

# **An Alternative Perspective on Global Imbalances and International Reserve Currencies<sup>1</sup>**

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## **Global Imbalances: They Just Won't Go Away**

The recent rapid increase of external surpluses in China, accompanied by rising US deficits has brought a revival of the discussion of global imbalances and threats of a global currency war reminiscent of the beggar my neighbor policies of the 1930s. There has also been a renewal of calls for the introduction of a new international reserve currency to replace the US dollar. Internal trade imbalances between northern and southern Europe have also been identified, as one of the factors undermining the sustainability of a single currency in the Euro area.<sup>2</sup>

These discussions ignore two basic facts noted by Keynes and Triffin in their criticism of the functioning of the international monetary system. Their criticism suggests that the basic problem is not the particular national liability that serves as the international currency, but rather the basic problem is to be found in the failure of an efficient adjustment mechanism for international imbalances. Unfortunately, the discussion of this mechanism is still undertaken as if the world were on a gold standard with limited international capital movements, rather than a mixed fixed-managed floating system in which international capital flows dominate trade flows.

## **Global Imbalances Under the Theoretical Gold Standard**

The 20th century gold exchange standard was based on a system of free international exchange of goods, services and capital. In such conditions, it was presumed that international competition would support the law of one price for all goods traded in international markets. When this was not the case and there were price discrepancies, international arbitrage would take place to eliminate them. Thus, if the gold price of goods in one country was below that prevailing in other countries, there would be an incentive to exchange gold for goods and export them to foreign markets where the gold price was higher. The result was the law of one gold price for similar goods irrespective of where they were produced. Alternatively, the goods value of gold would be equal in all countries so there would be no reason for gold movements.

However, when this arbitrage process was taking place surplus countries would be accumulating gold which would bring about a rise in domestic prices, raising the cost of exports and reducing the cost of imports, and vice versa in deficit countries, leading to automatic elimination of international imbalances. Another consequence of this international arbitrage equilibrium was that the purchasing power of private savings held in national currencies with a

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<sup>1</sup> Remarks Prepared for the Banco Central de la Republica Argentina *Jornadas Monetarias y Bancarias*, 2010, 2-3 septiembre de 2010

<sup>2</sup> Some of these issues have been dealt with in Levy Working Paper #528, and Levy Policy Note "Some Simple Observations on the Reform of the International Monetary System," 2009/8, June 2009

given gold parity would be stable over time in terms of both domestic and international purchasing power. It is important to note that both of these stability properties of the gold standard depended on the successful operation of the international arbitrage process, or as we would now call it, the international balance of payments adjustment mechanism.

### **Price or Quantity Adjustment: Keynes's Critique of the Barbarous Relic**

Keynes criticized this depiction of the operation of the gold standard because in practice it was the level domestic activity, rather than the arbitrage mechanism of price adjustment, that provided the adjustment mechanism. In addition he noted two asymmetries in the adjustment process based on economic activity. The first was that the domestic adjustment would fall primarily on the employment of labour since the price of labour would be more sticky than financial prices: "It is, therefore, a serious question whether it is right to adopt an international standard, which will allow an extreme mobility and sensitiveness of foreign lending, while the remaining elements of the economic complex remain exceedingly rigid. If it were as easy to put wages up and down as it is to put bank rate up and down, well and good. But this is not the actual situation."<sup>3</sup>

He also noted the now better known asymmetry between surplus and deficit countries. Countries that experienced a gold outflow due to an external deficit would have to cut their imports by reducing activity since they would run out of gold before the relative price adjustment process could take place, while surplus countries could simply allow their surpluses to accumulate without changing their policies. Keynes thus concluded that the adjustment process would produce a tendency toward reducing the global level of activity, primarily through lower output and employment. This implied that the stability of the international purchasing power of financial claims was preserved at the expense of the value of labour.

Keynes recommended the creation of a Clearing Union to introduce symmetry into the adjustment process. Payments imbalances would be settled by means of unit of account that could not be traded by private individuals in private markets. But, it was not the "imaginary money" of economic history, to use Einaudi's term, that he proposed to replace gold that was of importance in this proposal. It was the assumption that governments would agree to implement coordinated symmetric adjustment policies, either by rule or consultation, involving simultaneously actions to restore equilibrium to be taken by both deficit and surplus countries. The objective was a system in which the costs of adjustment would be borne equally by all countries, and by capital and labour because it would be possible to maintain full employment global demand.

### **Global Imbalances Under Bretton Woods**

As it well known, the Bretton Woods System did not implement this proposal to replace gold with a notional unit of settlement within the Clearing Union. Nonetheless it did seek to manage the adjustment process, rather than leaving it in the hands of international arbitrage. The imposition of par values for the US dollar or gold for current account convertibility meant that deficits were constrained by the size of a country's foreign exchange reserves, usually thought to be prudent at 3 or 4 months value of imports. Usually well before running down its reserve balances a deficit country would apply to the IMF for supplemental reserves that would only be

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<sup>3</sup> See *Treatise on Money*, Vol.II, p.336.

supplied on acceptance of domestic policy conditions that were designed to eliminate the external imbalance and generate the foreign exchange earnings required to repay the IMF loan. These policy conditions were based on a theory of balance of payments adjustment including absorption and expenditure switching. That is, constraining domestic expenditures and introducing exchange rate adjustment when income adjustment was insufficient. When strictly applied these measures implied that the size of a country's deficit balances could not depart far from the sum of its accumulated foreign exchange reserves plus its IMF gold tranche plus any additional program lending. Thus, the imposed policy conditionality replaced the operation of the movements of gold on the domestic money supply and price level that had operated under the gold standard. But in general the results were similar, with accumulated balances kept in a small range of variation around payments balance as determined by domestic reserves and IMF drawings.

However, this system preserved the asymmetric adjustment under the gold standard that Keynes had pointed out prevented global full employment because it placed no active constraint on the policies of surplus countries. Indeed, it was the limit on individual country deficits that placed a constraint on global surpluses and thus on the overall size of imbalances. However, this adjustment process meant that deficit countries were forced into a larger than necessary contraction in domestic incomes order to return to balance and repay lending than if the surplus countries had also been subject to simultaneous conditionality to reduce their imbalances. On average this approach produced a system in which all countries over time should be in external balance, however at the costs of lower average output and employment over time.<sup>4</sup>

#### **Triffin's exemption to the size of Imbalances under Bretton Woods**

There was, however, one important exception to the Bretton Woods limit on any country's deficit balance, the systemic implications of which were first pointed out by Robert Triffin<sup>5</sup> even before they were clearly visible to economists and Ministers of Finance. The fact that the US had accumulated most of the world's gold after the war meant that all other countries chose to fix a parity relative to the dollar rather than gold, while the US chose to peg to gold. The ability of the n-1 countries in a fixed exchange rate system to maintain parity was predicated on the n<sup>th</sup> country running a payments deficits sufficiently large to accommodate the global liquidity demand for the dollar as the intervention currency. Since there was no sanction on the size of surplus countries reserve balances, there was thus no effective constraint on the size of the US external imbalance.

But, as Triffin pointed out, there was a practical limit, set by the willingness of the central banks of those of the n-1 countries who were in surplus to continue to accumulate dollars once outstanding claims on the US exceeded its ability to meet them in gold at parity. But even this limit was not binding since any attempt to convert dollars into gold would break the gold parity and produce depreciation losses on the central banks' reserve holdings. The Triffin paradox was that it was impossible to have the dollar as the source of global liquidity and have a fixed value of the dollar in terms of gold in a growing global economy that required expanding international liquidity. The result of the unwillingness of the surplus countries to confront this irresolvable

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<sup>4</sup> However, if countries found IMF conditionality objectionable they could escape by opting for policies that kept domestic absorption at a level that produced a surplus, thus reinforcing the tendency of the system to keep global demand below the level required for full employment.

<sup>5</sup> *Gold and the Dollar Crisis*, Yale University Press 1960, which expands on two articles Triffin published in the Banca Nazionale del Lavoro *Quarterly Review*, March and June 1959.

Catch-22 was a series of gentlemen's agreements to pretend that the gold value of the dollar was unchanged by agreeing not to convert dollar balances, but nevertheless doing so in practice.

An important, if little recognized, corollary of the Triffin paradox is that the stability of the purchasing power of the reserve currency is linked to the existence of an adjustment mechanism that eliminates international imbalances, either automatically or through a coordinated policy mechanism; it has little to do with what actually serves as the international currency. This point was recognized in the discussions after the breakdown of the gold standard in proposals such as Gustav Cassell's for national monetary management to follow a stable purchasing power parity standard.<sup>6</sup> Proposals that Keynes also supported in his *Tract on Monetary Reform*.

### **Is It Possible to Resolve the Triffin Paradox?**

It is the nature of paradox that it cannot be resolved under the parameters of the problem. It requires a change in the parameters, and resolving Triffin's paradox meant abandoning the fixed rate system that had provided the constraints on global imbalances. Indeed, once the system moved to floating exchange rates the strong constraints on the deficits of any of the n-1 countries and the weak constraint on the nth country's deficit that had kept global imbalances within reasonable limits were relaxed. Under the "non-system" (it is Triffin's term) that replaced Bretton Woods any limits on imbalances would have to be the result of the impact of the flexible exchange rate on relative prices of traded goods, and more importantly of an inverse relation between the sign of the payments imbalances and the movement of the exchange rate. Indeed, in this new system the concept of external equilibrium lost much of its meaning for it now simply represented the exchange rate produced by the balance between the flows of goods and services, including capital flows.

### **Disequilibrating Adjustment to Imbalances and Capital Flows**

With the end of Bretton Woods came an acceptance, indeed encouragement, of free and unregulated international capital flows (Europe eliminated any residual controls in the run up to the ERM of the EMS at the end of the 1980s). Now deficit balances on current account for any country could reach any level that international investors were willing to finance, independently of the size of surplus balances. Instead of IMF intervention and conditionality, a new market-based adjustment mechanism came into play. Rapid growth and rising interest rates in a country with an increasing external deficit would produce an increasing positive international interest rate differential generating capital inflows similar to what in the 1990s came to be known as the "carry trade". Indeed, the introduction of tight monetary policies to reverse the imbalance would simply increase capital inflows and more than offset the deterioration in the external balance, producing an increase in foreign exchange reserves and an appreciation of the exchange rate. Both of these factors encouraged international investors to increase their inflows, and provided governments with an excuse to delay adjustment. After all, if international investors were willing to send more money then the existing government policies must be passing the market test. The continued appreciation of the exchange rate produced an additional return to the positive interest

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<sup>6</sup> See *The World's Monetary Problems*. London: Constable. A collection of two memoranda presented to the International Financial Conference of the League of Nations in Brussels in 1920 and to the Financial Committee of the League of Nations in September 1921

differential in the form of a domestic currency gain for international investors. Attempts to dampen the impact of inflows through sterilisation simply produced higher domestic interest rates and increased debt servicing costs to the government budget. Instead of the flexible exchange rate supporting payments adjustment by making foreign imports more expensive it did just the opposite. There was a self-reinforcing cumulative tendency towards a continued deterioration in the external accounts, and a seeming unending appreciation of the exchange rate. And the ability to support the increasing imbalance was reinforced by reference to the rapidly rising foreign exchange reserves that reinforced the belief of foreign investors in the stability of the process.

While the size of the US imbalance under Bretton Woods was determined by the confidence of foreign central banks that the US could liquidate the dollar balances at the gold parity, the size of any country's deficit under the post-Bretton Woods system was determined by the confidence of international investors that the country could continue to borrow in order to meet its debt service commitments.

Hyman Minsky<sup>7</sup> would have called this a “ponzi” scheme, which is what it was. George Soros recognized the operation of this cumulative (non)adjustment process as a form of what he called “reflexivity” and used it to good purpose in analyzing the return on US assets despite the deterioration of the US external account and the appreciating value of the dollar under the Reagan administration.<sup>8</sup> In this adjustment process the limit on imbalances is the confidence of global investors that the cumulative process and accumulating imbalances will continue to reinforce each other— and that they will be able to exit before the process goes into reverse.

### **The New Limited Role of the IMF in the market-based adjustment process**

In this adjustment process the IMF is not only powerless to constrain surplus imbalances it is also powerless to limit deficit imbalances. Its role is limited to acting to replace the private inflows when the reversal starts and international investors have decided that they can no longer profit from the rising imbalances. Unfortunately the policy conditions that are part of this funding are the same as under the old Bretton Woods regime, and often lead not to a reversal of the imbalances but to even large domestic income and employment losses. Indeed, in many cases the IMF is called in with the express purpose of bailing out the international investors that were unable to exit before the collapse. The result is a political backlash in which the government accepts policies that impose additional burdens on domestic residents in the form of income and employment losses in addition to wealth losses, while the IMF support is forthcoming only if foreign investors are made whole. The asymmetry is now between domestic labour and foreign capital.

Like any ponzi scheme this type of cumulative process must eventually come to grief in a colossal collapse and generalized default on foreign commitments leaving large domestic costs in the form of lost employment, wealth and income. The maximum size of imbalances in this system is limited by intermittent financial crisis, rather than by IMF conditionality. If countries choose to avoid the consequences of policy conditionality and the failure of the market-based adjustment mechanism to provide a return to equilibrium without financial crisis this will usually involve a policy to establish an external surplus, thus introducing another factor leading to increasing overall global imbalances. This process has been evident in the large build up of foreign exchange

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<sup>7</sup> For a late exposition of Minsky's use of the term see *Stabilizing and Unstable Economy*, Yale University Press, 1986.

<sup>8</sup> See *The Alchemy of Finance*, 1987, Chapter 3.

reserves in developing countries after the Asian-Russian-LTCM market meltdown in 1997-8. These policies could only have been successful when accompanied by the large increase in the US external deficit.

### **International Adjustment to Imbalance and the International Value of the Reserve Currency**

It is important here to recall the corollary of the Triffin paradox: in this type of adjustment mechanism there can be no guarantee of the purchasing power over goods value of the international currency, or of any currency, since the denouement of the adjustment mechanism inherently involves capital losses on foreign and domestic claims.

Changing the international currency does not provide a solution to the problem of the declining value of accumulated surpluses because that problem is caused by the absence of an international adjustment mechanism that is compatible with full utilization of global resources. One attempt to resolve this problem was the proposal of a commodity reserve currency which was widely discussed in the post-war period by economists as diverse as Hayek, Keynes,<sup>9</sup> Frank Graham, Friedman and Kaldor, among others as well as investment professionals such as Benjamin Graham<sup>10</sup>. Despite support from various UN agencies<sup>11</sup>, in particular by Raul Prebisch under UNCTAD, it was never tried.<sup>12</sup>

The question of preserving the value of accumulated surplus should rather be seen from the point of view of the excessive value of those surpluses, or from the inappropriate distribution of that value between labour and capital. With respect to the concerns that have currently been raised by China over the value of their accumulated surplus held in the form of dollar claims, it is important to recognize that they would already have been eliminated if an automatic price adjustment process based on exchange rate flexibility had been in place. And that this would have most probably have taken place through a reduction in domestic incomes and employment. The introduction of the SDR or another alternative will not protect the value of Chinese holdings when the value of the RMB is fixed at a rate that prevents this relative price adjustment. China cannot escape the losses on their dollar foreign exchange reserves due to the Triffin paradox any more than central banks could do so under Bretton Woods.

### **International Imbalances and Export Dependent Development**

This raises two more general questions. The first is that many developing countries have chosen to adopt a development strategy supporting domestic industrialization through net export promotion based on a competitive exchange rate. As noted above, a number of other countries have also adopted such policies in order to avoid IMF conditionality or adjustment to external flows through financial crisis. These policies are in direct contradiction to the operation of any automatic or coordinated adjustment policy for its efficient operation would make such policies

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<sup>9</sup> John Maynard Keynes (1938) "The Policy of Government Storage of Foodstuffs and Raw Materials", *Economic Journal*, September

<sup>10</sup> Benjamin Graham (1937) *Storage and Stability: A modern ever-normal granary*. 1997 reprint, New York: McGraw-Hill.

<sup>11</sup> See for example, Albert G. Hart, Nicholas Kaldor and Jan Tinbergen (1964) *The Case for an International Commodity Reserve Currency*. Geneva: UNCTAD. Reprinted in N. Kaldor, 1964, *Essays on Economic Policy II: Vol. IV of Collected Economic Essays of Nicholas Kaldor*. 1980 edition, New York: Holmes and Meier.

<sup>12</sup> A full set of references may be found at [www.bufferstock.org](http://www.bufferstock.org)

unsustainable. But by doing so these countries have explicitly foregone any guarantee of stability of the purchasing power of their external claims in exchange for domestic income and employment growth.

These countries can be viewed as lending to the rest of the world to finance the purchase of their net exports, or better as borrowing effective demand from the rest of the world. The successful pursuit of these policies will thus require either a distortion of prices, exchange rates or global demand. The resulting surpluses will also have global purchasing power values that are “distorted”, and thus cannot be guaranteed at any particular value. The successful implementation of these national strategies would require a coordinated global policy to allow semi-permanent surpluses and deficits amongst countries at different levels of development. But it would also require an appropriate distribution of the costs of these imbalances between surplus developing countries and deficit developed countries, including a mechanism to ensure provision of the required liquidity. Here the SDR might play a role, but only as a provider of liquidity, rather than as a stable store of international value, since there could be no automatic market adjustment mechanism to bring this about. Indeed, any insistence on eliminating global imbalances would be equivalent to preventing developing countries from pursuing these national development strategies based on export surpluses and competitive exchange rates.

### **Capital Flows, Development Strategies and Imbalances**

The second problem concerns international capital flows. The original Bretton Woods proposal did not envisage that such flows would play a substantial role, either in financing payments imbalances or in the international allocation of capital resources. The system has turned out to be rather different, and private flows, as shown above, have been capable of creating substantial cumulative distortions to the international adjustment mechanism. Thus, if international adjustment is to be coordinated, either to ensure the elimination of imbalances, or to permit semi-permanent imbalances to further the purposes of development strategies of particular developing countries, capital flows will have to be part of that coordination process. Such coordination would also have a major impact on the potential stability of the purchasing power of whatever liability is used as the international currency.

Thus, to conclude, the problem of the instability of the purchasing power of the international reserve currency is less a question of what serves as the international currency, but much more a question of the international adjustment mechanism and whether that mechanism is automatic, cumulative or coordinated, and whether it is compatible with global aggregate demand sufficient to provide full employment. It is even more importantly a question of the compatibility of export-led development strategies with international payments balance. If the former imply and require sustained imbalances, it is impossible to expect stability in the international reserve currency, whatever it may be. It is also impossible to expect the elimination of international imbalances. Any attempt to shore up its value will by definition undermine export-led development strategies. The only way out of this dilemma is to shift to domestic demand-led development strategies. And one of the reasons that US imbalances remain so large is that developed countries such as Germany and Japan have been unable to transform their growth from export-led to domestic demand led. This, along with free capital flows, is the real cause of the persistence of large global imbalances, not the national development strategies based on competitive exchange rate driven

domestic industrialization or the instability of the international value of the national currency serving as the international reserve currency.