.

DFG suggest that because the euro area has borne a large and disproportionate share of the adjustment of the U.S. trade imbalance, the European Central Bank will be compelled to engage in large-scale currency intervention to resist further euro appreciation. However, Roubini and Setser and Truman all argue that the European Central Bank is unlikely to do so, in part because of its conviction that the recent massive Japanese intervention had limited effectiveness. The implication is that there will be continuing downward pressure on the dollar against floating currencies until the overall adjustment is consistent with a lower U.S. current account deficit.

Might global imbalances spark a sharp decline in the dollar? Maurice Obstfeld (University of California at Berkeley) discusses the likelihood that the U.S. might face an emerging markets-style "sudden stop" crisis. In his work with Kenneth Rogoff, he questions the sustainability of U.S. current account imbalances, and suggests that a large depreciation of the dollar is indeed very likely.

Ron McKinnon (Stanford University) agrees with DFG that it is in China's interest to maintain a dollar peg, but his argument is different. He argues that a stable exchange rate is an important way for China to anchor low inflation expectations. Accordingly, he provides three arguments for why it is not a good idea for China to allow the renminbi to appreciate. First, an appreciation of the renminbi would not necessarily improve the U.S. trade balance; for example, it could lead to reduced world demand for China's exports, thus slowing China's economic growth, which, in turn, could lead to significant declines in Chinese demand for U.S. products. Second, it may create deflationary pressure in China. Third, it would encourage more speculative capital inflows.

Conclusion

One way to assess the arguments of DFG and their critics may be to examine the implications of the revaluation of the Chinese renminbi in July 2005, five months after the symposium took place. On one hand, it is clear that the Chinese have adjusted their currency by revaluing against the dollar and announced that they would move towards more flexibility in the future. These developments would seem to portend changes that conflict with the DFG vision of Asian countries' ongoing willingness to finance ever-increasing U.S. deficits in the interest of maintaining their trade balance surpluses.

On the other hand, it must be acknowledged that DFG's first works on this subject were published in 2003, and the imminent sharp adjustment in the dollar that was predicted by many has yet to take place. Indeed, so far, the renminbi has adjusted by less than 3%. As such, the DFG framework has already lasted for a notably long duration in today's volatile international financial markets.

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Symposium papers

Eichengreen, Barry. "Global Imbalances and the Lessons of Bretton Woods"

Goldstein, Morris, and Nicholas R. Lardy. "China's Role in the Revived Bretton Woods System: A Case of Mistaken Identity."

Kamin, Steven. "The Revived Bretton Woods System: Does It Explain Developments in Non-China Developing Asia?"

McKinnon, Ronald. "Exchange Rates, Wages, and International Adjustment: Japan and China versus the United States."

Obstfeld, Maurice, and Kenneth Rogoff. "The Unsustainable U.S. Current Account Position Revisited."

Roubini, Nouriel, and Brad Setser. "Will the Bretton Woods 2 Regime Unravel Soon? The Risk of a Hard Landing in 2005–2006."

Truman, Edwin. "The U.S. Current Account Deficit and the Euro Area."

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