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Thomas I. Palley

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Gordon Hall
418 North Pleasant Street
Amherst, MA 01002

Phone: 413.545.6355
Fax: 413.577.0261
peri@econs.umass.edu
www.umass.edu/peri/



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Abstract

Dooley et al. (2003) have argued that today's international financial system has structural similarities with the earlier Bretton Woods (1946 – 71) arrangements and is stable. This paper argues that the comparison is misplaced and ignores fundamental microeconomic differences, and that today's system is also vulnerable to a crash. Eichengreen (2004) and Goldstein and Lardy (2005) have also argued that the system is unsustainable. However, their focus is the sustainability of financing to cover the U.S. trade deficit, whereas the current paper focuses on inadequacies on the system's demand side. The paper concludes with suggestions for a global system of managed exchange rates that should replace the current system – hopefully, before it crashes.

Keywords: Revised Bretton Woods, export-led growth, aggregate demand.

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Thomas I. Palley
Economics for Democratic and Open Societies
Washington DC 20010
e-mail: mail@thomaspalley.com
www.thomaspalley.com

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I Introduction

In a series of papers Dooley, Folkerts-Landau and Garber (2003, 2004a, 2004b) – henceforth DFG – have suggested that today’s international financial system has structural similarities with the Bretton Woods arrangement that held sway between 1946 and 1971. Export-led growth by developing countries figures heavily in their analysis, and DFG have done a major service by reminding the economics profession of export-led growth and the possibility that it can have significant international macroeconomic effects.¹

This paper agrees with DFG’s emphasis on export-led growth, but challenges their comparison of today’s system with the Bretton Woods system. It also differs regarding their conclusion that today’s system is sustainable for the medium term, and instead argues that the system is prone to a crash. Other authors (Eichengreen, 2004; Goldstein and Lardy, 2005) have also argued that the system will crash, but their arguments are different. In particular, they focus on the sustainability of financing for the U.S. trade deficit, whereas the current paper focuses on the demand-side inadequacies of the system. Finally, the paper concludes with suggestions for a global system of managed exchange rates that should replace the current system – hopefully, before it crashes.

II The Revised Bretton Woods Hypothesis

The DFG hypothesis is that today’s international financial system has structural resemblances with the earlier Bretton Woods system. That earlier system was one of fixed exchange rates, and according to their analysis was a center – periphery system in which the post-World War II U.S. was the center, while war-ravaged Europe was the

¹ Blecker (2000) and Palley (2003) have earlier explored the global macroeconomic inconsistencies of export-led growth.

developing periphery. Within this framework, the U.S. proceeded to run progressively growing trade deficits with Europe that eventually caused the system's demise, but that demise was slow in coming.

DFG argue that today's global financial system has strong resemblances with this earlier system, with the U.S. still the center, but East Asia (especially China) now playing the role of the periphery. China has an explicitly fixed exchange rate vis-à-vis the dollar, while other East Asian economies actively manage their exchange rates to prevent them appreciating against the dollar. Additionally, the East Asia region is running huge trade surpluses with the United States.

The economic logic behind the new system is that East Asian economies are pursuing export-led growth, in which exports are the engine of growth. Lacking sufficiently robust domestic demand, they need exports to keep their factories operating. Export success then serves to attract large-scale foreign direct investment that creates jobs, builds manufacturing capacity, and transfers technology. Moreover, foreign investors finance this capital accumulation by providing the foreign exchange to purchase the capital goods. They also organize its transfer, installation, and operation. In this fashion, countries acquire jobs and a modern internationally competitive manufacturing sector.²

However, the price the periphery must pay is exports to the center. This explains why savings flow north from poor to rich, rather than from rich to poor as predicted by

² DFG emphasize the connection between exports, FDI, and growth. Goldstein and Lardy (2005) have rightly criticized them for overemphasizing the contribution of FDI to China's growth. That said, FDI is a critical component of China's capital and technology accumulation strategy. More importantly, the link that should be emphasized is between exports and industrial investment in general, with exports spurring both foreign direct investment and domestic manufacturing investment. Exports provide the classic "vent for surplus" in China's economy. China's entrepreneurial tradition makes it highly efficient at organizing capital accumulation. However, China has not yet put in place a domestic consumption market that can absorb the production China is capable of organizing. This point is emphasized in Palley (2006a).

conventional inter-temporal consumption smoothing models of the international economy. Additionally, since international competitiveness is key to export-led growth, countries actively pursue policies aimed at maintaining under-valued exchange rates. This explains China's refusal to revalue its exchange rate despite its massive and growing trade surplus, and it also explains the pattern of accumulation of dollar denominated official reserves throughout East Asia.

III The misplaced analogy with Bretton Woods

DFG's analogy of the present system with Bretton Woods rests on a number of similar macroeconomic patterns, including quasi-fixed exchange rates and the fact of persistent and growing U.S. trade deficits financed by the periphery. This analogy is wrong and ignores the fundamentally different microeconomic regimes governing the two periods.

There are three significant differences between today's system and the earlier system. First, today's trade deficits are the result of on export-led growth predicated upon under-valued exchange rates, yet the purpose of Bretton Woods was to prevent "beggar-thy-neighbor" trade based on competitive devaluation such as had afflicted the international economy in the Great Depression era. Though Germany's exchange rate alignment in the old Bretton Woods system came to be significantly under-valued, that was not the case for the United Kingdom. Moreover, the Bretton Woods system had formal provisions whereby countries with structural trade deficits could devalue.

Second, the current period has multi-national corporations shifting to China to establish state of the art export platforms whose production is intended for export back to the center (the U.S.). This contrasts with the 1950s and 1960s when American multi-

nationals established production facilities in Europe for purposes of supplying the European market. Companies such as Ford, General Motors and IBM produced in Europe for Europe, not for export back to the United States. Likewise, European capital accumulation was primarily intended for European markets.

Third, the growing U.S. trade deficits of the 1960s were driven by full employment in the U.S. with growing wages, a growing manufacturing sector, and increasing manufacturing employment. This contrasts with current trade deficits that are driven by debt-financed consumption spending supported by a house price bubble, and these deficits are also displacing U.S. manufacturing. Whereas the U.S. trade deficits of the 1960s were consistent with a robust and stable aggregate demand generation process, the current system is hollowing out the income and aggregate demand generation process and eroding manufacturing capacity.

III Why the new regime will fail

DFG maintain that the new system is sustainable and can last for another decade. In terms of their Bretton Woods analogy, the situation is closer to 1958 than 1968 (the Bretton Woods system collapsed in 1971). The reason for this stability is that the new arrangement suits both U.S. and East Asian interests - particularly those of China. The steady flow of imports that constitute the U.S. trade deficit, supply a stream of cheap consumption goods that lowers consumer prices, keeping down inflation. This enables the Fed to hold the line on interest rates despite reduced unemployment rates.

Additionally, East Asian countries contribute to the favorable interest rate environment by re-cycling their trade surpluses into U.S. Treasury bonds as part of their strategy of keeping their currencies undervalued vis-à-vis the dollar.

East Asia benefits from exporting to the U.S., which keeps its factories fully employed. Export success in turn spurs domestic and foreign direct investment in manufacturing, fuelling growth and development. For China, this is especially important as it needs to create jobs rapidly to absorb rural migration to the cities. If jobs are not forthcoming, this could trigger social and political unrest that would pose a threat to Communist Party rule. These benefits mean that East Asian governments are willing to continue accumulating U.S. financial assets, ensuring a sustainable stream of financing for the U.S. trade deficit at current interest rates and exchange rates. For East Asian countries, portfolio risk and return are not the driving force of their financial investment decisions, and therefore do not enter their calculus. Economic growth is.

Additionally, this configuration of national economic interests is under-written politically by U.S. multinationals. Given their East Asian investments and the profitability of sub-contracted production, these corporations are willing to do the political lobbying in Washington that heads-off “protectionist” pressures generated by the trade deficit and U.S. de-industrialization. Finally, the fact that the dollar is no longer officially convertible into gold adds extra stability to the system, and closes the weakness that brought down the original Bretton Woods system.³

Existing arguments why the system is unstable

DFG’s claim regarding the stability of the new system has been challenged by several authors. Eichengreen (2004) argues that the system will collapse because of inconsistencies between the system and individual country financial interests. While it is true the system delivers export-led growth for East Asian economies, countries are

³ President Nixon suspended the right of countries to convert official dollar reserves into gold on August 15, 1971 in the face of large gold conversions, especially by France.

obliged to accumulate massive dollar reserves. These accumulations are unwise from a portfolio standpoint, lacking diversification and exposing countries to massive capital losses (equal to several percentage points of GDP) should the dollar ever fall in value. As a result, individual countries have an incentive to diversify their reserve holdings even though they benefit from the system as a whole. In effect, there is a classic cartel problem with individual members having an incentive to cheat on the system.

There are two serious objections to Eichengreen's analysis. The first objection concerns where East Asian countries place their reserves. Here, the principal option is the euro. There may also be some purchasing of other East Asian country currencies, especially the yen. Additionally, there may be some buying of gold and commodities, and countries may also buy real assets such as equities. However, these diversification activities do not necessarily fatally wound the system.

Selling dollars and buying euros will appreciate the euro vis-à-vis the dollar, undermining European international competitiveness and exporting deflation and unemployment to Europe. However, the dollar will retain roughly the same parity against East Asian currencies. As their principal export market, all East Asian economies have an incentive not to let their currency appreciate too much against the dollar, and they all have an incentive not to appreciate too much against rival East Asian economies. These incentives provide a centripetal force that stabilizes the system.

Similarly, purchases of commodities and equities may cause commodity and asset price inflation, but they too leave the dollar exchange rate essentially unchanged. And to the extent that East Asian countries do sell Treasury bonds, this will drive up U.S. interest rates, thereby providing an incentive to remain invested in dollars.

A second objection to Eichengreen's claim concerns its assumption that East Asian economies ultimately face capital losses on their dollar reserve holdings. This assumption tacitly assumes the conclusion that the system is unstable. In fact, it is quite possible that China could end up reaping large capital gains on its holdings. The logic is as follows. China is resisting exchange rate appreciation to preserve its export-led growth model. Yet, at the same time it is gradually working toward international opening of its capital markets. Such opening could eventually trigger a depreciation of renminbi if Chinese wealth holders exit the domestic system for purposes of economic and political portfolio diversification.⁴ In this event, China will make large capital gains on its reserve holdings, and it will also get a second wind for its export led-growth program.

This scenario should be extremely troubling to U.S. policymakers concerned about America's industrial base, yet the U.S. Treasury Department is actively promoting such an outcome by demanding capital market openness. Once China liberalizes its capital markets and floats its exchange rate, the U.S. will no longer be able to claim that China is manipulating its exchange rate and international legal grounds for action against China will disappear. Yet, capital market opening and renminbi depreciation are the diametric opposite of what the U.S. needs. The U.S. problem is with the trade balance and the exchange rate, and that calls for Chinese revaluation without capital market opening. The Treasury's policy promises to aggravate both the exchange rate and trade balance problems.

The U.S Treasury's policy stance repeats the mistakes made with Japan in the early 1980s. At that time Japan was running a large trade surplus and was relatively

⁴ Chinese wealth holders will want to diversify for standard economic reasons. They will also want to diversify for political reasons given the questions about rule of law in China and the potential for future political instability.

financially closed. The U.S. Treasury pushed Japan to open its financial markets, which Japan did. As a result, un-diversified Japanese wealth holders exited Japan looking to invest overseas, causing the yen to fall and increasing Japan's trade surplus.

Goldstein and Lardy (2005) provide a second line of criticism of DFG's stability claim. Their analysis is a combination of positive and normative arguments that say not only will the system breakdown because of costs to China of maintaining it, but it is also in China's best interests that it breakdown. The principal focus of their analysis is the high cost to Chinese authorities of sterilizing monetary inflows into China. To prevent exchange rate appreciation China's central bank sells renminbi, which increases the money supply and poses inflationary dangers. To sterilize this money supply increase, the bank then sells domestic bonds and soaks up excess liquidity. However, this in turn drives up interest rates, and distorts financial signals. To counter this, the central bank has turned to administrative controls such as higher reserve requirements on commercial bank deposits and higher administered deposit rates to attract and retain bank deposits. However, Goldstein and Lardy believe that at the end of the day these measures will prove inadequate, and China will suffer from a combination of costly inflation and costly financial system distortions that misallocate and waste resources. They believe these costs will compel China to abandon its under-valued exchange rate.

In addition to this argument, Goldstein and Lardy challenge the underlying premise of the DFG hypothesis, namely that FDI-driven export-led growth is critical for China's industrialization. Third, they subscribe to the capital loss on reserves argument put forward by Eichengreen (2004). Fourth, they argue that there are large terms of trade gains to be had by China from revaluation. This will lower the domestic cost of

commodity and capital goods imports, and it will not have a large effect on Chinese manufactured exports because they consist considerably of processed products based on imported inputs.

Goldstein and Lardy's arguments are subject to important counter-arguments.⁵ First, the sterilization cost argument is essentially a monetarist argument, yet the empirical link between the money supply and inflation is known to be long and variable. China's administrative controls have worked well so far, and they may continue to work with the assistance of minor adjustments. Second, China's stiff resistance to revaluation provides a "revealed preference" statement by China's economic policy authorities showing that the contribution from export-led manufacturing growth is very important. Third, as noted above, it cannot simply be assumed that China will end up suffering capital losses on its reserve holdings. Fourth, China has an alternative plan for dealing with financial sector resource misallocation. That plan is partial privatization of its banks, the goal being for western banks to modernize and improve the banking systems credit allocation function. This is to be done within the existing export-led growth strategy, which China's authorities view as helping the industrial sector and promoting capital accumulation and job creation. Together, these arguments counter Goldstein and Lardy's arguments why the system is unstable.

A new explanation of instability

DFG, Eichengreen (2004), and Goldstein and Lardy (2005) focus on the sustainability of the supply of financing for the U.S. trade deficit. DFG believe this supply is sustainable because it meets the needs of supplier (surplus) countries.

Eichengreen and Goldstein and Lardy believe it is not. The current paper argues that the

⁵ These arguments are developed in greater detail in Palley (2006a).

system is indeed unsustainable and will crash, but not for reasons of supply. Rather, it is for reasons associated with the sustainability of the demand side of the system. This demand side weakness has been overlooked because of failure to understand the microeconomic workings of the current regime.

These workings are shown in figure 1. The key insight is that the financing of export-led growth and the U.S. trade deficit is a two-stage intermediated transaction. One half of the process involves a transaction between governments and financial intermediaries (call them banks) in U.S. financial markets. The other half of the process involves a transaction between U.S. banks and ultimate U.S. borrowers (call them consumers). The international transaction can be loosely identified with the supply of credit from East Asian economies to the U.S. economy. The domestic transaction can be loosely identified with the provision and demand for credit within the U.S. economy. The system can break down in either the international credit market or the domestic credit market. Thus far, attention has exclusively focused on the international credit market and possible withdrawal of financing by foreign lenders. However, the real non-sustainability may lie on the domestic credit market side.⁶

Export-led growth relies on selling goods in the U.S. market, but to sell there must be a buyer. For the last several years the U.S. consumer has been that buyer, and is even sometimes characterized as “the buyer of last resort.” This consumer spending has been significantly financed by borrowing, which in turn has been supported by a housing price bubble.

⁶ These arguments are developed in two policy briefs, “Export-led Growth: The Elephant in the Room (January 13, 2006b)” and “Two Views About a Possible Hard Landing: Foreign Flight versus Consumer Burnout (December 23, 2005)” posted at www.thomaspalley.com.

At this stage, there are several factors that could end the consumption boom. One possibility is that the Federal Reserve may over-shoot with its interest rate tightening campaign, triggering a recession. A second possibility is that local American banks may tighten lending standards and reduce lending because they see households as financially over-extended and housing collateral as over-valued. A third possibility is that consumers may voluntarily reduce spending. One reason is that the housing price bubble may be topping out, thereby eliminating future gains to borrow against and even possibly imposing losses. A second reason is that U.S. households face adverse wage and income pressures generated by international outsourcing. These pressures have been spreading from the manufacturing sector to the larger service sector.

If U.S. consumption spending falls, East Asian exports will fall. When that happens, the willingness of East Asian economies to finance the U.S. trade deficit becomes redundant. At that stage, international financing is no longer a binding constraint. Instead, the constraint will lie in U.S. goods markets and domestic credit markets, and East Asian economies can do nothing to force those transactions by providing credit to banks. It is the borrower and local bank that must seal that deal. The bottom line is that the system is vulnerable to a crash that originates within the U.S., and about which East Asian economies can do little. Indeed, the competitive pressures unleashed by export-led growth and outsourcing, are part of the constellation of forces making for such a crash.

IV What happens if the U.S. economy sinks into recession?

In the event that the U.S. falls into a consumer-led recession, East Asia is likely to be significantly impacted. This contrasts with the recession of 2001, which was an

investment-led recession that left East Asia relatively unscathed because it largely exports consumer goods. A first impact would be felt via reduced exports, which would lower employment. A second impact would be felt via reduced foreign direct investment. With excess capacity and diminished export prospects, multinationals would have reduced incentives to make new investments.

The U.S. is also likely to find it difficult to escape a consumer-led recession. The previous recession was escaped by the combination of a budget U-turn from surplus to massive deficit, a significant reduction in interest rates that spurred mortgage refinancing that re-liquified household balance sheets, and by consumer borrowing collateralized by a house price bubble. Today, these options are no longer available, and the only significant space for policy stimulus is for the Fed to reverse itself and cut rates. However, such rate cuts will likely be much less effective than previously. One reason is the stock of high interest mortgages has already been depleted and refinanced. The second reason is that lenders will be less inclined to lend given households' more financially stretched positions. A third reason is that house prices have already risen and are more likely to go down than up. The net result is that interest rate reductions are likely be akin to "pushing on a string."

That raises the question of what will happen to the dollar? Diminished U.S. economic prospects are likely to promote some portfolio shifting toward Europe and Japan. However, the reliance of Europe and Japan on exports to the U.S. means they too will be adversely impacted by a U.S. recession, which will reduce the incentive to shift into euro and yen investments. Side-by-side, the East Asian countries will be even keener to retain competitiveness given they will already be suffering diminished exports. That

suggests they will continue to restrict appreciation against the dollar. The net result is that the dollar may not fall very much, making it harder for the U.S. to beat the recession. The prognosis is therefore one of prolonged slump.

V Still wanted: a new global financial architecture

Not only do DFG see the system as stable, they also see it as providing significant welfare benefits for all parties involved. In a subsequent paper DFG (2004b) have argued that the surpluses earned by East Asian economies represent a means of acquiring foreign exchange collateral needed to underwrite foreign direct investment in those economies. From their point of view the system should be left as is.

One problem with this collateral argument is that it is distinctly odd that Japan is still accumulating collateral. More importantly, their argument does not accord with the historical record of how the new system came into being. The system is a product of a recent evolution, spurred by the East Asian financial crisis of 1997. In response to that crisis, East Asian economies decided to build up massive foreign exchange reserves as a protection against future financial panics. They have done this by accepting the currency devaluations imposed by markets in the panic of 1997, and this has subsequently turned out to confer growth and development benefits on them.

There are several important points that follow from this. First, the accumulation of official reserves has not been driven by a desire to accumulate collateral to underwrite FDI. It has been driven by a desire to protect against the possibility of future capital flight. Second, the system is an accidental product, the result of state policy responses to unwelcome market developments. Viewing the system as the product of optimizing markets is the disease of modern economists who interpret everything in this light. Third,

the system is globally problematic for reasons discussed in Blecker (2000) and Palley (2003). In particular, it promotes global deflation through its excessive emphasis on exports, which hollows out the income and aggregate demand generation process in the U.S. via de-industrialization and out-sourcing.

This points to the continuing need for a new global financial architecture. The global economy papered over the problems of the East Asian financial crisis, but this has in turn caused new problems. A new financial architecture, addressing both the root cause of the 1997 East Asian financial crisis and the problems that have emerged since, is therefore still needed.

The core problems of the international financial system concern capital mobility and exchange rates. Destabilizing capital mobility was the essential problem behind the East Asian financial crisis, and exchange rates are the essential problem behind today's global financial imbalances. The Bretton Woods system was one of fixed exchange rates and tight capital controls. In today's world neither are feasible nor desirable. Instead, a contemporary financial architecture should involve managed capital mobility and managed exchange rates. Particularly important is the need to recognize that the existing system is a problem for both periphery and center. After the East Asian crisis there was a tendency to talk as if only the periphery needed change. The reality is both need change.

There have been many proposals for redesigning the global financial architecture. Blecker (1999), Griffiths-Jones and Kimmis (1999), and Palley (1999) provide treatments that deal with governing and improving the quality of capital flows. Their collective proposals include improved prudential regulation, Chilean-style speed bumps that implicitly tax short-term inflows, currency transaction taxes, domestically imposed

reserve requirements on lenders, and obligations for lenders to hedge foreign currency lending on behalf of borrowers.

The 1997 financial crisis was centered on capital mobility. Today's problem is gross trade imbalances. These imbalances have elevated the significance of exchange rate misalignments, pointing to the need for a system of managed exchange rates that promotes exchange rate stability. The obvious candidate is some form of crawling band target zone system as proposed by Williamson (1985, 1999), Bergsten et al. (1999), Grieve-Smith (1999), and Weller and Singleton (2002).

Such a system involves choice of a number of parameters that would need to be negotiated by participants. First, there is choice of the target exchange rate. Second, there is the choice of size of the band in which the exchange rate could fluctuate. Third, there is a choice whether the band would be hard or soft. A hard band is automatically and decisively defended; a soft band is one that allows for marginal temporary deviations outside the band, while retaining a commitment to bring the exchange rate back within the band when market conditions are most conducive. Fourth, there is the choice of the rate of crawl. This involves determining the rules governing the adjustment of the target and band. Issues here concern the periodicity of adjustment, and the rule governing adjustment of the nominal exchange rate.

Regarding the target exchange rate, a sensible candidate is the notion of fundamental equilibrium exchange rates proposed by Williamson (1994). The basic notion is that participating countries select a set of exchange rates consistent with their targeted current account and GDP outcomes.⁷

⁷ Operationally, for the single country case, this is done as follows. The first step is to empirically estimate a current account equation of the form $CA = \alpha_0 + \alpha_1 Y + \alpha_2 e + \alpha_X X$, where CA = current account, Y = GDP, e = exchange rate, and X = vector of exogenous variables. This estimated equation is then solved to yield

Finally, rules of intervention to protect the target exchange rate need to be agreed upon. Historically, the onus of defending the exchange rate has fallen on the country whose exchange rate is weakening. This requires the country to sell foreign exchange reserves to protect the exchange rate. Such a system is fundamentally flawed because countries have limited reserves, and the market knows it. This gives speculators an incentive to try and “break the bank” by shorting the weak currency, and they have a good shot at success given the scale of low cost leverage that financial markets can muster. Recognizing this, the onus of exchange rate intervention needs to be reversed so that the strong currency country (the central bank whose exchange rate is appreciating) is responsible for preventing appreciation, rather than the weak currency country being responsible for preventing depreciation. Since the strong currency bank has unlimited amounts of its own currency for sale, it can never be beaten by the market. Consequently, once this rule of intervention is credibly adopted, speculators will back off, making the target exchange rate viable. Such a procedure recognizes and addresses the fundamental asymmetry between defending weak and strong currencies.

VI Conclusion: beyond the mentality of policy passivity

Today’s global financial system is a haphazard sub-optimal creation. Whereas East Asian economies are strategically manipulating their exchange rates, U.S. policymakers have rejected intervention on the grounds that markets know best and should be left alone. This asymmetry has allowed East Asia to pursue neo-mercantilist policies that have contributed to today’s massive global financial imbalances.

the fundamental equilibrium exchange rate (e^*) consistent with the target current account (CA^*), target GDP (Y^*), and given levels of exogenous variables, yielding $e^* = -\alpha_0/\alpha_2 - \alpha_1 Y^*/\alpha_2 + CA^*/\alpha_2 - \alpha_X X/\alpha_2$

In a multi-country exchange rate system, these equations must be estimated and solved simultaneously across countries to ensure a consistent set of exchange rates. Moreover, it is also necessary for countries to agree on a consistent set of national current account targets as not all countries can run surpluses.

The U.S. policy mentality is at odds with reason and the evidence. There are many theoretical reasons for believing that foreign exchange markets are prone to herd behavior. There is also strong empirical evidence that exchange rates depart from their theoretically warranted equilibrium levels - be they defined as purchasing power parity or as the exchange rate consistent with sustainable current account deficits. And from a realpolitik standpoint, it is unwise for a country to let itself be out-gamed by others.

East Asian policymakers are right to believe that they can improve economic outcomes through exchange rate intervention. As Williamson (1999) observes, policymakers that use theory to think sensibly about the exchange rate and how to manage it can do a better job than a pure unregulated float. The problem is that East Asia has gone about this intervention in an uncooperative manner, and that threatens disastrous outcomes.

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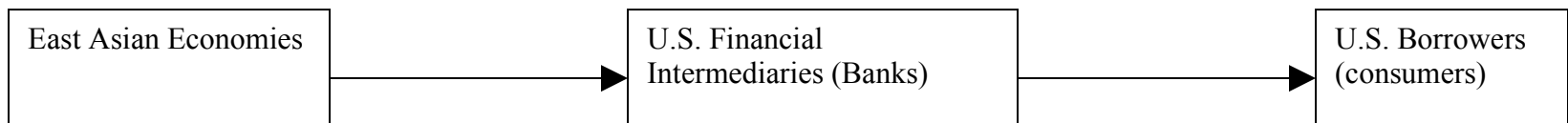


Figure 1. The structure of U.S.- East Asia borrowing.