A NEW BRETTON WOODS SYSTEM FOR ASIA?

By Deepak Lal

Bad ideas never die. Nearly three decades after the collapse of the Bretton Woods system of fixed but changeable exchange rates policed by the IMF, there is a growing clamour in Asia for the creation of an Asian version of Bretton Woods policed by an Asian Monetary Fund. Whilst economists at Deutsch Bank have propounded a theory accounting for the accumulation of hard currency official reserves since 1997 by East Asian central banks of $2.1 trillion, which harks back to the surplus labour model of Arthur Lewis. It is best to begin with the ‘theorists’.

In a series of papers (available as NBER Working Papers), the Deutsch Bank economists (Dooley, Folket-Landau and Garber (DFG)) motivated by the strange policies and outcomes in China have in a series of papers provided a theoretical framework for what they call the revived Bretton Woods system in Asia. They consider the problems of capital importing countries with large pools of underemployed labour, and argue that an export led growth strategy underwritten by an undervalued exchange rate and capital inflows is the best way of employing and raising the incomes of this vast labor reserve. This is of course a variant on the famous model of industrialization with surplus labor devised by Sir Arthur Lewis, the gloss being that whereas Sir Arthur advocated import substituting industrialization to mop up the surplus labour, DFG advocate export led growth instead. As an alternative this is clearly more efficient than the import substitution route to development and in fact was part of the Asian model which came to grief in the 1980s.

But DFG add an ingenious twist to explain Chinese policies. They claim that, given China’s high savings rates, though domestic capital formation to absorb the surplus labour would be possible, it would be inefficient as compared with getting multinationals to come in and build a capital stock which is competitive in world markets. But, as the capital inflow accompanying this direct foreign investment is not really needed, and if
absorbed would lead to a real exchange rate appreciation which would undermine exchange rate protection, the Chinese authorities sterilize these inflows and return them to the country of origin of the multinationals by buying their government bonds and holding them in their reserves. The additional benefit from following this strategy is that the multinationals become lobbyists for allowing Chinese imports into the developed countries against the understandable howls of their import competing industries.

Goldstein and Lardy (Financial Times, Mar. 4, 2005) have however questioned this interpretation of Chinese policies. They argue that more than half of China’s exports go to non-U.S. countries with currencies not pegged to the dollar; the Chinese real trade weighted real exchange rate appreciated by 30 percent between 1994 and early 2002 and then depreciated by 10 percent by end 2004, so keeping an undervalued real exchange rate is not Chinese policy; foreign investment has only financed 5 percent of fixed investment whose effects are swamped by the misallocation of investment flowing through China’s weak financial system; US companies investing in China export little back to the U.S. mainly servicing the domestic market, while the foreign investors from the Chinese diasporas who are the main exporters to the U.S. have little clout in keeping the U.S. market open to Chinese goods.

As I argued in my columns on the Chinese economic miracle, the Chinese exchange rate policy is not dictated by exchange rate protection, as by the fear of a severe financial crisis given its unreformed and extremely fragile financial system if it allows the yuan to float. The debauching of the Chinese financial system by the state enterprises will only end with the privatization or closure of these loss making enterprises. But now, there is also considerable international pressure on the Chinese to revalue the yuan, whilst the continuing sterilization of foreign currency inflows threatens a loss of monetary control.

So what is likely to come of the Japanese sponsored initiative for an Asian Monetary Fund and an Asian Bretton Woods? This seems to be a scheme hatched in cloud cuckoo land. Here are some of the obvious obstacles. First, like Bretton Woods the Asian exchange rate system would have to be tied to a key currency. If it is to be an Asian currency, it will have to be the yen. Would Asia and particularly China be willing to join a yen bloc? With the resurgent nationalist antipathy against the Japanese this
seems unlikely. Would the Chinese be willing to accumulate yen assets, providing unrequited capital inflows into Japan, as they have done with the US. This seems highly unlikely. Finally, if the new Asian Bretton Woods is to maintain a quasi fixed exchange rate regime as its parent did, it would be subject to the same threats of speculative attack which brought down the original Bretton Woods.

An immutably fixed regional exchange rate scheme like the Euro would not face this speculative threat to a quasi fixed exchange rate system. But the conditions for a currency union to work are very stringent. Even the Euro’s future is uncertain. As the recent travails of France and Germany have shown a common monetary policy in the Eurozone is a straitjacket which cannot deal with the asymmetric shocks which the component economies of the region face. The Euro was created by putting the cart of monetary union before the horse of political union. The attempt to create this political union through the new European constitution is a belated attempt to remedy this defect. But it remains to be seen if “Europe” is ready for such a political union.

While there might at least be a hope that a United States of Europe might emerge, it is entirely fanciful to even contemplate a United States of Asia. Only if such a behemoth was in the offing would a common currency of the union would be credible as the currency’s demise would be coterminus with that of the state issuing it. Lacking such a political union a currency union is only credible if it fulfils the conditions for an ‘optimum currency area’. Even less than Europe does Asia meet them. To deal with the unemployment that asymmetric shocks to different regions in the currency area could cause, there must be wage and price flexibility or else easy migration- as in th US- between regions with deficient and excess demand for labour. Moreover, there has to be some form of lid on expansionary fiscal policy as in the Euro zones’ stability pact to prevent profligate regions from running deficits financed by bonds issued in the common currency which then become a liability of the whole union. With regional unemployment unable to be tackled either via the exchange rate or expansionary fiscal policy, federal fiscal transfers on a requisite scale to tackle regional unemployment- as in a genuine federal polity like the US- are required. Merely to state these conditions should be enough to show the absurdity of the proposal for an Asian monetary union.
Just as East Asia is coming to realize that there is no alternative to what is derisively called the Anglo-American model of shareholder based capitalism, it is time they also came to realize that there is really no alternative to adopting freely floating exchange rates. What they need to do is to institute the domestic financial reforms which will allow flexible exchange rates to operate smoothly. These are lessons which India too needs to take to heart.