



An Alternative Perspective on Global Imbalances and International Reserve Currencies

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Why Do We Expect External Equilibrium?



- **Recent Historical Experience is Imbalances**
- **Mix of Institutions and Equilibrium Theory**
 - Institution: Gold Standard
 - It really wasn't: Cf: Arthur Bloomfield
 - Theory: Price Specie Flow
 - It really didn't work by prices only: Cf: David Hume
 - Output also adjusts: Keynes asymmetric adjustment
 - Automatic adjustment via internal price changes and external competitiveness
 - Goods arbitrage would lead to Global Law of One Price
 - Purchasing Power of Gold Uniform in all Countries
- **Mean Reversion to Equilibrium on Goods Trade**
- **Constant Purchasing Power Of all Domestic currencies**

Why Should Imbalances to be Contained?



- **New Institution to Replace Gold Standard**
 - Bretton Woods System
 - Peg to \$ or Gold
 - Government (or IBRD) to control capital flows
- **New Theory**
 - Absorption/Expenditure Switching
- **Deficit balances Limited**
 - By Foreign Exchange Reserves
 - By IMF gold tranche
 - Conditions to return to balance and repay IMF
- **No limit on Surplus balances (scarce currency clause never implemented)**
- **Balances contained within Reserves and Surplus Countries policies**

The Bretton Woods Paradox



- **Triffin: One country has no limit**
 - Reserve Currency provides Global Liquidity
 - Must Run Deficits to Provide Global Liquidity
 - To Allow Other Central Banks Intervention currency
 - To Serve as Global Store of Value
- **Balance of nth country is determined by policies of n-1 countries in global system**
- **The Paradox: When Foreign \$ Claims Exceed Fort Knox**
 - Dollar undergoes “real” depreciation
 - Supported by catch-22 faced by Foreign Central Banks
 - Confidence of Foreign Central Bankers Determines \$ parity
- **Keynes point: Asymmetric Adjustment Preserved**
 - Except for Reserve Currency!
- **The value of the reserve currency and all others is no longer uniform – no mean reversion to parity value**

No-Limit on Balances Post-Smithsonian



- **The Triffin Paradox could not be Resolved**
- **New Institution: Flexible Exchange Rates**
 - Stabilising Speculation
- **New Theory: Efficiency Global Allocation of Capital**
 - Return of Global Capital Flows
- **Limits on Deficit balances is now foreign capital inflow**
 - Without Limit: as long as foreign investors have confidence
 - They replace central banker's confidence under BW
- **But, the new adjustment process supports imbalance**
 - Raising interest rates creates differential and inflows
 - Rising external reserves create confidence
 - Appreciating currency creates confidence (and higher returns)
 - Makes domestic producers less competitive and increases deficit
- **Limit on Imbalance is Capital Reversal and Financial Crisis**
- **IMF only intervenes after crisis to bail out the foreign investors**

New Theory? Cumulative Causation?



- **Soros: Reflexivity**
 - Reagan deficits; Strong \$ Reflexivity
- **Also called Cumulative Causation: Advanced by:**
- **Pioneers of Development:**
 - Myrdal, Prebisch, Nurkse
- **Macro-Finance economists:**
 - Kaldor, Keynes, Minsky
- **Evolutionary Economists:**
 - Marx, Veblen
- **No forces to return to equilibrium**
- **Cumulative forces accentuates differences/imbbalances**
- **Imbalances may be a natural result of the global system**
- **No stable international value of currencies**

Role of Late Industrialising Developing Countries



- **Developing Countries**
 - Late Catch up – Export led Industrialisation
- **Developing Countries Demand Liquidity**
 - To serve as insurance for financial crisis
 - To avoid IMF conditionality
- **Both Require External Surplus**
- **Both Support Imbalances**
 - History: Reconstructing Europe, Japan, Currently China
- **An adjustment mechanism that eliminated imbalances would preclude these development strategies**
- **Makes “Coordination” impossible: precludes development**
- **New Paradox: Capital flows allow divergent policies**
- **Controls will thus be necessary for co-ordination**

Alternative to New Paradox



- **Alternatives:**

- Back to BW: Management of Capital Flows
- Export-led Surplus Developing countries must eventually graduate to become Deficit domestic demand-led developed countries
- Global Imbalances would be lower if Japan and Germany stopped acting like late industrialisers

- **Conclusions**

- The key to Imbalances is in the global adjustment mechanism
- Imbalances will not be eliminated by substituting the reserve currency with the SDR or a global currency
- There is no possibility to stabilise the international value of any currency, much less the reserve currency
- The problem of imbalances is not in the use of a national currency as the reserve currency
- Or in the export strategies of developing countries

- **Domestic demand is currently the scarce good**

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