Barry Eichengreen's Conference – Paris January 15th 2011

Presentation by Christophe Destais

In its General Theory, Keynes wrote "The importance of money flows from it being a link between the present and the future." (L'importance de la monnaie vient du fait qu'elle est un lien entre le present et le futur). Paraphrasing Keynes, I would say, the importance of historical studies of money and monetary policies flows from it being a link between the past and the future.

The subject sounds complex and it is. Yet, policy mistakes in the field of money and exchange rates, especially between the two world wars, had consequences that went far beyond anything one could imagine in terms of destructions of the economies and even the mankind itself.

Studying the history of money in depth is therefore not only a matter of knowledge but also an indispensable tool to understand what is going on in the present and avoid the future mistakes and their uncontrollable consequences.

Four years ago, what I just said might have sound out of touch to some ears. No more. The deep financial crisis we have been experiencing in the developed countries of the west refreshed the memories of those who thought that with the Great Moderation (a prolonged period of low inflation and growth nearing its potential level) monetary history had stopped.

Studying the history of money and drawing the lessons from the past for the present and the future, while at the same time integrating the specificities and the complexities of each period is a difficult task. Taking time to explain to generations of students, policy makers and the general public how this complex web of monetary and financial assets and liabilities, institutions and even individuals interacts is even more difficult. This is a challenge Barry Eichengreen has been taking for the past 30+ years, in my view with talent and persuasiveness. This is a challenge we are taking with him today.

Barry is Professor of Economics and Professor of Political Science at the University of California, Berkeley since 1987. He is also a Research Associate to two prestigious networks of economic researchers that are familiar in France only to economists: the National Bureau of Economic Research (Cambridge, Massachusetts) and the Centre for Economic Policy Research (London, England). In 1997-98, Barry was Senior Policy Advisor at the International Monetary Fund during the Asian crisis when expertise like his was badly needed by the Fund.

Barry is a prolific author. I will therefore mention none but a few books he wrote or co-authored or co-edited.

- *Golden Fetters* (le carcan en or), which identifies the gold standard as being the chief culprit for transmitting the economic depression around the world ;
- *Emerging Giants: China and India in the World Economy* ;
- *Globalizing Capital: A History of the International Monetary System* ;
- *The European Economy since 1945: Coordinated Capitalism and Beyond.*

And last, but not least, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* that we will mainly discuss today.

The talk will be divided into two. First, Agnes and myself will have a conversation with Barry that will last approximately 25 minutes. Then, the conversation will be extended to the audience.

Before this conversation starts, I would like to thank all our colleagues and friends who made it possible. First, and foremost, the University of Paris 1 and in particular its vice-president Mr. Pierre Charles Pradier who did everything he could so that its premises are opened to the public at a not so convenient time for those who work in this building. It tells us that French Universities can be flexible and responsive to opportunities. I also devote my thanks to the CEPII team which this week has organized not less than a two day conference with people from all over the world, two events opened to the public and two external seminars opened to the press, French companies and policymakers. I finally thank you the audience for showing up at a time that is more traditionally devoted to shopping, family business or meeting friends.

Barry Eichengreen

Barry Eichengreen is the George C. Pardee and Helen N. Pardee Professor of Economics and Professor of Political Science at the University of California, Berkeley, where he has taught since 1987. He is a Research Associate of the National Bureau of Economic Research (Cambridge, Massachusetts) and Research Fellow of the Centre for Economic Policy Research (London, England). In 1997-98 he was Senior Policy Advisor at the International Monetary Fund. He is a fellow of the American Academy of Arts and Sciences (class of 1997).

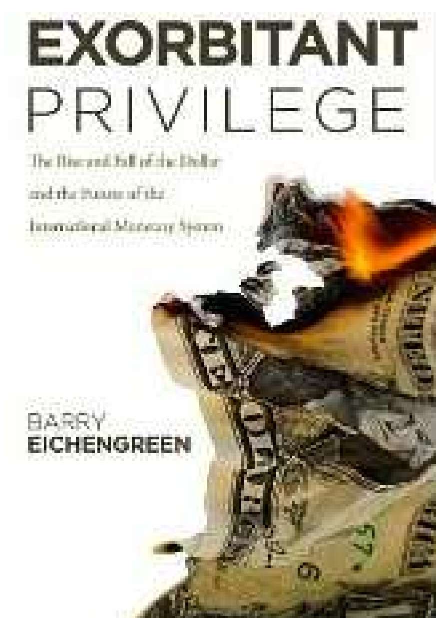
Professor Eichengreen is the convener of the Bellagio Group of academics and economic officials and chair of the Academic Advisory Committee of the Peterson Institute of International Economics. He has held Guggenheim and Fulbright Fellowships and has been a fellow of the Center for Advanced Study in the Behavioral Sciences (Palo Alto) and the Institute for Advanced Study (Berlin). He is a regular monthly columnist for Project Syndicate.

His most recent books are *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (forthcoming January 2011), *Emerging Giants: China and India in the World Economy*, co-edited with Poonam Gupta and Ranjiv Kumar (2010), *Labor in the Era of Globalization*, co-edited with Clair Brown and Michael Reich (2009), and *Fostering Monetary & Financial Cooperation in East Asia*, co-edited with Duck-Koo Chung (2009). Other books include *What G20 Leaders Must Do to Stabilize Our Economy and Fix the Financial System,* coedited with Richard Baldwin,(e-book 2008), *Rescuing Our Jobs and Savings: What G7/8 Leaders Can Do to Solve the Global Credit Crisis,* coedited with Richard Baldwin,(e-book 2008), *Globalizing Capital: A History of the International Monetary System*, Second Edition (2008), *The European Economy since 1945: Coordinated Capitalism and Beyond* (updated paperback edition, 2008), *Bond Markets in Latin America: On the Verge of a Big Bang?*, co-edited with Eduardo Borensztein, Kevin Cowan, and Ugo Panizza (2008), and *China, Asia, and the New World Economy*, co-edited with Charles Wyplosz and Yung Chul Park (2008).

Professor Eichengreen was awarded the Economic History Association's Jonathan R.T. Hughes Prize for Excellence in Teaching in 2002 and the University of California at Berkeley Social Science Division's Distinguished Teaching Award in 2004. He is the recipient of a *doctor honoris causa* from the American University in Paris, and the 2010 recipient of the Schumpeter Prize from the International Schumpeter Society. He is President of the Economic History Association in the 2010-11 academic year.

EXORBITANT PRIVILEGE

**The Rise and Fall of the Dollar
and the Future of the
International Monetary System**



For more than half a century, the U.S. dollar has been not just America's currency but the world's. It is used globally by importers, exporters, investors, governments and central banks alike. Nearly three-quarters of all $100 bills circulate outside the United States. The dollar holdings of the Chinese government alone come to more than $1,000 per Chinese resident.

This dependence on dollars, by banks, corporations and governments around the world, is a source of strength for the United States. It is, as a critic of U.S. policies once put it, America's "exorbitant privilege." However, recent events have raised concerns that this soon may be a privilege lost. Among these have been the effects of the financial crisis and the Great Recession: high unemployment, record federal deficits, and financial distress. In addition there is the rise of challengers like the euro and China's renminbi. Some say that the dollar may soon cease to be the world's standard currency--which would depress American living standards and weaken the country's international influence.

In *Exorbitant Privilege,* one of our foremost economists, Barry Eichengreen, traces the rise of the dollar to international prominence over the course of the 20th century. He shows how the greenback dominated internationally in the second half of the century for the same reasons--and in the same way--that the United States dominated the global economy. But now, with the rise of China, India, Brazil and other emerging economies, America no longer towers over the global economy. It follows, Eichengreen argues, that the dollar will not be as dominant. But this does not mean that the coming changes will necessarily be sudden and dire--or that the dollar is doomed to lose its international status. Challenging the presumption that there is room for only one true global currency--either the dollar or something else--Eichengreen shows that several currencies have shared this international role over long periods. What was true in the distant past will be true, once again, in the not-too-distant future.

The dollar will lose its international currency status, Eichengreen warns, only if the United States repeats the mistakes that led to the financial crisis and only if it fails to put its fiscal and financial house in order. The greenback's fate hinges, in other words, not on the actions of the Chinese government but on economic policy decisions here in the United States.

Incisive, challenging and iconoclastic, *Exorbitant Privilege* is a fascinating analysis of the changes that lie ahead. It is a challenge, equally, to those who warn that the dollar is doomed and to those who regard its continuing dominance as inevitable.

Features

- Definitive history of the dollar's rise and potential fall in modern times by a pre-eminent economist
- Penetrating account of the global financial crisis's impact on currencies around the world
- Analyzes the prospects for American economic power in a reshaped global economy in the coming years
- Explains in accessible prose how the international currency system works

Reviews

"*Exorbitant Privilege* is a book for anyone who has been perplexed why, despite the frequent predictions of the dollar's demise over the last fifty years, it has managed to maintain its position as the world's pre-eminent reserve currency. The book includes both a lively historical account of the dollar's role in the international monetary system and an incisive and balanced discussion of future challenges."--Liaquat Ahamed, author of *Lords of Finance*

"When everyone from Brazil's leader to Sarah Palin questions the dollar's status as a reserve currency, it is time for an expert to sort out the truth from the hyperbole. Barry Eichengreen performs this service with unwavering clarity."--Sebastian Mallaby, Council on Foreign Relations

"Professor Eichengreen has written a truly superb book on the role and global standing of the dollar--past, present and future. Those exposed to the evolution of the globally economy, and that's virtually all of us, will find his book extremely thoughtful and a great read."--Mohamed El-Erian, CEO and co-CIO of PIMCO

"Eichengreen is the master of international money in history and its troubles. *Exorbitant Privilege* is a fine account of whence it came and a judicious survey of where it might go."--James K. Galbraith, author of *The Predator State: How Conservatives Abandoned the Free Market and Why Liberals Should Too*

"Barry Eichengreen again demonstrates his ability to integrate economic history and theory with political analysis in order to illuminate the critical issues of international finance. The timely and accessible book is must reading for all concerned with the prospective balance of international power--financial, economic and political--in a multi-polar world."--William H. Janeway, Warburg Pincus

"Barry Eichengreen's book couldn't be more timely . . . Elegant and pithy."--*Finance & Development* , IMF.org

About the Author(s)

Barry Eichengreen is Professor of Political Science and Economics at the University of California, Berkeley. His previous books include *The European Economy Since 1945, Global Imbalances and the Lessons of Bretton Woods, Capital Flows and Crises* , and *Financial Crises and What to Do About Them* . He has written for the *Financial Times, Wall Street Journal, Foreign Affairs* , and other publications.

The Dollar: Dominant no more?

Barry Eichengreen © voxEU.org
10 January 2011

The dollar's key role in international markets is once again in the spotlight. This column introduces a new book by Barry Eichengreen: Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System. As the author puts it, "If you were worried by talk of currency war late last year, you ain't seen nothin' yet."

If the euro's crisis has a silver lining, it is that it has diverted attention away from risks to the dollar. It was not that long ago that confident observers were all predicting that the dollar was about to lose its "exorbitant privilege" as the leading international currency. First there was financial crisis, born and bred in the US. Then there was the second wave for quantitative easing, which seemed designed to drive down the dollar on foreign exchange markets. All this made the dollar's loss of pre-eminence seem inevitable.

The tables have turned. Now it is Europe that has deep economic and financial problems. Now it is the European Central Bank that seems certain to have to ramp up its bond-buying program. Now it is the Eurozone where political gridlock prevents policymakers from resolving the problem.

In the US meanwhile, we have the extension of the Bush tax cuts together with payroll tax reductions, which amount to a further extension of the expiring fiscal stimulus. This tax "compromise", as it is known, has led economists to up their forecasts of US growth in 2011 from 3% to 4%. In Europe, meanwhile, where fiscal austerity is all the rage, these kind of upward revisions are exceedingly unlikely.

All this means that the dollar will be stronger than expected, the euro weaker. China may haves made political noises about purchasing Irish and Spanish bonds, but which currency – the euro or the dollar – do you think prudent central banks will it find more attractive to hold?

What about the alternatives?

There are of course a variety of smaller economies whose currencies are likely to be attractive to foreign investors, both public and private, from the Canadian loonie and Australian dollar to the Brazilian real and Indian rupee. But the bond markets of countries like Canada and Australia are too small for their currencies to ever play more than a modest role in international portfolios.

Brazilian and Indian markets are potentially larger. But these countries worry about what significant foreign purchases of their securities would mean for their export competitiveness. They worry about the implications of foreign capital inflows for inflation and asset bubbles. India therefore retains capital controls which limit the access of foreign investors to its markets, in turn limiting the attractiveness of its currency for international use. Brazil meanwhile has tripled its pre-existing tax on foreign purchases of its securities. Other emerging markets have moved in the same direction.

China is in the same boat. Ten years from now the renminbi is likely to be a major player in the international domain. But for now capital controls limit its attractiveness as an investment vehicle and an international currency. Yet this has not prevented the Malaysian central bank from adding Chinese bonds to its foreign reserves. Nor has it prevented companies like McDonald's and Caterpillar from issuing renminbi-denominated bonds to finance their Chinese operations. But China will have to move significantly further in opening its financial markets, enhancing their liquidity, and strengthening rule of law before its currency comes into widespread international use.

So the dollar is here to stay, more likely than not, if only for want of an alternative.

With exorbitant privilege comes exorbitant responsibility

The one thing that could jeopardise the dollar's dominance would be significant economic mismanagement in the US. And significant economic mismanagement is not something that can be ruled out.

The Congress and Administration have shown no willingness to take the hard decisions needed to close the budget gap. The Republicans have made themselves the party of no new taxes and mythical spending cuts. The Democrats are unable to articulate an alternative. 2011 will see another $1 trillion deficit. It is hard to imagine that 2012, an election year, will be any different. And the situation only deteriorates after that as the baby boomers retire and health care and pension costs explode.

We know just how these kind of fiscal crises play out, Europe having graciously reminded us. Previously sanguine investors wake up one morning to the fact that holding dollars is risky. They fear that the US government, unable to square the budgetary circle, will impose a withholding tax on treasury bond interest – on treasury bond interest to foreigners in particular. Bond spreads will shoot up. The dollar will tank with the rush out of the greenback.

The impact on the international system would not be pretty. The Canadian and Australian dollar exchange rates would shoot through the roof. A suddenly strong euro would nip Europe's recovery in the bid and plunge its economy back into turmoil. Emerging markets like China, reluctant to see their exchange rates move, would see a sharp acceleration of inflation and respond with even more distortionary controls.

With exorbitant privilege comes exorbitant responsibility. Responsibility for preventing the international monetary and financial system from descending into chaos rests with the US. How much time does it have? Currency crises generally occur right before or after elections. Can you say November 2012?

Editor's note: This first appeared on the Oxford University Press Authors' Blog. Reposted with permission.

Fetters of gold and paper

Barry Eichengreen Peter Temin 30 July 2010 © voxEU.org

The world economy is experiencing tensions arising from inflexible exchange rates – particularly the dollar-renminbi peg and the Eurozone. Drawing on lessons from the gold standard, this column points out that an international monetary system is a system – nations' policies have spillovers. Now, as in the 1930s, surplus nations' refusals to increase spending force deficit countries to contract. Keynes drew this lesson from the Great Depression, which is why he wanted measures to deal with chronic surplus countries. Sixty-plus years later, we seem to have forgotten his point.

The lessons-of-the-1930s marketplace has become highly competitive in recent years (see for example Mason and Mitchener 2010, Fishback 2010, and Helbling 2009). Our own entry focuses on the role of pegged exchange rates in propagating the financial crisis and on the lessons of experience under the gold standard.

That the gold standard played an important role in the global crisis of the 1930s is an idea in which we both have a stake (Temin 1989, Eichengreen 1992). The gold standard was characterised by the free flow of gold between countries, fixed values of national currencies in terms of gold, and the absence of an international coordinating organisation.

These arrangements implied that there was an asymmetry between countries with balance-of-payments deficits and surpluses. There was a penalty for running out of reserves and being unable to maintain the fixed value of the currency, but no penalty (aside from foregone interest) for accumulating gold. The adjustment mechanism for deficit countries, under normal circumstances, was deflation rather than devaluation.

The result was that the surplus countries, the US and France, sucked gold and foreign reserves out of the deficit countries, Germany and the UK, all through the 1920s. While there was no pressure for the former to reflate, there was increasingly intense pressure for the latter to deflate.

The gold standard is ideology

But the gold standard was not just a monetary arrangement. It was also an ideology. Depression-era choices were made according to a worldview in which maintenance of the gold standard was the primary prerequisite for prosperity. Policies were therefore formulated to preserve the gold standard, not to stabilise output and employment. Central bankers thought that maintaining the gold standard would restore employment, while attempts to increase employment directly would fail. The collapse of output and prices and the loss of savings as banks closed in the early 1930s were precisely what the gold standard promised to prevent.
Reconciling outcomes with expectations consequently required interpreting these exceptional events in unexceptional terms. Where the crisis was most severe, blame was laid on the authorities' failure to embrace the gold-standard *mentalité*. The Federal Reserve and the Bank of England, it was alleged, succumbed to the lure of managed money. Having refused to obey the rules of gold standard, they committed abuses of credit, sterilised international gold flows, and prevented them from exerting their normal stabilising influence on credit conditions. This in turn prevented prices and costs from adjusting.

In the deflationary circumstances of the time, this was precisely the wrong way of thinking about the problem.

The 21st century analogues – the euro and the dollar-renminbi peg – are not identical, but the parallels are there.

Eurozone commitment: Harder than gold

Adopting the euro is, if anything, an even harder commitment than gold. Countries could leave the gold standard during crises without enraging investors, but countries cannot temporarily abandon the euro in times of crisis (Eichengreen 2007, Blejer and Levy-Yeyatia 2010), proposals for Greece to take a euro-holiday notwithstanding (Feldstein 2010).

But the Eurozone did not simply follow the gold standard; it also followed Bretton Woods. The importance of this lays not so much in the Bretton Woods system itself as the negotiations leading up to it. Keynes, one of the key negotiators, had come to realise the pernicious influence of the gold standard as it operated in the interwar years. He acknowledged that deflating in response to a loss of reserves, under already deflationary circumstances, was harmful not only for the initiating country but also its neighbours.

His plan for avoiding this outcome in the post-war world was that surplus countries would be obliged to curtail their imbalances just as deficit countries were obliged to curtail theirs. Keynes's plan did not come to fruition because of a disagreement between the US and Britain. But that the question was unresolved is no excuse for forgetting it now.

Dollar-renminbi peg as ideology

The other important exchange rate, the dollar-renminbi peg, is best thought of in terms of the ideology of Chinese development policy. The role of the peg is three-fold:

- to facilitate the export of manufactures,
- to ease the decisions of foreign companies contemplating investment in China,
- and to enlarge the earnings of Chinese enterprises that are the main source of savings for infrastructure investment.

As in the 1920s, there is some awareness that policies in the countries linked together by this regime have implications for the other participants, but there is also little willingness to act on that awareness. In 2006 the IMF arranged a Multilateral Consultation with the goal of encouraging them to take those cross-border implications into account. The US and China meet annually in a bilateral Strategic and Economic Dialogue. The IMF conducts regular multilateral surveillance exercises. But few consequential policy adjustments are evident.

The point of this discussion is not to let deficit countries – Germany in the context of the gold standard, Greece in the context of the euro, the US in the case of global imbalances – off the hook. All three were reluctant to acknowledge that they faced budget constraints. All three lived beyond their means, running budget and current-account deficits and financing them by borrowing abroad.

But there is another side of this coin – the policies of the surplus countries. In the 1920s and early 1930s, the difficulties of Germany and other Central European countries were greatly

aggravated by policies of gold sterilisation by the US and France. With these countries in balance-of-payments surplus, someone else had to be in deficit. With their refusal to expand, someone else had to contract. With their refusal to extend emergency financial assistance, the extent of the contraction to which the deficit countries were subject intensified. The political consequences proved disastrous.

A similar process is currently underway. Greece trades with Germany, which has a strong surplus. With Germany reluctant to raise spending, a cash-strapped Greece has no alternative but to deflate. Whether it can cut spending by 10 % of GDP in short order remains to be seen. Greece's problem now, like Germany's in the early 1930s, is that cutting costs only makes the burden of indebtedness heavier.

1931 German debt moratorium: Greek debt restructuring 2010?

This is why even US President Hoover was ultimately forced to recognise the need for a German debt moratorium. And it is why internal devaluation, the only form of devaluation available to Greece, will require restructuring its debts. Just as the Hoover Moratorium required a change in policy by the US, a Greek restructuring will require a change of heart by the EU and IMF.

Similarly, in the absence of China and other countries boosting their spending and allowing their currencies to rise faster against the dollar, the only way for the US to grow employment is by making its exports more competitive. President Obama's goal of doubling US exports within five years is designed to map this route to full employment. But absent an adjustment in the real exchange rate, delivered by more spending and either nominal currency appreciation or inflation in Asia, this will have to be done by cutting costs or miraculously raising productivity. The failure of efforts to do so would open the door to a protectionist backlash.

Conclusions

The point is that an international monetary system is to be a *system* in which countries on both sides of the exchange rate contribute to its smooth operation. Actions by surplus countries, and not just their deficit counterparts, have systemic implications. They cannot realistically assign all responsibility for adjustment to their deficit counterparts.
Keynes drew this lesson from the Great Depression. It was why he wanted measures to deal with chronic surplus countries in the international monetary plan he developed during World War II. Sixty-plus years later, we seem to have forgotten his point.

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Europe's Inevitable Haircut

Barry Eichengreen © Project Syndicate
2010-12-09

BERKELEY - What once could be dismissed as simply a Greek crisis, or simply a Greek and Irish crisis, is now clearly a eurozone crisis. Resolving that crisis is both easier and more difficult than is commonly supposed.

The economics is really quite simple. Greece has a budget problem. Ireland has a banking problem. Portugal has a private-debt problem. Spain has a combination of all three. But, while the specifics differ, the implications are the same: all must now endure excruciatingly painful spending cuts.

The standard way to buffer the effects of austerity is to marry domestic cuts to devaluation of the currency. Devaluation renders exports more competitive, thus substituting external demand for the domestic demand that is being compressed.

But, since none of these countries has a national currency to devalue, they must substitute internal devaluation for external devaluation. They have to cut wages, pensions, and other costs in order to achieve the same gain in competitiveness needed to substitute external demand for internal demand.

The crisis countries have, in fact, shown remarkable resolve in implementing painful cuts. But one economic variable has not adjusted with the others: public and private debt. The value of inherited government debts remains intact, and, aside from a handful of obligations to so-called junior creditors, bank debts also remain untouched.

This simple fact creates a fundamental contradiction for the internal devaluation strategy: the more that countries reduce wages and costs, the heavier their inherited debt loads become. And, as debt burdens become heavier, public spending must be cut further and taxes increased to service the government's debt and that of its wards, like the banks. This, in turn, creates the need for more internal devaluation, further heightening the debt burden, and so on, in a vicious spiral downward into depression.

So, if internal devaluation is to work, the value of debts, where they already represent a heavy burden, must be reduced. Government debt must be restructured. Bank debts have to be converted into equity and, where banks are insolvent, written off. Mortgage debts, too, must be written down.

Policymakers are understandably reluctant to go down this road. Contracts are sacrosanct. Governments fear that they will lose credibility with financial markets. Where their obligations are held by foreigners, and by foreign banks in particular, writing them down may only destabilize other countries.

These are reasonable objections, but they should not be allowed to lead to unreasonable

conclusions. The alternatives on offer are internal and external devaluation. European leaders must choose which one it will be. They are united in ruling out external devaluation. But internal devaluation requires debt restructuring. To deny this is both unreasonable and illogical.

The mechanics of debt restructuring are straightforward. Governments can offer a menu of new bonds worth some fraction of the value of their existing obligations. Bondholders can be given a choice between par bonds with a face value equal to their existing bonds but a longer maturity and lower interest rate, and discount bonds with a shorter maturity and higher interest rate but a face value that is a fraction of existing bonds' face value.

This is not rocket science. It has been done before. But there are three prerequisites for success.

First, bondholders will need to be reassured that their new bonds are secure. Someone has to guarantee that they are adequately collateralized. When Latin American debt was restructured in the 1980's under the Brady Plan, these "sweeteners" were provided by the United States Treasury. This time around, the International Monetary Fund [C1] and the German government should fill that role.

Second, countries must move together. Otherwise, one country's restructuring will heighten expectations that others will follow, giving rise to contagion.

Finally, banks that take losses as a result of these restructurings will need to have their balance sheets reinforced. The banks need real stress tests, not the official confidence game carried out earlier this year. Where realistic debt-restructuring scenarios indicate capital shortfalls, across-the-board conversion of bank debt into equity will be necessary. And where this does not suffice, banks will need immediate capital injections by their governments.

Again, making this work requires European countries to move together. And, with banks' balance sheets having been strengthened, it will be possible to restructure mortgage debts, bank debts, and other private-sector debts without destabilizing financial systems.[C2]

Now we get to the hard part. All of this requires leadership. German leaders must acknowledge that their country's banks are dangerously exposed to the debts of the eurozone periphery. They must convince their constituents that using public money to provide sweeteners for debt restructuring and to recapitalize the banks is essential to the internal devaluation strategy that they insist their neighbors follow.

In short, Europe's leaders - and German leaders above all - must make the case that the alternative is too dire to contemplate. Because it is.

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