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Bretton Woods Reconsidered: The Dollar Standard and the Role of China[1]

Ronald I. McKinnon[2]

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Although significant, the importance the 1945 Bretton Woods Agreement for the postwar international monetary order has been over-rated. Its major Articles were not effective until many years after World War II. It was not a grand treaty that reconciled the interests of many diverse counties over a few weeks. Rather, BW was essentially an arrangement between just two countries—Britain and the United States—negotiating for more than two years before the founding conference in 1944.

After World War I, monetary chaos prevailed with the British trying and failing to re-establish the international gold standard, which ultimately imploded into the Great Depression. What then was the international exchange rate cum monetary regime that undergirded the remarkably rapid post World War II economic recovery and growth in the noncommunist industrial countries— what the French, somewhat inaccurately, still call "Les Trente Glorieuses". The underlying reality was that commercial banks and private traders—exporters and importers—began using the U.S. dollar as international money, which was later codified by governments into a system of fixed-dollar exchange rates with other currencies.

In 1945, the United States had the world's largest economy and the only intact financial system without inflation or exchange controls restricting the free use of its currency by foreigners. Exporters the world over (outside of the restricted but declining British sterling area) began invoicing and demanding payments in dollars. Importers then began to hold dollar balances directly, but not exclusively, in American banks. Importers also came to rely on their banks to provide dollars on demand for their domestic currencies. So commercial banks everywhere became money changers using the dollar as the intermediary currency, subject to its country's more or less rigid exchange controls. And amazingly, outside of today's eurozone, the dollar is still the dominant vehicle currency for interbank foreign exchange transactions. Following the lead of private markets, central banks in 1945 began to build up their official exchange reserves in dollars, in part as a backstop for their commercial banks' fluctuating dollar needs. In addition, as conveniently recognized international liquidity, interest-bearing U.S. Treasury bonds (as distinct from gold) were favored as a precautionary reserve. But what then caused

[1] This paper is written more as a memoir with only the occasional academic reference. Detailed references and supporting data in figures and tables are contained in the author's recent book *The Unloved Dollar Standard: From Bretton Woods to the Rise of China* (Oxford University Press 2013, Chinese translation, China Financial Publishing House 2013.)

[2] Professor Emeritus, Stanford University, http:www.stanford.edu/~mckinnon

this dollar-based regime to evolve into one of officially fixed exchange rates? (After all, as late as 1949, there were chaotic and massive depreciations of some European currencies.)

The Marshall Plan and Fixed Exchange Rates

Basically, it was the 1947 Marshall Plan that set the stage for the remarkable recovery of the Western European economies from World War II. The plan did not just allocate American funds bilaterally to individual countries. Instead, aid was given multilaterally with the strong conditionality that Western European governments start dismantling the currency restrictions and quota protections that were hampering intra-European trade. The capstone was the formation of the European Payments Union (EPU) in September 1950 among 15 Western European countries. Each member country declared an exact dollar exchange rate parity—without even the 1% margins on either side of the central rate permitted by the IMF's Article IV. Then Western European central banks (rather than private commercial banks) began to clear intra European payments multilaterally. If any one European country had a net payments deficit, ie., the sum of its payments for imports exceeded what it was earning on exports, its central bank used a dollar line of credit from the EPU to fill the gap—but with effective sanctions requiring repayment. In addition to stimulating Western Europe's strong trade-led recovery from the war, the Marshall Plan cum EPU started what became wider European trade and monetary integration. This fixed-rate dollar standard was substantially broadened when Japan joined in 1949. Like many continental European countries, Japan had suffered severe physical and financial damage during the war. It had open and repressed inflation, interest rate and balance of payments restrictions, multiple exchange rates, and virtually no postwar recovery. Then a Detroit banker, Joseph Dodge, visited Tokyo empowered with an American line of dollar credit to provide advice for stabilizing the economy under strict conditionality. In 1949, the multiple exchange rate regime was unified into a single exchange parity: 360 yen/dollar. For more 20 years, the Japanese government subordinated its monetary and fiscal policies to maintaining this fixed dollar exchange rate--thus ridding Japan of inflation and anchoring its price level (WPI). With a stable price level and stable exchange rate, the Japanese economy then took off into its "miracle" phase of 9 to 10 percent growth in real output into the early 1970s.

After the United States' emergence from World War II as the world's unique economic and financial hegemon, it did not complain about how other countries set their dollar exchange rates: a policy then called "benign neglect". Not having an exchange rate obligation of its own, the U.S. could focus its monetary and fiscal policy on the state of purely domestic inflation or unemployment. And the American price level was stable in the 1950s into the mid-1960s—thus incidentally stabilizing prices in the rest of the noncommunist industrial world.

Having foreign central banks intervene only in dollars to secure their exchange rates, with the Fed staying out, has the great advantage of preventing official interventions at cross purposes: a great strength of the international dollar standard. But such a system only works smoothly if the government of the center country (without a direct exchange rate policy of its own) remains passive, i.e., does not object to the way other countries set their dollar exchange rates.

The Nixon Shock

However, the worldwide anchoring effect of a stable dollar began to unravel with the Nixon shock of August 1971. By threatening to impose tariffs on imports of manufactures, the U.S. government forced Japan and the Western European governments to appreciate their currencies against the dollar. As early as 1970, in anticipation of the dollar's being devalued, "hot" money flowed out of the United States to peripheral countries with at least semi-convertible currencies: Japan, Canada, and Western Europe. To prevent their currencies from appreciating even more than Nixon wanted, their central banks intervened massively to buy dollars with domestic base money. Their collective loss of monetary control then created the great worldwide inflation of the 1970s into the early 1980s [McKinnon 2013, ch 4]. Although the dollar remained the facilitator of multilateral exchange in private markets, its anchor for price and exchange rate stability worldwide was lost.

What so upset President Nixon? In the late 1960s, the U.S. began to lose control over its own price level. Without proper tax financing, U.S. government spending for the Vietnam war escalated along with welfare expenditures for President Lyndon Johnson's so-called great society programs—all accommodated by overly easy money by the U.S. Federal Reserve Bank. The surge in demand caused U.S. prices to begin rising modestly: the CPI increased from about 1.6 percent annually in 1965 to 5.5 percent in 1969.

Under Article IV of the BW Agreement, other industrial countries kept their nominal dollar exchange rates fixed. Thus, with even moderate internal inflation, U.S. industry became less competitive—particularly from foreign manufactured imports. American industrial trade unions, with hubris from the previous 25 years of uninterrupted growth, insisted on fully indexing nominal wages to internal price inflation while bargaining for additional real wage increments. By 1969, the previously large U.S. trade surplus had virtually disappeared.

By 1970, to restore America's international competitiveness, particularly in manufacturing, the Nixon government faced a difficult choice: either (1) raise taxes and tighten monetary policy to disinflate the American economy, or (2) force other industrial countries to appreciate their currencies ostensibly to make American industry more competitive. Although more painful politically, if (1) had been successfully implemented, the dollar's role as a stable nominal anchor for the rest of the world could still be with us! Instead, the Nixon government chose dollar devaluation under (2), and the world experienced the great inflation of the 1970s and much financial volatility subsequently—which harmed the American economy as well foreign ones.

The Exchange-Rate Trade-Balance Fallacy and the Weak Dollar

In defense of politicians, however, many economists advocated (and still advocate) floating exchange rates. Worse, the standard textbook model linking a country's exchange rate to its net trade balance—sometimes called the elasticities approach—suggests that a country with an unwanted trade deficit should depreciate its currency, and countries with unwarranted trade surpluses should (be forced to) appreciate [Meade 1951]. Although having some validity for insular economies when international trade had been severely truncated, and strict foreign exchange controls prevented the free movement of capital, as in the 1930s into the 1950s, this insular economy model fails to correctly portray the impact of exchange rate changes in today's highly open economies with massive flows of international trade and investment. When an economy is highly open, a government cannot manipulate its exchange to have any predictable effect on its net trade balance [McKinnon 2013, chs 7 & 8]. But predictable movements in future exchange rates can generate destabilizing hot money flows [McKinnon ch 5].

However, faced with a seemingly unending string of American trade deficits from the end of the 1970s through to 2014, American policy makers have remained in thrall to the exchange-rate trade-balance fallacy. They have continually tried to devalue the dollar—either by threatening to impose import restrictions on trade-surplus countries unless they appreciate, or by following ultra low interest rate policies that ignite hot money inflows into convertible-currency countries with naturally higher interest rates on the dollar standard's periphery—largely Western Europe and Japan in the 1970s, but more emerging markets in the new millennium.

President's Nixon's demand in August 1971 that all the then industrial countries appreciate their currencies against the dollar, which they all did—averaging 17 percent by the following December— was a harbinger of things to come. In the mid-1970s, Japan bashing on the yen/dollar rate started and lasted for more than 20 years. The Japanese succumbed to American protectionist threats: the yen appreciated all the way from 360 to the dollar in 1971 to touch 80 in April 1995. Japanese domestic investment slumped, knocking Japan off its high growth path. The flood of hot money into Japan contributed to land and stock-market bubbles, which burst in 1990. In 1985, the Japanese price level (WPI) began falling from the overvalued yen and then bursting asset bubbles—with even nominal wages falling into the new millennium. Short-term interest rates approached zero in the late 1990s.The only thing that did not fall was Japan's trade surplus (Qiao 2007)! So Japan's lost decades of economic growth could well be attributed to what McKinnon and Ohno (1997) called "The syndrome of the ever-higher yen".

The more recent China story has important parallels with Japan's historical experiences under the dollar standard. On the positive side, China unified its currency (eliminated multiple exchange rates) and successfully disinflated its domestic economy by credible pegging the renminbi at 8.28 yuan/dollar in 1994—much like Japan's earlier experience in 1949—while moving to current-account convertibility by 1996. China kept its nominal dollar exchange rate stable for the next decade of extremely high growth in trade and real GDP.

However by 2000, China's bilateral trade surplus with the U.S. surpassed that of Japan's and continued to rise rather sharply. Under the mantra of the exchange-rate cum trade-balance fallacy, many U.S. politicians and economists then shifted from bashing Japan to bashing China on the RMB exchange rate. But Chinese politicians resisted much more strongly and avoided a Japan-like debacle—although the resistance was not complete. In July of 2005, the People's Bank of China began to loosen its dollar peg and embarked on a series of mini- appreciations with occasional stops so as to average about 3 percent per year. It appreciated from 8.28 yuan/dollar in 1994 to about 6.2 yuan/dollar in mid 2014—nothing like the earlier more massive appreciations of the yen.

Although not much affecting China's trade and GDP, China's mini appreciations worsen hot money inflows. With U.S. short-term interest rates near zero, and high-growth China with naturally higher interbank rates averaging about 4 percent, and with expected RMB appreciation about 3 percent, this amounts to a huge 7 percent gap in effective interest rates. Carry traders in various guises then try to move hot money from dollars into RMB. So China is forced to retain exchange controls—inevitably somewhat porous—on inflows of financial capital. Even so, the People's Bank of China must continually buy dollars to stabilize the yuan/dollar rate—thereby risking an inflationary loss of monetary control unless this creation of excess base money is somehow sterilized.

Other emerging markets (EM) have similar monetary control problems arising from U.S. near- zero interest rates creating an ebb and flow of hot money into their economies. But they are less able than China to contain the resulting exchange rate volatility—for their own economies as well in creating cycles in primary commodity prices in the world at large [McKinnon 2014].

Losing the World's Nominal Anchor and America's Saving Deficiency

Since 1945, the dollar standard has played a dual role in the world economy—for private international commerce, and for domestic macroeconomic control by governments—and these two roles are natural complements in such a key currency regime.

(1) The dollar facilitates international trade by providing a common invoice currency for primary commodities and for the exports of developing countries, and it is the vehicle currency used by banks to greatly reduce the private costs of making foreign exchange payments multilaterally both spot and forward.

(2) Insofar as foreign governments have pegged their exchange rates to the dollar, it acts as a nominal anchor for their price levels—sometimes in the context of major domestic disinflationary financial reforms.

In the Trente Glorieuses with very high growth in the postwar industrial economies, U.S. government policy ensured that both (1) and (2) more or less held. The U.S. Federal Reserve acted correctly as the world's de facto central banker.

But from the 1970s down to the present day, an unfortunate confluence of economic circumstances began to undermine (2)—the dollar's anchoring role in the world economy. U.S. saving rates, both private and government, began to fall somewhat endogenously. Private saving edged downward but public saving, in the form of federal fiscal deficits, fell quite sharply on occasion. In the 1980s, President Reagan presided over a large military buildup that was not tax financed—and which led to the famous "twin" deficits of fiscal and trade. Although there were the usual dire warnings that such fiscal deficits would harm the economy, U.S. interest rates actually fell in the course of the Reagan "boom" in the late 1980s.

While generally unrecognized by politicians and most economists, it was (and is) the U.S. central position within the world dollar standard that allows the United States to borrow very cheaply by selling U.S. Treasury bonds and other financial assets to foreigners—mainly central banks in West Germany and Japan in the 1980s. Having learned a false lesson that deficits did (and do) not matter, this has emboldened American politicians—Keynesians to be more Keynesian in targeting unemployment with massive fiscal deficits during the 2008 downturn and disappointingly slow recovery—and supply siders (sometimes called the Club for Growth) to become ever more reckless in their demands to cut taxes, or refuse tax reforms to raise more revenue, or to provide tax revenues for needed public goods—such as highways.

In the new millennium, Emerging Markets have been the big buyers of U.S. Treasuries and other dollar assets—with China alone having official foreign exchange reserves of more than 4 trillion U.S. dollars, which is about half the EM total. But so what? What harm comes from America's soft international borrowing constraint that reduces domestic saving and creates a more or less permanent fiscal and trade deficits?

First, the trade deficit itself. America's main international creditors—mainly West Germany and Japan in the 1980s, but now more China and other industrialized Asian emerging markets—are major exporters of manufactures. Thus the real counterpart of their purchases of U.S. financial assets is to run trade surpluses in manufactures with the U.S. Indeed, in recent decades, virtually the whole of the U.S. current account deficit (equal to America's saving deficiency) is equal to the U.S. trade deficit in manufactures (McKinnon 2013, Ch 6).

If Democrats or Republicans wanted to ameliorate industrial decline, they should take steps to increase America's saving rate by reducing or eliminating the fiscal deficit. Instead they labor under the false doctrine: the exchange-rate trade-balance fallacy. They accuse foreigners of unfairly manipulating their exchange rates to keep them undervalued, and one result is the excessive use of antidumping duties against many different kinds of manufactured imports. But the major cost of this false doctrine is to distract political attention away from the fiscal deficit. And in his most recent budget, President Obama projects large federal fiscal deficits as far as the eye can see, through 2015 and beyond.

Second, this exchange-rate trade-balance fallacy undermines the dollar standard's natural stabilizing role in world economy: providing a nominal anchor for other countries, most of whom for good reasons would prefer to operate with stable dollar exchange rates. Without an exchange rate policy of its own, the U.S. government continually tries to weaken the value of the dollar against other major currencies—either directly as with Japan bashing followed by China bashing, or indirectly by setting interest rates too low (now near zero) that induces volatile hot money outflows which force at least some EMs to appreciate and other more mature industrial countries to keep their interest rates similarly too low to avoid appreciating.

Reforming the Unloved Dollar Standard: The Role of China

Despite this rather sorry tale of the loss of worldwide macro stability because of the erosion of the dollar's anchoring role under (2) above, its remarkably resilient facilitating role for money changing under (1) above remains in place. As of 2014, the dollar still remains the most commonly used currency for invoicing exports, vehicle currency for interbank foreign exchange transacting, and reserve currency for governments.

Even so, nobody loves it. Foreigners are distressed by macroeconomic shocks emanating from the United States, and the "exorbitant privilege" of America having an indefinitely long line of cheap dollar credit from the rest of the world. Americans, laboring under the exchange-rate trade-balance fallacy and their large trade deficit, complain that foreign governments manipulate their dollar exchange rates unfairly to secure a mercantile advantage—while the rules of the dollar standard game leave the U.S. with no direct exchange rate policy of its own.

So we have the great paradox. Although nobody professes to love the dollar standard, the revealed preference of both governments and private participants in the foreign exchange markets since 1945 has been to continue to use it. As the principal monetary mechanism ensuring that international trade remains robustly multilateral rather than narrowly bilateral, it is a remarkable survivor that is too valuable to lose and too difficult to replace.

There are great economies of scale of having just *one* international money. But, many, many suggestions have been made for replacing the dollar with something else—a commodity reserve currency in the 1950s, the IMF's Special Drawing Rights in the early 1970s, an internationalized yen in the Japanese bubble phase of the 1980s, the euro in its good phase in the early 2000s, and now an internationalized renminbi from China's trade ascendancy. I won't rehearse the pros and cons of each one here, nor propose a new one.

Realistically, the remarkable resilience of the dollar standard leads me to conclude that "international" monetary reform really should be directed to improving the monetary and exchange rate policies of the United States—possibly with China becoming a more equal partner, and the IMF continuing to provide important legal cover.

The most important aspects of any such reform are conceptual:

(i) To rid Americans of their weak-dollar syndrome by exposing the exchange-rate trade-balance fallacy in textbooks and in the financial press, and

(ii) To get U.S. politicians to see the link between ongoing fiscal deficits leading to trade deficits and the "excess" imports of manufactures that so upset many of their constituents.

Although eliminating U.S. fiscal deficits might be all well and good on domestic grounds, in a growing world economy aren't U.S. current account (trade) deficits are needed to provide sufficient international (dollar) liquidity for foreign central bank exchange reserves on the one hand, and foreign commercial bank working balances on the other? While seemingly plausible, this common objection to the U.S. returning to fiscal and trade balance is misguided.

During the Trente Glorieuses, the U.S. ran with substantial current-account surpluses—the counterpart of Marshall and other foreign aid, large U.S. foreign direct investments, and substantial purchases of longer-term foreign private bonds—usually denominated in dollars. In the immediate postwar, this large American gross capital outflow meant that foreign central banks could rather rapidly restore their official exchange reserves by building up stocks of U.S. Treasuries and dollar depository claims on American banks. Thus the outflow from the United States of longer-term relatively illiquid investment abroad was greater than its current-account surplus. This difference was then financed by a return capital inflow (albeit smaller) in the form of foreigners building up liquid dollar claims on the United States—thus gaining international liquidity.

In effect, if American politicians could be persuaded to eliminate the current U.S. fiscal deficit or even move it into surplus, a reshuffling of the capital account of the U.S. balance of payments would ensure the sufficient provision of international liquidity. As the current account deficit was phased out, U.S. longer term capital outflows such as foreign direct investment would increase, possibly quite sharply, while foreigners could continue to build up their liquid dollar claims unimpeded. As the U.S. moved away from being a net borrower in world financial markets, more international capital could flow into poorer countries—albeit only those which were credit-worthy. And U.S. protectionists would have a tougher time making arguments for tariff or quota restrictions on the reduced flow of imports.

But this hypothetical reshuffling of U.S. international payments is best done in the context of mutual adjustment with America's largest creditor, China. Just as the 1944 Bretton Woods Agreement was negotiated between just two countries, the key to successful rehabilitation of today's dollar standard is a modus vivendi between China and the United States.

China's enormous trade-led growth since 1980, secured by its membership in the WTO in 2001, and macroeconomic stability since 1994 when its dollar exchange rate was fixed, has greatly benefited from unrestricted multilateral exchange under the dollar standard. The vast expansion of China's dollar-based trade has made it, albeit inadvertently, a pillar of the dollar standard. China would have a lot to lose if the dollar standard were to collapse or become seriously damaged. So what is a short laundry list of issues over which the two countries might negotiate?

(1) The end of American China bashing to appreciate the RMB, which has been a consequence of the influence on Americans of the exchange-rate trade-balance fallacy.

(2) The U.S. agrees to phase out its fiscal deficits in return for China phasing in higher domestic consumption. Each country can decide on its own mix of tax and expenditure measures for achieving these ends. If both governments move simultaneously, disturbances in the foreign exchanges are minimized so that it is easier to maintain stability in the yuan/dollar exchange rate [McKinnon 2013, ch.9]

(3) The Fed agrees to begin raising U.S. interest rates to more normal levels to relieve the pressure of hot money inflows into China and other emerging markets. China then agrees to start phasing out its capital controls as a step toward "internationalizing" the renminbi and opening up its capital markets (McKinnon 2014b).

(4) Mutual goodwill coming out of these negotiations then could spread to other areas such as flawed U.S. antidumping laws and Chinese regulatory pursuit of highly competitive foreign firms for "anti-trust" and other questionable violations of Chinese laws.

Although cloaked in the garb of an international agreement, these measures could well increase domestic economic efficiency in each country. A relevant historical example is China joining the WTO in 2001. At the time, one motivation of Premier Zhu Rongji was that the by-laws of the WTO would help prevent protectionism from hampering China's own interprovincial trade.

A Concluding Note on the International Monetary Fund

It may seem surprising that my "reconsideration of Bretton Woods" hasn't included any call for revising the present Articles of the International Monetary Fund established in 1944, with surprisingly few amendments since then. However, once one realizes that the world's basic money machine has all along been an international dollar standard—albeit one which continually metamorphoses—it is not so surprising.

Although not particularly useful in the immediate aftermath of World War II, the IMF has evolved into an important and constructive legal adjunct to the dollar standard. In particular, it has successfully pressured virtually all member countries to adopt Article VIII, the commitment to current-account currency convertibility for exports and imports of goods and services.

Although not required by any Article, the IMF has in the past been too hasty in pressuring some emerging markets with currency mismatches to get rid of capital controls—resulting in over- borrowing in international financial markets. But that era seems to be over. Of course, if the United States itself imposed comprehensive capital controls, the international dollar standard would collapse! But for emerging markets on the dollar standard's periphery, there is a strong case for using capital controls to contain "hot" money flows [McKinnon 2013, Chs. 5&13].

The second constructive role of the IMF is that of a crisis manager in the foreign exchanges—making (mainly dollar) loans with strict conditionality, usually to less developed countries that are not big enough to overwhelm the financial resources of the Fund. With its large body of financial experts, the IMF becomes (is) the natural lender of "first resort" in ameliorating foreign exchange crises around the world.

However, really big crises—such as those associated with the world economic downturn of 2008 or the euro crisis of 2011—are usually marked by a flight of private capital into dollars as the international financial "safe haven". Even when the world crisis was touched off by the subprime mortgage crisis in the United States itself, international banks everywhere tried to replenish their depleted stocks of the world's vehicle currency. Then the U.S. Federal Reserve Bank becomes the natural lender of "last resort". And in both crises, the Fed lent heavily to selected foreign central banks by swapping dollars for their domestic currencies—collateralized lending.

Much of the spirit of the 1944 Bretton Woods agreement was to try to curb beggar-thy-neighbor exchange-rate changes and hot money flows that so disrupted the world economy in the 1930s. A return to exchange stability anchored by a credibly stable yuan/dollar rate, to which other countries—particularly in Asia—attach themselves voluntarily, would reflect that spirit.

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