

July 1, 2005

**Comments on Dooley and Garber  
“Is it 1958 or 1968?”  
Three Notes on the Longevity of the Revived Bretton Woods System”**

**For the Brookings Panel on Economic Activity  
March 31-April 1, 2005**

**Jeffrey Frankel, Harvard University**

*“I have listened to both sides of this debate. Here is what I think. I think those who call for a fixed exchange rate are right in the short run. And those who call for a floating exchange rate are right in the long run. How long is the short run, you ask? You must understand. China is 8000 years old. So when I say, short run, it could be 100 years.”*  
-- Li Ruogu, Deputy Governor, People’s Bank of China, May 2004, as paraphrased by author.

*“Certainly we don’t want... the US situation of having a trade deficit of 6 percent of GDP” - same official, as reported by the FT, p.1, 12/23/04, under the headline, “China Tells US to Put its House in Order.”*

In a recent series of papers that have deservedly received a lot of attention, Michael Dooley and Peter Garber have put forward the view that the essential elements of the current international monetary situation bear a strong resemblance to the Bretton Woods system, with the Asian central banks today playing the role of dollar accumulators that Europe played in the 1960s.<sup>1</sup> There is a lot of insight in their views, which are all the more useful for their unconventional perspective and language. This is not just another recitation of familiar positions in a fixed vs. floating debate. For example, I think the authors are right that, “The problem for China is to mobilize its existing enormous domestic savings to create a growing, internationally competitive capital stock that can rapidly employ hundreds of millions of worker in productive activity. A serious constraint is the lack of a domestic financial system capable of channeling these savings into productive capital, of proper technology and management skills” (p.6). To link these issues to the US balance of payments situation was an original, imaginative and thought-provoking leap.

It is fair to claim, as they do, that much of their analysis has been generally accepted. This is not to say that we have to credit the authors for the insight that Asian central banks are now financing much of the US current account deficit; this much is obvious. And, at the other end, I think the authors have been forced to clarify that they are not claiming that the current system can continue indefinitely – that the dollar will

---

<sup>1</sup> Usually with David Folkerts-Landau.

never have to devalue – which many of us thought we heard them saying at first.<sup>2</sup> But I credit them with the useful insight that the willingness of Asia, and especially China, to pile up unheard of quantities of dollars is not simple myopia or mercantilism, but is rather part of a deliberate strategy of export-led growth that may not be foolish, given the structural limitations of their financial and corporate governance system.

I will begin by re-stating the authors' case. It is not always easy to understand everything they say, perhaps due to the novelty of some arguments. I will try to be helpful in defending them against some of the critiques that have demanded their response. Indeed, I may carry the parallel with the Bretton Woods period further than they themselves intended or would like. I will then, in some respects try to suggest some different (and perhaps less unconventional?) language to explain what seems to me the same argument. On the key question that is posed by the title, however, which is whether we are at the beginning of the system or the end, I am going to come down on the latter side, or more precisely that we are *closer to* the end. One could argue that we are actually *at* the end, 1971, since the dollar depreciated substantially against most currencies during 2002-04, precisely as so many of us predicted it would when the US shifted macroeconomic gears four years ago. But we may still have a little ways to go in other respects, such as the much-anticipated end of the peg of the renminbi to the dollar. I shall argue that in one respect we may be at 1967.

### **Is the Bretton Woods analogy appropriate?**

The five features that the authors enumerate at the beginning of their paper in fact bear little resemblance to the Bretton Woods system. Certainly, with no mention of pegged exchange rates or gold, this list bears little relation to the system that was agreed at Bretton Woods, New Hampshire, in 1944. But I think we take “Bretton Woods” to refer to the de facto system under which other currencies were pegged to the dollar, and other central banks held dollars as the reserve asset because it was convertible into gold.<sup>3</sup> Specifically, “Bretton Woods period” refers to the years from 1958, when the European countries restored convertibility as envisaged in the IMF Articles of Agreement, to 1971 when the dollar devalued, or perhaps just to 1968, when the US ceased to allow foreign citizens to convert dollars to gold.

The ten-to-thirteen years that this de facto system lasted is not very long in the scheme of things. One might even question whether it was a “system,” given that it was breaking down throughout these years, under strain from the US balance of payments deficit. But pretty much everyone has long understood these points. That the dollar is still the main international reserve currency today, and that Asian central banks see it in their interest to pile up large quantities of dollars, which finances a large US balance of payments deficit as in the 1960s, is alone probably enough to justify the analogy with

---

<sup>2</sup> E.g. Eichengreen (2004). Dooley, Folkerts-Landau and Garber (2003) wrote “there is a line of countries waiting [to follow the development strategy of keeping their currencies undervalued against the dollar] sufficient to keep the system intact for the foreseeable future.”

<sup>3</sup> E.g., McKinnon (1996), especially p. 41.

Bretton Woods. The picture is indeed of a “system” in the respect that it shows how the two halves, US and periphery, fit together into a whole, a mode of analysis that has largely died out from international macroeconomics since 1971, as Eichengreen points out.

True, only China and a couple of other Asian economies (only Hong Kong and Malaysia) have currencies that are fixed to the dollar today, even de facto. But dollar purchases by foreign central banks, especially in Asia, in efforts to prevent their currencies from appreciating against the dollar, have nonetheless been very large recently. They have financed an increasing share of the US current account deficit, which itself has been widening sharply, over the last four years.

In the third of the “three notes” that constitute the Dooley-Garber paper, the authors take pains to defend themselves against the criticism that the United States was not running a current account deficit in the 1960s as it is today. I am with them on this. In the first place, the long term trend in the US current account during the Bretton Woods period was negative, even if the balance was usually greater than zero. The US had run substantial surpluses in the late 1940s, because it emerged from the war with its productive capacity intact. (This was called the period of “dollar shortage.”) The surpluses diminished in 1950s. True, they then recovered a bit, peaking in 1964. But from then on the general trend was downward until the system fell apart in 1971.

In the second place, more comprehensive measures of the balance of payments -- starting with the basic balance (which includes Foreign Direct Investment and other long-term capital flows) and the liquidity balance (which includes also short-term non-liquid flows plus errors and omissions) -- did turn negative. The overall US balance of payments went into deficit in 1958, which is presumably why the authors single out that year for their Bretton Woods analogy. These deficits defined the 1960s as a period of excess supply of dollars.<sup>4</sup>

In both cases, Europe in the 1960s and China today, rising foreign direct investment – bilateral, as well as overall outward from the US and overall inward to the partners in question -- was an important part of the story, as important as the trade balances. [One difference is that in Europe in the 1960s the voices decrying “the American challenge” were louder than those favoring the foreign multinational companies as part of an intelligent growth strategy, while China seems more welcoming.] When De Gaulle complained about the US “exorbitant privilege” of being able to trade pieces of paper for items of more tangible value, he had in mind Americans acquiring French factories as much as, or more than, French goods. So I think the authors are on

---

<sup>4</sup> The US was losing reserves throughout 1958-67, and in large amounts during 1970-71, which forced the devaluation and closing of the gold window. Foreign central banks were also piling up dollars, and in larger magnitudes, through most of 1960s, and especially starting in 1970. [1968-69 actually went the other way, perhaps because the US had begun to make an effort on fiscal policy with the tax surcharge.]

firm ground in focusing on a broader measure of the balance of payments, one that includes direct investment, such as the basic balance or the liquidity balance.

## **Terminology**

Let's spend a moment on language, so we are all sure we are talking about the same things. I may have some translating to propose.

The authors use the phrase "Trade account country" to refer to a country that offsets current account imbalances with large changes in official reserves. They particularly have in mind China, which has been running a trade account surplus and offsetting it with increases in reserves. They use the phrase "Capital account country" to refer to one that offsets its current account deficits with capital inflows. [Then there is the third set of countries – Europe and a few others – that are floaters.] In standard models the first group would be characterized by low capital mobility and high propensity for the authorities to intervene to stabilize the exchange rate, and the second group by high capital mobility and less tendency to intervene.

I am afraid that I don't care for the names, "Trade account country" and "Capital account country." Each time I read them, I have to stop and think to remind myself which one is which in the authors' scheme. I think it would be much more intuitive if they were to call Asia the "Exporting countries," the US "the Consuming country," and Europe, "the Investing countries."

In the "second note" of this paper, they focus on the term "dominance," which refers to whether changes in the balance of payments are dominated by official versus private capital flows. I find this term also somewhat opaque [and the term "global dominance index" somewhat sinister !]. I am with them entirely on the point that private-sector asset demands [presumably acting upon public-sector money supplies] do not perfectly determine all exchange rates and other asset prices, that foreign exchange intervention can also be important, especially for countries with capital controls and default risk like China. But if this is the framework they wish to use, then it sounds like the key distinction is not the importance of the trade account versus the capital account, but rather the importance of official reserve transactions versus the private capital account. This might be another reason to abandon the term "trade account countries."

In empirical tests on statistics of capital accountness that they devise, they find that the degree of capital mobility is indeed correlated with their dominance measure, but the degree of exchange rate flexibility is not. I don't find this too surprising. It has become a common finding, even though previously unpredicted, that fixed-rate countries do not appear to intervene more than floating rate countries – in times series and cross-country dimensions alike. In this respect, it is harder to tell the difference between the Bretton Woods and floating rate eras than one would expect. [Japan is a good example of a country that intervenes a lot, even though it has no exchange rate target – and for that matter even though it also experiences huge private capital outflows.]

## **America as the World's Banker**

I learned from Charlie Kindleberger 30 years ago that one way to think of the chronic willingness of other countries to absorb dollars is that the United States acts as the world's banker, that we provide the service of transforming maturities, taking short-term deposits and investing in longer-term higher-risk, higher-return, assets such as FDI.<sup>5</sup> Thus I accept the idea that both parties stand to gain from an exchange of gross capital flows, where the US undertakes direct investment in China, and China acquires dollar bonds. Notwithstanding that US treasury bills tend to pay a much lower rate of return on average than the US earns on its investments in other countries, I buy the argument that this can be part of a useful development strategy. I leave it to others to point out that the recent surges of capital into China have been portfolio investment, not FDI, and that even the FDI has for the most part not come from the United States.<sup>6</sup> I am still thinking about the notion that the FDI is the lesser credit – which must mean that the danger of expropriation by China's government is greater than the danger that the US will depreciate away the value of the bonds – and that therefore China has to offer collateral to the US, and that supplying exports up front constitutes this collateral. Interesting.

But while I am thinking about this, I have a question. Where do private short-term liquid portfolio flows belong in the story? Are we sure it is the liquidity balance that matters, as the authors say, rather than the most comprehensive measure of the balance of payments called the official settlements balance, or official reserve transactions balance. Why not also include short-term portfolio capital flows, even those that are liquid? In other words, why not draw the line so that all private transactions appear above it, and nothing besides official reserve transactions appears below it? Isn't the main point the US ability to run deficits on the overall balance of payments, and the way other countries are forced to run corresponding surpluses in order to earn foreign exchange reserves? Wasn't that the point of the two-country version of the monetary approach to the balance of payments in the 1960s?<sup>7</sup> Don't the arguments about how developing countries are forced to post "collateral" against capital inflows apply as much – actually, more – to their inflows of short-term portfolio capital as to FDI?

If it is just the US monetary authorities that are playing the role of world banker, then the answer is that we want to look at the official settlements balance. If it is the entire US commercial banking sector, then the answer is the liquidity balance. The language of "private vs. public" domination of the capital account makes it sound like it is the official settlements balance that is key, that we should "draw the line" below all private transactions, even liquid short-term banking flows. Consistent with this, the biggest increase in China's balance of payments over the last few years has been neither in the current account nor FDI, but rather in unmeasured inflows that are generally considered to be speculative and short-term: Chinese citizens bringing back onshore liquid investments that they had previously managed to accumulate offshore. Nor is the circumstance unique to China of short-term capital flowing from the US to the emerging market, that is, in the same direction as the FDI,. This has been a feature of other

---

<sup>5</sup> Kindleberger (1965) .

<sup>6</sup> E.g., Prasad and Wei (2005)

<sup>7</sup> E.g., Mundell (1968) and Dornbusch (1973).

emerging markets, both during the most recent boom phase of the international debt cycle (2002-05) and the preceding one (1990-96). Hence all the talk about how capital inflows are more likely to lead to crises if their composition is tilted in the direction of short-term loans, unless such they are fully offset by reserves.

One reason to skip directly to the official settlements balance is that the liquidity balance and the others are no longer computed. The U.S. stopped trying to calculate these statistics long ago, in part because the capital account statistics are not good, and in part because it is difficult even in principle to define what is short-term and what is long-term, and in part because the entire exercise of distinguishing between autonomous and accommodating transactions became obsolete with the end of the Bretton Woods system. [In the case of the basic balance, it is still reported for some countries, such as Japan.]

### **Long-term interest rates**

The authors cite low real interest rates as evidence that the world is experiencing a glut of saving – that the relationship is being pushed by the Asian desire to save, rather than pulled from the US desire to consume. It is true, as they say, that “the fact of unusually low long term interest rates for this stage of the cycle is a direct challenge to those who claim that the end is near” (p.2). My view is that one of the things economists can most usefully contribute to real-time analysis of the economy is to point out when some market seems to be out of line from historical relationships, with the implication that it is likely to correct itself within a couple years. [Examples include the undervalued stock market in 1980, the overvalued dollar in 1985, the overvalued yen in 1995, the overvalued stock market in 2000, and the undervalued euro in 2002.] Perhaps those observers are right who say that the recent co-existence of low US rates with big budget deficits shows that there has been a major fundamental shift in the willingness of global investors to hold US debt. But I am willing to bet against it. Here is one testable disagreement.

My view is that the bond market was buoyed over the years 2001-04 by three factors, each of which is already starting to come to an end:

1. easy monetary policy – i.e., the purchases of US Treasury securities by the Fed (which began to reverse in the summer of 2004).
2. the same thing in Asia – i.e., purchases of US securities by Asian central banks (who get center-stage in the Dooley-Garber story), and
3. the fact that investors appear still to be putting some weight on official government projections of declining future budget deficits, despite all the reasons to disbelieve them. Investors have yet to internalize fully the dismal fiscal outlook inherent in more objective forecasts.

As these three factors come to an end, long-term interest rates should rise from their current levels, near 4% at the time of writing, to above 6%. I calculate this as approximately  $2\frac{1}{2}\%$  inflation + 2% for a normal real short-term rate + 1% for a normal term premium + 1% in an extra term premium for an expected path of rising debt/GDP). [That is not even counting the proposed dumping of huge new quantities of US treasury bonds on the market to fund a transition to privatized social security accounts. Nor does it count possible unforeseen factors such as new instability coming from the Middle East or new oil price

increases. It seems to me that a future crash is more likely to come in the bond market than anywhere else.] Time will tell.

I would also guess that the dollar will probably resume its depreciation, long before all unemployed or badly employed labor in China is reallocated to world-class production (which the authors say will take at least ten years, p.8). It is now in China's own interest to move away from the peg. It has more reserves than it can use.<sup>8</sup> But the Chinese authorities do not want to be pushed into revaluing the renminbi against the dollar. [See paraphrased quote at the top of this comment.] It is safer to bet against the US bond market: I think it will probably fall before the dollar does, or at worst at the same time.

Perhaps my answer to the question whether we are in 1958 or 1968 is that we are in 1967. In that year, the seriousness of the balance of payments had become clear, and yet large increases in government spending were still coming out of Washington -- much of them on a foreign military adventure -- without any willingness to pay for it by raising taxes.<sup>9</sup> The phrase is "guns and butter." Perhaps if it had not been for the Vietnam War, Great Society program, and associated fiscal and monetary profligacy, the Triffin Dilemma<sup>10</sup> would have taken decades to work itself out fully. But the excessively expansionary US macro policy accelerated the process, so that the end came in 1971. To my way of thinking, a fundamental systemic structure that produces rising US balance of payments deficits, *combined with* excessively expansionary macroeconomic policies that accelerate the trend, sounds like the situation today. It is in this respect that I think the current period resembles the 1960s even more, perhaps, than Dooley and Garber think so. But it is also for this reason that I think the situation is unlikely to be sustainable for 10 or 20 years.

Incidentally, easy monetary policy kept real interest rates fairly low in 1967 as well: 4.2 % on the fed funds rate and 5.1% on 10-year government bonds, against 3.0 % in CPI inflation. Thus the Johnson deficits are a better precedent for the Bush deficits that are the Reagan deficits, which were not initially accommodated by monetary policy.

### **The Euro as a rival for the dollar**

I both agree and disagree with the authors' rejection of recent media reports that central banks are jumping on a bandwagon of diversification of their reserves out of dollars. Where I agree is that there is an element of hysteria to such reports, which come in highly predictable waves every time the dollar has been depreciating for a couple of years in a row. The most recent previous cycle occurred in 1994-95, when articles suggest that the dollar might lose its status as unrivaled international reserve currency, that

---

<sup>8</sup> Frankel (2004).

<sup>9</sup> E.g., Solomon (1977), 102-104. In 1968, Congress did pass an income tax surcharge to help pay for the spending. It was too little, or too late, or both, to head off rising deficits and inflation.

<sup>10</sup> Triffin (1960).

it was in danger of "going the way of sterling, the guilder, the ducat and the bezant."<sup>11</sup> It was not hard to predict the current cycle of alarmist articles in the financial media.

The last cycle of alarms was wrong. In the first place, shares of reserve holdings in central banks, and other measures of international currency use, change only slowly over time. In the second place, these measures in the 1990s actually showed that the dollar's share had reversed the downward trend of the 1970s and 1980s.<sup>12</sup>

But this time may be different, which is where I do not share the confidence of with the authors. The share of the dollar in international reserves has again resumed its downward trend. And there are two or three available explanations. In the first place, there is now an obvious rival, the euro, which is more credible as an alternative than the mark or yen were. In the second place, the US now has a net international debt that is large and rapidly rising.

Some argue that central banks in Asia hold so many dollars already, that they will be reluctant to diversify into other assets for fear this will precipitate a big depreciation of the dollar in which the value of their holdings will be the hardest hit. No doubt individual central banks indeed have this concern. But, as often, I agree with Eichengreen (2004): each individual participant will realize that it stands to lose more if it holds pat than if it joins the run, when it comes to that. If narrow economic self-interest is not sufficient to stop the slide, will enlightened geo-political calculation do it? In the meantime, the United States has lost popular sympathy and political support in much of the rest of the world. In the past, deficits from imperial overstretch have been manageable because others paid the bills for our troops overseas: Germany and Japan during the Cold War, Kuwait and Saudi Arabia in 1991. Now the hegemon has lost its claim to legitimacy in the eyes of many. Next time the US asks other central banks to bail out the dollar, will they be as willing to do so as Europe was in the 1960s, or as Japan was in the late 1980s after the Louvre Agreement? It seems unlikely.

Menzie Chinn and I document econometrically some of the commonly hypothesized determinants of reserve currency shares: size of home economy, rates of return, stability of the value of the currency, historical inertia, and a tipping phenomenon. We have found each of these to be statistically significant during the period 1973-1998. We found surprisingly little support another hypothesized variable, the net international investment position of the home country).<sup>13</sup>

We use the short EMU period 1999-2003 as a crude test of the out-of-sample performance of the estimated equation. It correctly predicts a small increase in the euro share at the expense of the dollar during this period. We then use the parameter estimates to project into the future. The projections are naturally very sensitive to what one assumes about the explanatory variables, particularly the size of euroland. Our preliminary finding is that if some Central and Eastern European countries join EMU by 2010, and Sweden, Denmark and (most importantly) the United Kingdom join by 2015,

---

<sup>11</sup> Kindleberger (1995, p.6).

<sup>12</sup> Frankel (1995).

<sup>13</sup> Chinn and Frankel (2005) also give many other references to the literature, including Bergsten (1975), Dooley, Lizondo, and Mathieson (1989) and Eichengreen and Mathieson (2000).

so that euroland becomes larger than the United States, the tipping phenomenon could set in soon thereafter. The euro could definitively pass the dollar, perhaps in the subsequent decade. Even if some important EU countries remain outside the euro, as is likely, the tipping could result, nevertheless, in response to a future trend depreciation of the dollar that continued at the same pace as in the past.

It is still true that measures of international currency use such as reserve shares change slowly over time. So if any newspaper headlines proclaim that the dollar may be overtaken by the euro, it is important to realize that this is unlikely to happen for a long time. But if it does happen, the consequences are likely to be large. It would mean the end of America's "exorbitant privilege." It is not just a ten-year "system" that would be coming to an end, but perhaps a century of US economic hegemony.

### *References*

Bergsten, C.Fred, 1975, The Dilemmas of the Dollar, New York Univ. Press, New York.

Chinn, Menzie, and Jeffrey Frankel, 2005, "Will the Euro Eventually Surpass the Dollar as Leading International Reserve Currency?" for NBER conference on *G7 Current Account Imbalances: Sustainability and Adjustment*, Newport, RI, June 1-2, 2005, edited by Richard Clarida.

Dooley, Michael, David Folkerts-Landau, and Peter Garber, 2003, "An Essay on the Revived Bretton Woods System," NBER WP no 9971, Sept.

Dooley, Michael, J. Saul Lizondo, and Donald Mathieson, 1989, "The Currency Composition of Foreign Exchange Reserves," IMF Staff Papers 36, no.2, June, 385-434.

Dornbusch, Rudiger, "Devaluation, Money and Nontraded Goods," American Economic Review, December 1973, 871-880.

Eichengreen, Barry, 2004 "Global Imbalances and the Lessons of Bretton Woods," NBER WP no. 10497.

Eichengreen, Barry, and Donald Mathieson, 2000, "The Currency Composition of Foreign Exchange Reserves: Retrospect and Prospect," IMF Working Paper wp/00/131, Washington DC.

Frankel, Jeffrey, "Still the Lingua Franca: The Exaggerated Death of the Dollar," Foreign Affairs, 74, no. 4, July/August 1995, 9-16

Frankel, Jeffrey, 2005, "On the Renminbi: The Choice Between Adjustment Under a Fixed Exchange Rate and Adjustment under a Flexible Rate," Dalian, China, May 2004. NBER Working Paper No. 11274, Apr..

Kindleberger, Charles, 1965, "Balance of Payments Deficits and the International Market for Liquidity," Princeton Essays in International Finance No. 46, Princeton University, 1965.

Kindleberger, Charles, 1995, "Dollar Darkness," The International Economy, May/June.

McKinnon, Ronald, 1996, *The Rules of the Game*, MIT Press: Cambridge MA.

Mundell, Robert. 1971. *Monetary Theory*. Pacific Palisades: Goodyear.

Prasad, Eswar, and Shang Jin Wei, 2005, "The Chinese Approach to Capital Inflows: Patterns and Possible Explanations," NBER Working Paper no. 11306, May.

Solomon, Robert, 1977. *The International Monetary System: An Insider's View 1945-1976* , Harper and Row NY.

Triffin, Robert, 1960, *Gold and the Dollar Crisis* .