



## Stabilizing the international monetary system<sup>☆</sup>

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### Abstract

The paper focuses on one key difference between the international monetary system of the 1960s and the one prevailing today. In the 1960s, the dollar was the main reserve currency, and governments not wanting to accumulate dollars had only one obvious option—buying gold from the US Treasury. Today, they have a different option—using dollars to buy euros. There is as yet no firm evidence that Asian central banks are switching from dollars to euros, but a less radical change in their behavior could pose serious problems. They may go on buying dollars to keep their currencies from appreciating but then return to the foreign-exchange market to sell the dollars for euros. The euro would then appreciate sharply, and US interest rates would rise because of the fall in the foreign demand for US government debt. These unwanted effects could be avoided by either of two innovations: (1) The ECB could establish a special facility to accommodate the demand for euros; its liabilities would comprise euro-denominated claims issued off-market to other central banks, and its assets would comprise US government debt. The ECB would incur an exchange-rate risk unless the US Treasury were willing to issue euro-denominated debt in exchange for dollar-denominated debt acquired by the ECB. (2) Central banks could deposit unwanted dollars with a facility administered by the IMF; its liabilities would comprise SDR-denominated claims, and its assets would comprise US government debt indexed to the dollar value of the SDR. The first proposal would confer a large reserve-currency

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role on the euro. The second would confer that role on the SDR, and it would preclude future instability resulting from subsequent shifts between the dollar and the euro.

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The collapse of the Bretton Woods System, three decades ago, had several causes. It was due partly to the gradual deterioration in the net reserve position of the United States—the increase of its dollar liabilities to foreign central banks relative to its own gold holdings. It was due partly to the economic recovery of Western Europe and Japan, which eroded the US trade surplus and called for a devaluation of the dollar—something that the United States could not achieve in an orderly way because of the fundamental asymmetry in the Bretton Woods System; the dollar was used by other countries to define and defend the values of their currencies. And it was due partly to a policy error by the United States – its failure to pay for the Vietnam war by raising taxes.

### 1. Comparing two imbalances

The situation today is similar in some respects but different in others. The reserve position of the United States is not at issue, because the dollar is no longer tied to gold, and the United States has no comparable obligation to convert into some other monetary asset the dollars held by foreign official institutions. Furthermore, the United States had a current-account surplus in the 1960s, although it was not large enough to cover the capital outflow from the United States, most notably the large direct-investment outflow from the United States to Europe. Today, by contrast, the United States has a huge current-account deficit. It already exceeds 5% of GDP and shows no sign of shrinking, despite the depreciation of the dollar that has already taken place. In fact, the deficit is likely to grow substantially in the next several years, absent a major change in economic fundamentals.<sup>1</sup> As a result, the United States has become a net debtor in the strict sense of the term, after excluding foreign direct investments from both sides of its balance sheet. At the end of 2003, foreign claims on the United States exceeded US claims on foreigners by \$2.94 trillion, and foreign official dollar holdings held in the United States rose from \$1.21 trillion in December 2002 to \$1.65 trillion in June 2004.<sup>2</sup>

Some say that this situation is sustainable for several more years. I will tell you why I disagree. But let me first remind you of two more differences between the present situation and the one in 1971, when the Bretton Woods System started to disintegrate:

<sup>1</sup> See the projections in Mann (2004), and Roubini and Setser (2004).

<sup>2</sup> Total official dollar holdings were even larger, as some official institutions hold some or all of their dollars outside the United States. According to the International Monetary Fund, foreign official dollar holdings totaled at least \$1.79 trillion at the end of 2003 (IMF, 2004, Table 1.3).

- First, we do not face a sudden collapse of a rule-based regime, because we do not have a rule-based regime. Three of the four key players, the euro zone, Japan, and the United States, have floating exchange rates, and floating rates do not collapse, although they can change more quickly and by larger amounts than might be desirable for the maintenance of macroeconomic stability. The fourth key player, China, is the only one with a fixed exchange rate.
- Second, the dollar was the main reserve currency available during the Bretton Woods era, and governments not wanting to hold more dollars had only one obvious alternative, buying gold from the US Treasury. Few governments did that, however, during the final years of the Bretton Woods era. They knew that a further fall in the US gold stock could trigger a scramble for gold and the collapse of the system itself, which is what happened in August 1971, when the anticipation of additional gold losses prompted the United States to close the gold window. Today, however, they have another option, using dollars to buy euros.

We thus face the rising risk of a disorderly shift from the present dollar-based monetary system to a multiple-currency monetary system based on the dollar and the euro. Some of my European friends would welcome the ultimate outcome, a large international role for the euro, but they should be worried about getting there quickly.

I began with the collapse of the Bretton Woods System, but those who believe that the US current-account deficit is in fact sustainable look back even further. In three recent papers, Dooley, Folkerts-Landau, and Garber (2003, 2004a, 2004b) draw an extended analogy between the situation in the 1960s and the one today. In the 1960s, they say, Europe and Japan resisted the revaluation of their currencies vis-à-vis the dollar in order to pursue export-led growth. Today, they say, China and other Asian countries are doing the same thing, and they will go on doing that. China, in particular, has embarked on a massive task – moving tens of millions of people from rural to urban life and creating the jobs required to achieve that outcome. In their most recent paper, moreover, the three authors carry their analogy further. The Asian countries, they suggest, are willing to accumulate large dollar holdings in order to collateralize the risks assumed by foreigners making investments in China.

Roubini and Setser (2004) have raised several objections to this reassuring story. They note, for example, that the likely growth of the US current-account deficit may soon exceed the ability of Asian central banks to absorb additional dollars. At the very least, it will make it increasingly difficult for them to manage their money supplies in a manner consistent with price stability.<sup>3</sup> Those of us with long memories, moreover, will recall that the United States had to use many carrots and sticks during the 1960s in order to induce European governments to finance the US payments deficit, because they were reluctant to accumulate dollars. It threatened to repatriate the dependents of US troops in Europe; it extracted advance payments for military hardware sold to its NATO partners; and it extracted a written promise from the German government to go on holding

<sup>3</sup> See also Eichengreen (2004), who argues that the Asian countries lack incentives to act collectively in their common interest, whereas the countries principally involved in financing the US payments deficit during the 1960s shared a common interest in preserving the Bretton Woods System.

dollars rather than buy gold from the US Treasury.<sup>4</sup> Throughout the 1960s, moreover, Europeans blamed the United States for ‘exporting inflation’ to Europe, although it had little inflation to export. And the Bretton Woods System broke down, when, as now, the policy stance of the United States was seen to foretell a rapidly growing imbalance in its external accounts. Hence, I draw little comfort from the three authors’ extended analogy.

## 2. Comparing two outcomes

How, then, will the story end? There is no gold window to close and no way to negotiate a general exchange-rate realignment like the short-lived realignment cobbled together in 1971. One can conceive of an orderly ending, involving a bargain among the key countries, but mainly a bargain between Beijing and Washington. But it is more likely to end in a disorderly way.

Let us start with fundamentals. A large reduction of the US current-account deficit cannot be achieved without a further depreciation of the dollar. I am not sure that I buy the big model-based number produced by Obstfeld and Rogoff (2004), which relies mainly on a single expenditure-switching effect, an increase in the price of tradable goods relative to nontradables. But the dollar must depreciate against the Chinese yuan and the other Asian currencies that are closely tied to it. There has also to be an increase of US national saving that can take two forms, an increase of private-sector saving by households or firms, or an increase of public-sector saving of a size that is unobtainable without higher taxes, given the fairly small size of nondefense discretionary spending.

What, then, would be needed for an orderly ending? China would have to agree to revalue the yuan, not to introduce a modicum of exchange-rate flexibility, but rather to change the yuan-dollar rate by no less than 10%. And Washington would have to agree to cut the US budget deficit, not merely to *predict* a reduction over the next few years but rather to bring one about by raising taxes. To say this is, of course, to say in effect that there will be no such bargain. The Chinese fear, understandably, that a once-for-all change in the yuan-dollar rate will be wrong-sized and will then provoke massive speculation, an inflow of funds if it is seen to be too small or an outflow of funds if it is seen to be too large. And the Pentagon’s fixation with regime change appears to have infected the US Treasury. It has focused obsessively on China’s exchange-rate regime rather than the price of the Chinese currency.<sup>5</sup> Furthermore, the White House would not raise taxes, the only statement I will make without fear of contradiction.

This brings us, then, to the disorderly ending. There is, as yet, no evidence that foreign central banks are selling dollars, although there are lots of rumors. During 2003, in fact, the share of the dollar in total reserves, measured at constant exchange rates, rose by more

<sup>4</sup> On these and other measures taken by the United States, see Eichengreen (2000).

<sup>5</sup> Goldstein and Lardy (2003) make the same point more politely. They recommend that China revalue its currency immediately and then move to a floating exchange rate later, after it is taken the various steps required to strengthen its financial system.

than 2% points, from 68.4% of identifiable currency reserves to 71.7%. Put differently, the dollar accounted for 88.9% of the total increase in currency reserves during 2003.<sup>6</sup>

The problem I foresee, however, need not begin with a big shift by a very large holder of dollars. It is as likely to begin with diversification at the margin. Asian and other central banks will go on buying dollars in the foreign-exchange market in order to keep their currencies from appreciating. But they may then return to the foreign-exchange market to sell the dollars for euros. Should this practice spread, moreover, it will be hard for any prudent central bank to add to its dollar holdings, and some may begin to sell more dollars, to reduce their dollar holdings, not merely keep them from growing.

The economic implications are obvious. The euro will appreciate vis-à-vis the dollar, and US interest rates are bound to rise on account of the fall in the foreign demand for US government debt. The further effects are equally obvious, although we cannot know their size. The euro area will suffer a deterioration in its trade balance, although the effect may be damped down by slower economic growth, which has been heavily export dependent. The United States may also experience slower economic growth, because of the increase in interest rates. But the size of that growth-depressing effect is apt to depend on the way that higher interest rates affect US housing prices. The increase of national saving that must somehow occur in order to reduce the US current-account deficit could indeed be furnished by the private sector, rather than the public sector, if a fall in housing prices led to a fall in household spending. But that would be a painful and inefficient way to reduce the US current-account deficit, and I am not predicting it. I am trying merely to describe an unpleasant possibility, the way in which a disorderly move to a multiple-currency system might play itself out.

## 3. Comparing two innovations

My story would change, for example, if the European Central Bank began to intervene in the foreign-exchange market to hold down the dollar price of the euro, if it were willing to ‘print’ the euros demanded by other central banks. That would short-circuit the painful process I have just described. The ECB might find it hard to sterilize the money-supply effects of large-scale intervention, but there are ways in which it can deal with that problem.

Suppose that the ECB were willing and able to establish a special-purpose facility. The liabilities of the facility would comprise the euro-denominated claims issued off-market to other countries’ central banks; its assets would comprise the US government securities bought directly or indirectly from those central banks (and it could use the interest income from those securities to make interest payments to those central banks). The ECB would incur an exchange-rate risk. But it could shift that risk to the US government, if the latter were willing to issue euro-denominated debt in exchange for the dollar-denominated debt acquired by the ECB.

Some of you may recognize this proposal as an ad hoc version of a better plan proposed many years ago, and I would prefer that earlier plan to the one I have just made. When

<sup>6</sup> Author’s calculations from data in IMF (2004), Table 1.3.

the dollar was depreciating in the late 1970s, the US Treasury and IMF staff suggested the creation of a new facility, a so-called ‘substitution account’, under the auspices of the IMF. Its liabilities would consist of SDR-denominated claims issued to central banks that wanted to reduce their dollar holdings. Its assets would consist of US government debt indexed to the dollar value of the SDR.<sup>7</sup> The United States would thus incur an exchange-rate risk, but the potential cost of incurring that risk would be somewhat smaller than the potential cost of my previous proposal, a bilateral deal between the ECB and the US Treasury, because the dollar is part of the currency basket defining the value of the SDR. The proposal came close to adoption 25 years ago, until the US Treasury insisted that the IMF should bear the exchange-rate risk by pledging its gold holdings to back the liabilities of the substitution account. And the proposal died a natural death when the dollar strengthened on foreign-exchange markets.<sup>8</sup>

I conclude with two observations. Proposals of the sort I have just made would not obviate the need to reduce the US current-account deficit. There would still be the need for more dollar depreciation and for an increase of US national saving, a sharp cut in the budget deficit, to make room for the reduction in the current-account deficit. And the proposals are not meant to lengthen the life of the dollar as a reserve currency. They would, in fact, reduce its role substantially. But they would prevent the large appreciation of the euro that might otherwise occur. The two proposals differ, however, in one important way. The one involving the ECB would confer a reserve-currency role on the euro. The one involving the IMF would confer a reserve-currency role on the SDR, which is the better way to go, because it would preclude the possibility of subsequent destabilizing shifts between the dollar and the euro.

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<sup>7</sup> On the history of this particular proposal, see Boughton (2001), pp. 936–43. He notes correctly that the US Treasury and IMF staff had rather different objectives. The US Treasury sought to forestall the further weakening of the dollar on account of reserve-currency diversification; the IMF sought to achieve the objective set forth in the Fund’s Articles of Agreement, making the SDR the principal reserve asset of the monetary system. On the analytics of the proposal, see Kenen (1980).

<sup>8</sup> Reflecting on this episode, a senior US Treasury official remarked sadly that there is never a good time to reform the international monetary system. When the dollar is weak, the United States does not have enough bargaining power to hold down the cost of reforming the system. When the dollar is strong, the rest of the world has no interest in reform. Ten years earlier, however, a more senior US official, John Connally, put it differently: “The dollar is our currency but your problem.”

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