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Book Review

Global Imbalances and the Lessons of Bretton Woods

Barry Eichengreen. 2010. Cambridge, Massachusetts: MIT Press

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In recent years, the role of the US dollar as the world's reserve-currency has been widely debated. The United States' increasing and massive budget deficits have raised serious concerns about the value of the dollar in the long-term. The deficit rose to 11 per cent of gross domestic product in 2009. It exceeds the reasonable level of 5 per cent. While countries like Russia, China, France, Japan, India, Brazil, South Korea, South Africa strongly support a new world reserve currency, countries like Saudi Arabia and other emerging economies defend the dollar as the world's main reserve currency.

Will the dollar be the dominant reserve currency in the future? Barry Eichengreen, a professor of economics and political science at the University of California, Berkeley, explores the issue in his book *Global Imbalances and the Lessons of Bretton Woods*. This book is divided into four chapters which are based on a series of Eichengreen's public lectures. The book offers a well-organised explanation and discussion with particular interest in global imbalances, the Bretton Woods system, today's international financial system, the collapse of the Gold Pool, revaluing China's yuan and the role of the dollar in the future. Although some of the discussions may not be easy to understand without some basic understanding of economic theory, the book is a good read.

In Chapter 1, Eichengreen rejects contemporary economists' view that equates today's monetary system to the Bretton Woods system in the past. In this view, the global imbalances (US balance of payments deficits and Asian balance of payments surpluses) have little pressure on the dollar. High demand for dollar assets from fast growing export-led growth nations will prevent the dollar from depreciating. Therefore, there is no need for any adjustment in the US current account deficit. In a nutshell, the dollar will still be a main reserve currency in a decade or two.

Eichengreen's view of the dollar is less optimistic. The stability of dollar is questionable. The dollar may not enjoy the dominant status as the world's reserve currency as in the several past decades. Today's world is different from that of the Bretton Woods system in 1944-1971. The members of periphery countries are larger and more heterogenous than in the 1960s (Europe and Japan). Integration in periphery economies is less advanced and regional cooperation (ASEAN+3, EMEAP and APEC) is more weakly institutionalised. Different stages of economic development and non-uniform policies make defining collective interest more difficult. Without collective action, the dollar receives less support.

The emergence of the euro as a close rival to the dollar provides foreign governments and central banks an option to diversify out of dollars to avoid capital losses. Also the creation of the Asian Bond Fund and the Asian Bond Market Initiative leaves some scope for reallocating reserve portfolios toward assets denominated in regional currencies. Another

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important development in recent years is the United States' growing current account deficit, which makes the country the world's largest debtor and raises fears for the dollar's stability. In contrast to the 1960s, capital outflows from the US reflected higher US saving rates with more favourable implications for debt sustainability.

In Chapter 2, *The Anatomy of the Gold Pool*, Eichengreen focuses on the experience of the Gold Pool (1961-1968), which he believes is crucial for understanding the Bretton Woods system but has been weakly documented. The Gold Pool was established to regulate the London price of gold and to stabilise the market. The Pool failed because it was difficult for each member country, in particular France, to resist the temptation to convert dollars into gold for an indefinite period. Based on the Gold Pool experience, Eichengreen explains why it is difficult to hold together the cartel of Asian central banks that support the dollar. Besides the lack of collective interest, opaqueness in the reserve-management policies of each of the central banks and absence of an enforcement mechanism complicates the task of holding together the cartel. Furthermore, the action of some major oil producing countries of converting more dollars into gold means more dollars must be absorbed by Asian central banks to prevent the dollar's fall. But, this action is costly and unlikely to be sustained. Eichengreen argues that gradually Asian countries are moving away from the model of an export-led growth economy supported by an undervalued exchange rate, with some countries more ready than others to adjust to a fall in the dollar in the future. However, the Gold Pool collapse does not suggest the early collapse of the Asian cartel of central banks that supports the dollars.

In Chapter 3, *How to Exit a Currency Peg: Japan and the End of the Bretton Woods System,* Eichengreen discusses the controversy over China's exchange rate policy, calls for yuan revaluation, and evaluates Japan's experience exiting the peg system in 1971. He argues that the revaluation must be undertaken carefully. Although Japan was more advanced than China is now, Japan's experience provides insight into China's monetary options today. Graphs, tables and regressions in this chapter are very well-explained and useful. However, the finding in Table 3 is based on spurious OLS regression estimation. For a series with a mixed order of integration, an estimation using ARDL would have provided more robust estimates. Similarly, the estimation in Table 3.8 would be have been more credible if Eichengreen had included diagnostic test checks for each of the regressions. Noteworthy also is Eichengreen's advocacy of yuan revaluation.

In Chapter 4, *Sterling's Past, Dollar's Future*, Eichengreen addresses the use of the sterling as a reserve currency in the past and its collapse. The discussion traces how the dollar became the dominant reserve-currency. Despite the global imbalances, the dollar is still the dominant reserve currency for the world. Nevertheless, he disagrees that there can only be one reserve currency at a given point in time. He sees the euro as the potential candidate in year 2020 or 2040 and rejects other currencies. Unfortunately, no recent data on the euro is given in this chapter to back his claim. The data in Table 4.2 only shows a small role for the euro in 2004. He explains that large current account deficits and rapidly growing net foreign debt threaten to undermine the dollar. Foreigners will grow reluctant to hold more dollars and dollar-denominated assets. However, he is optimistic that the US current account deficit can be brought under control. So far Eichengreen is right in his prediction. The dollar is continuously falling, with the fall apparently caused by high deficits in the US economy. Currently, the nation is expected to accumulate debt as much as USD14.3 trillion.

Meanwhile, China, Russia, Japan, France and Brazil have increasingly replaced the dollar with a basket of other currencies and gold.

It is worth noting that Eichengreen's discussions do not incorporate the recent crisis in the euro economy. Greece, Ireland, Spain and Portugal were badly affected by the recent global financial crisis 2007-2008 and required huge bailouts from the European Central Bank. This event has negative effects on the euro and has given rise to uncertainty in the euro in the future. Paul Krugman in the *New York Times Magazine*, 12 January 2011, argues that Europe is no different from the Unites States. Both suffered a severe slump in their economies from the recent global financial crisis. Both the United States and Britain have been running deficits, as a percentage of GDP, that are comparable to the deficits in Spain and Ireland. He is sceptical about the euro's future. Indeed, he does not believe the idea of a European single currency that will work as well as the dollar. Understanding this, Britain favours its freely floating national currency.

Eicheengreen is not alone in his assessment of the dollar's future. In a World Bank report, *Global Development Horizons 2011-Multipolarity: The New Global Economy*, the future international monetary system is predicted to be dominated by a multicurrency system or multipolar international currencies and the euro is the close rival to the dollar. However, the most likely currencies serving as the key international currency are the dollar, the euro and the yuan. This is based on the growing roles of the Unites States, the European countries and China as the major growth poles in 2025. The dollar is expected to lose its status as the dominant reserve currency by 2025 while the yuan will take a longer time to establish its position. Although it will take some time for China to reform its less-developed and restricted financial market, reform is inevitable, in particular to address the problem of currency mismatch. At present, some measures to internationalise the yuan have been introduced by Chinese authorities. The report is positive on the prospect for the euro. The European integration will lead to reforms that overcome the problems of sovereign debt crises of its member countries and moral hazard created by bailouts of heavily indebted governments. It rejects the SDR, a single multilateral reserve currency as the future international reserve currency due to the difficulty of achieving coordination to manage the reserve currency.

Basically, the book discusses the issues in a timely and insightful manner. It is compact and factual. It gives a neat and broad perspective on global imbalances, the Bretton Wood system, the dollar as the world's reserve currency and the yuan revaluation. The book is valuable to students, scholars and researchers in economics who want to know more about the current world economy.

However, the use of the endnote is too excessive and this distracts from the pleasure of reading the book. Referring to the endnotes very often interrupts the flow of the reading and sometimes the information is trivial, for example, the source of a reference. It would have been better if the source of reference had been cited in the discussion page. Also some of the explanations in the endnotes could have been better explained in the chapter. For example, the explanation in endnotes 59 to 76 would be more appropriate if explained in the chapter rather than as an endnote.

Some of the discussions are explained using long, complex sentences. This may confuse the reader who will require more time to understand the message. For example "the result was a commitment to the early restoration of current account convertibility, which occurred in Europe at the end of 1959 and in Japan several years later, but combined with authorisation to maintain controls on capital-account transactions for an indefinite period, which for some countries has meant up to the present day" (p.10). While, in another case, "Bretton Woods was a compromise between the gold standard of the late nineteenth and early twentieth centuries, in which each country pegged the domestic price of gold and left gold imports and exports unrestricted, and the post-1971 fiat-money system in which the dollar and other currencies stood in their own right, backed only by the resources of the issuing country and by investors' confidence in the determination and ability of its government to maintain the purchasing power of the monetary unit." (p.38)

Overall, aside from these minor blemishes, this is an interesting and informative book. It provides an important discussion of key concerns in the current economy. As such it is a must-read book for economics students, lecturers, bankers and policy makers.