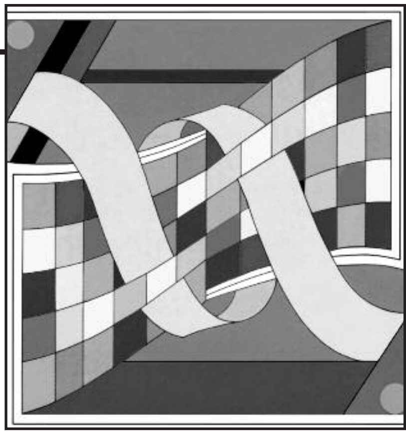

The Story of a Disillusion

BY MARTIN KESSLER

A review of
The Unloved Dollar Standard: From Bretton Woods to the Rise of China,
by **Ronald I. McKinnon,** Oxford University Press, 2012

Ronald McKinnon's book, *The Unloved Dollar Standard,* is the story of a disillusion. The post-Bretton Woods system backed by a dollar anchor freed from its gold link could have ensured global monetary stability—or so thought the author as a young economist in the late 1960s.

Forty years later, looking back at this period, McKinnon blames the repeated failures of the system on American policymakers who have systematically "bashed" other countries for their exchange rate policies instead of realizing their own monetary shortcomings. Overall, this stimulating book gives McKinnon scope to fully explain his iconoclastic arguments, some of which will already be familiar to readers of this magazine. While mainly a collection of shorter and longer already-published articles, *The Unloved Dollar Standard* reveals a story spanning from the demise of the Bretton Woods system to our paradoxical times, where dollar domination seems to linger stubbornly while many expect its decline in the face of Chinese ascension. The crux of McKinnon's argument is that given the dollar's role as the world's key currency, domestic policy mistakes have global consequences. A weakening dollar triggers "hot money" outflows to other countries—whether Europe or Japan in the 1970s or emerging market countries in the last decades. Faced with upward pressures on their exchange rates, countries resort to intervention and increase their dollar reserves, thus raising the domestic money supply—along with domestic inflation. In the end, according to McKinnon, inflation becomes global whether through the two oil shocks of the 1970s or the global commodity price bubble of 2007.

Why did the United States fail to play its role as guardian of the key world currency? Why did American policymakers repeatedly target a lower dollar, whether by directly intervening on the foreign exchange markets or by "talking it down"? McKinnon's main answer to that question is that economists and policymakers, worrying about growing trade deficits, held the wrong belief that correcting the exchange rate can play a role in adjusting the trade balance. Why is that? Following the so-called "absorption approach," the trade balance is first and foremost the result of saving and investment decisions—both of which could move in a different direction than desired by economists who call for correction of the exchange rate.

The three consequences for our post-crisis world are at odds with the usual discourse. First, because interest rate differentials trigger hot money flows to countries in the periphery, the United States should aim at closing this gap by raising the federal funds rate. Second, because an appreciation of the renminbi would do nothing to rebalance the external surplus, it is better for China to rely on the stability of a fixed exchange rate and resist international pressures to appreciate. And third, since global imbalances can

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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Washington, D.C. 20002
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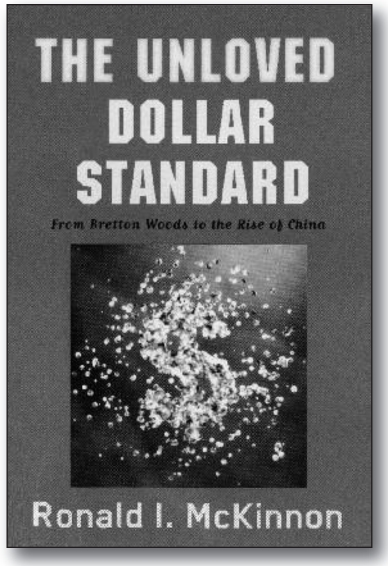
only be corrected by adjusting real variables, they need to be dealt with by tightening fiscal policy in the United States and easing it in China.

One does not have to be a hardcore Keynesian to wonder what the effect would be of such a demand shock on the U.S. economy. Real fixed investment is still below its pre-crisis level and consumption has barely recovered, while inflation lingers below 2 percent. While emerging markets do complain about "hot money" flows which hamper their competitiveness, controls on inflows and reserve accumulation are available tools. And, in particular, reserve accumulation as a temporary tool to balance capital inflows is very different in nature than reserve accumulation financed by a current account surplus. This latter case is a fully mercantilist strategy of subsidizing exports to accumulate reserves.

Let us focus on China's case. Fixing the exchange rate has allowed China to anchor credible inflation expectations—a key element in China's stable growth since the mid-1990s—and undervaluation led China to develop a strong export sector with high rates of productivity growth. This became problematic in 2005–2008, when the current account surplus soared. True, it was a period of nominal appreciation against the dollar, but the effective exchange rate appreciation was much smaller—barely making up for the 2002–2005 depreciation—because other currencies (the euro in particular) also appreciated during this period. Finally, in the period since the crisis until 2012, the renminbi continued its appreciation while the current account fell sharply, without any materialization of the wage stagnation feared by McKinnon. More importantly, while it is true that much of the adjustment of current account imbalances must come in part from real variables affecting the too-high saving ratio (such as demography, lack of safe domestic assets, and so forth), renminbi appreciation is a key variable in allowing the adjustment from an export-oriented economy to one oriented more toward consumption. Indeed, as explained by economist Paul Krugman in a 1990 article, a country that wishes to reduce its current account surplus by, say, 3 percent of GDP, should raise its consumption by a much larger amount, since most of this consumption will be geared towards goods produced at home. The complementary adjustment has to be done through prices, meaning the exchange rate. It might seem like a technical point, but it is at the core of the adjustment debate. Whether on the American or the Chinese side, the demand shock has to be accommodated by an appreciation of the renminbi. To compare, think about the north and south of Europe: a similar adjustment is happening between creditor and debtor countries, but the lack of exchange rate variation makes it even harder.



Given the dollar's role as the world's key currency, domestic policy mistakes have global consequences.

Last, while McKinnon insists on the steadying regional influence of China's exchange rate stability, it has also been a drag on the exports of other countries of a similar level of income. They are either forced to follow China's exchange rate policy and accept higher inflation levels, or are priced out of export markets in developed countries. As trade with China increases, countries have increasingly started to mimic the renminbi's exchange rate. This means that China has to adapt to its role as the largest world trader, creditor (in terms of official reserves, since Japan has a larger net foreign assets), and soon-to-be largest economy. In this sense, the view of China as an immature creditor needs to be updated. While McKinnon seems to think that the dollar standard, though unloved, is here to stay in the foreseeable future, China is taking steps toward an international renminbi, whether through swap lines to avoid the trade disruptions of possible dollar shortages, through partial opening of its capital markets, or steps toward international use of the renminbi in the offshore market. Recent reexaminations of the switch from the pound to the dollar as the key world currency show that the change happened rapidly after the United States became the main economic superpower. In this perspective, a floating renminbi is an essential step, and one that will have to happen in not-too-distant future in the reform process. ◆