Remarks on Occasion of the 70th Anniversary of Bretton Woods

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By the final panel of a two day conference almost all issues have already been discussed. I will therefore engage in some R&R, reminiscences and reflections, since I have passed my 50th anniversary in dealing with issues of the international monetary system, having served on three occasions in the US government during the 1960s and on a longer occasion in the 1970s.

My first observation concerns the title of this session, "Bretton Woods and the IMS in a Multipolar World?." In my experience with foreign economic policy, we have always lived in a multipolar world. Serious trade negotiations involved at a minimum Europe, Canada, and Japan as well as the United States at the core (the Quad), plus many others. Negotiations on international monetary issues involved Britain, France, and Germany as well as the United States, and often other countries. China now plays an important role, as do Brazil and India in trade, so the world is different, but it has not recently become multipolar because of the addition of those countries. (India has long been a potential player, as it was at Bretton Woods even while still a British colony, but she has insisted that because she is poor she should take on no global responsibilities, and has generally gotten away with it, but that phase too may be over.) Even the international use of currencies has never been unipolar. While the US dollar has played the predominant role since the 1940s, the British pound was important (in the form of the sterling balances) into the 1970s; the German mark began to be used as an international currency, subsequently replaced by the euro with an even greater role. Maybe the Chinese yuan will be added to this list in the future, but not soon except as a bit player, since it remains inconvertible and its judicial system cannot be trusted to render impartial judgments.

In his recent book, *The Battle of Bretton Woods,* Ben Steil argues that Harry Dexter White wanted the US dollar to replace the British pound as the leading international currency and worked to that end. I will leave that issue to the historians, although I thought Ed Conway at this conference did an effective job of casting doubt on Steil's claim. Certainly in my later experience the US government did much to support the pound, as Michael Bordo reminded us. It was not for disinterested reasons: US officials worried that a weak pound would spread weakness to the US dollar (I questioned that proposition at the time), and also wanted Britain to maintain a military engagement east of Suez.

Two books have been published in the past year, by Ronald McKinnon *(The Unloved Dollar Standard)* and Eswar Prasad (*The Dollar Trap*), both non-Americans teaching in the United States, that conclude, with a note of regret, that the US dollar will be the dominant international currency for a long time. There will be nibbling at the edges, but the US dollar will retain its central position. I basically agree with their judgment. It rests on three foundations. The first is the size of the US economy and especially the size and the liquidity of the US financial market, which still accounts for nearly half of the world financial system by value (more if only tradable securities are taken into account), along with an independent and impartial judicial system for settling commercial disputes. The second is the extensive network externalities that have been established through historic use of the US dollar, as in the use of English as a common means of communication across linguistically diverse societies. No one consciously chose it, but it is now established and self-re-enforcing. Third is the absence of an effective alternative, a point to which I return below. The euro is the obvious competitor, but it has recently received a (temporary) set-back by economic troubles in Europe and the fragmentation of the European financial market. In the longer run, Europe is in relative economic decline, much more so than the United States, largely for demographic reasons (from 29% of the world economy in 2007 to 19% by 2017 on one estimate, including the UK, and continuing thereafter).

The US dollar's role will be extremely hard to dislodge or replace. As an unlikely example, US dollars account for 60% percent of bank deposits in Laos, a communist country with central planning, close to China. Laotians distrust the kip. The traditional form of household saving is gold leaf, but the authorities prefer bank deposits in US dollars, which unlike gold can be socially mobilized for productive investment.

The suspension by the United States of gold convertibility of the US dollar in 1971 has featured in several presentations, so perhaps I should say something about it. US monetary policy was tight in late 1968 and 1969, with funds flowing into the United States, thus providing the conditions for the first decision in 1969 to allocate newly created SDRs. Then the USA ran into recession, US monetary policy eased considerably, and funds began to flow out of the United States. Inflation had increased under the pressures of the Vietnam War. An increase in IMF quotas had been agreed, requiring at that time that 25% be paid in gold. A number of countries desired to replenish their national gold stocks, and turned to the US Treasury to do so. The SDRs came too little too late; Triffin's dilemma was at hand.

In August, President Nixon announced a major change in economic policy, of which suspension of gold convertibility was a minor but logical part. The aim of the policy was to limit inflation through the introduction of wage and price controls and to improve the US balance of payments through devaluation of the US dollar against other leading currencies, an action which under the Bretton Woods system as it had evolved was not in the hands of the United States. The United States could change its official price of gold, but the exchange rates were determined by other countries. To induce others to appreciate their currencies relative to the US dollar, the US imposed an import surcharge on all dutiable imports. That led to the Smithsonian Agreement of December 1971, which involved removal of the surcharge in exchange for agreement by others to appreciate their currencies by varying amounts, led by the Japanese yen at 15%. At French insistence, the USA also agreed to raise the official price of gold from USD 35 to USD 42.22 an ounce.

By the analysis of the Treasury staff, and independently by the IMF staff, the negotiated re-alignment of exchange rates was too little to correct the US payments imbalance; but it was all the Europeans would agree to. Nixon had suggested that gold-convertibility of the US dollar would be re-established (for official monetary transactions) after the re-alignment of exchange rates; an increase in the official price of gold made no sense otherwise. But under the circumstances, gold convertibility was (properly) not re-established, and so it remains today. The Smithsonian agreement rates were proved inadequate within the next 15 months, and the system moved to floating exchange rates among the major currencies.

The major issue domestically not surprisingly was the wage and price controls, which proved challenging from the beginning. Suspension of gold convertibility was a small part of the total policy package, although one of special interest to aficionados of Bretton Woods.

Much is made of the benefits of the international role of the dollar for the United States, captured in the enticing term "exorbitant privilege," a claim that is usually made on the basis of no analysis. Fred Bergsten years ago raised questions about this presumption, but they have been largely ignored. McKinsey Global Institute boldly and usefully attempted to quantify the gains a few years ago, and came up with about 0.3% of US GDP. Their estimate is made of three components, two positive and one negative. The positive ones involve seigniorage on holdings of US currency outside the United States and a lowering of interest rates on US bills and bonds due to widespread holdings of them outside the United States. The negative one involves the loss of net exports due to a more appreciated US dollar. Estimates of the second two factors are inevitably problematic, and I believe MGI over-estimated the impact on interest rates; if so, the net gain would be even smaller, and perhaps negative. Three-tenths of US GDP is a large absolute number; but I suspect it is much smaller than those who use the term "exorbitant privilege" implicity have in mind. It is more fun, if less exacting, to use qualitative quantifiers in political discourse.

Much is made these days about the allegedly nefarious influence of US monetary policy on the rest of the world – whether in its easing mode, or in its prospective tightening mode. Such complaints are made usually on an implicit "ceteris paribus" assumption: country x would be better off if US monetary policy were not so easy. But this is not legitimate: serious analysis requires *mutatis mutandis*. If US monetary policy had been less easy over the period 2009–2013, the US economy would have been more depressed, or at least so the Federal Reserve thought (and I agree with that view). Would country x have been better off with a deeper US recession? Highly unlikely for most values of x. Similarly, "tapering," that is, a gradual tightening of US monetary policy, will occur in the context of an improving US economy, not by itself. Disturbances abroad created by higher interest rates in the United States have to be evaluated against the backdrop of a stronger US economy.

Could the US dollar be replaced in its international uses, at least its official international uses, by a non-national unit, such as the SDR, as suggested in 2009 by Governor Zhou Xiaochuan of the Peoples Bank of China? My answer is affirmative, at least for official functions – and with that maybe private functions would follow after some period of time. But it would require a *major* negotiating effort by governments, which would face some thorny issues, such as how to deal with the outstanding US dollars, euros, and other currencies currently held in international reserves. No agreement could be reached on a substitution account over three decades ago, and the amounts involved are very much larger today.

More fundamentally, such a negotiation would have to address the adjustment process, particularly the obligations that countries in balance-of-payments surplus should accept – an issue that has appeared recently within the euro area, and globally with China. In a grand cost-benefit analysis, would the incremental benefits of replacing the US dollar with the SDR be worth the cost, given that negotiating time and skill is a scarce resource in all countries? How substantial would the economic gains be, as opposed to basically aesthetic considerations of apparent symmetry?

We need concrete proposals, not abstract calls for a "new Bretton Woods." (As was pointed out, Bretton Woods took place only after two years of detailed discussion and preparation.) In this spirit, I made a proposal in time for the G20 summit in 2011, which according to its chairman President Sarkozy of France was to be devoted in part to improving the international monetary system. It was not a great proposal, but it was the best I could think of at the time, and it was put forward to provoke debate and to stimulate other, better, proposals (it can be found in the May 2011 issue of *Central Banking*). It fell like a rock. Maybe the timing was wrong: international monetary reform was crowded off the G20 agenda by the euro crisis, which was reaching its peak during that year. Or maybe, what no one wants to admit openly, the issue is not important enough to warrant discussion of concrete proposals. It is a topic people enjoy grumbling about but do not want to take the effort to do something about.

I will close with one further reflection, apparently tangential but in fact closely related. What should be the role of reserve-holding central banks in a multipolar international monetary system? One role they should not play is profit centers, like a business. Normally, central banks will in fact be profitable, since their principal liabilities do not pay interest, and their principal assets do earn interest. But they exist to perform public functions – to govern the domestic supply of money and perhaps also to manage the country's exchange rate – not to make profits. Their two businesses require liabilities and at least some assets to be in different currencies. Conventional accounting standards, which would routinely convert foreign currency holdings into domestic currency, should not be applied, and should not be taken seriously. Changes in the exchange rate should be determined on their economic merits, not on the basis of whether they give rise to capital gains or losses under conventional accounting. And central banks should not alter the composition of their foreign exchange reserves in order to profit from anticipated changes in exchange rates between foreign currencies. As members of the Bank for International Settlements and the International Monetary Fund, they should be regarded as insiders, not eligible to trade in foreign exchange except in carrying out their proper central bank functions. If they violate these rules, they should be ostracized from the official community.