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Debt Man Walking: The US, China, Japan and the Foundations for a New Bretton Woods [Updated]

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What are the links among Japan, China and the United States that will shape the outcomes of the current economic and financial crisis that appears to have metastasized into a global crisis of the whole postwar international order? Because that order rests heavily on Asian export-led export growth strategies and the transfer of massive Chinese and Japanese trade surpluses that support the dollar's role as the universal currency, any solution for the US and the international order will require the cooperation of the two Asian economic powers. John Judis looks far beyond the US treasury bailouts to offer thoughtful perspectives on the crisis and its resolution. MS

Economists know the fatal flaw in our system--but they can't agree how to fix it.

For those Americans who are not daily readers of the Financial Times, the past few months have been a crash course in the abstract and obscure instruments and arrangements that have derailed the nation's economy. From mortgage-backed securities to credit default swaps, the financial health of the country has undergone a gory public dissection. And yet, as Barack Obama prepares to take office, one particularly frightening problem has escaped public notice; indeed, it may not even make the agenda of the global summit being held this weekend, dubbed "Bretton Woods II" after the postwar system of currency controls. The international monetary system is in big trouble.

The stock market in free fall in October-November, 2008

For decades, the United States has relied on a tortuous financial arrangement that knits together its economy with those of China and Japan. This informal system has allowed Asian countries to run huge export surpluses with the United States, while allowing the United States to run huge budget deficits without having to raise interest rates or taxes, and to run huge trade deficits without abruptly depreciating its currency. I couldn't find a single instance of Obama discussing this issue, but it has been an obsession of bankers, international economists, and high officials like Federal Reserve Chairman Ben Bernanke. They think this informal system contributed to today's financial crisis. Worse, they fear that its breakdown could turn the looming downturn into something resembling the global depression of the 1930s.

The original Bretton Woods system dates from a conference at a New Hampshire resort hotel in July 1944. Leading British and American economists blamed the Great Depression and, to some extent, World War II on the breakup of the international monetary system in the early 1930s and were determined to create a more stable arrangement in which the dollar would replace the British pound as the accepted global currency. The new system, devised by economists Harry Dexter White and John Maynard Keynes, fixed the dollar's value at $35 for an ounce of gold. National governments, rather than speculators, were to set the value of their currencies in relation to the dollar and would have to disclose any changes in advance to the new International Monetary Fund (IMF).

Site of the Bretton Woods conference

The dollar became the accepted medium of international exchange and a universal reserve currency. If countries accumulated more dollars than they could possibly use, they could always exchange them with the United States for gold. But, with the United States consistently running a large trade surplus--meaning that countries always needed to have dollars on hand to buy American goods--there was initially little danger of a run on the U.S. gold depository.

Bretton Woods began to totter during the Vietnam war, when the United States was sending billions of dollars abroad to finance the war and running a trade deficit while deficit spending at home sparked inflation in an overheated economy. Countries began trying to swap overvalued dollars for deutschmarks, and France and Britain prepared to cash in their excess dollars at Fort Knox. In response, President Richard Nixon first closed the gold window and then demanded that Western Europe and Japan agree to new exchange rates, whereby the dollar would be worth less gold, and the yen and the deutschmark would be worth more relative to the dollar. That would make U.S. exports cheaper and Japanese and West German imports more expensive, easing the trade imbalance and stabilizing the dollar.

By imposing a temporary tariff, Nixon succeeded in forcing these countries to revalue, but not in creating a new system of stable exchange rates. Instead, the values of the currencies began to fluctuate. And, as inflation soared in the late 1970s, the system, which still relied on the dollar as the universal currency, seemed ready to explode into feuding currencies.

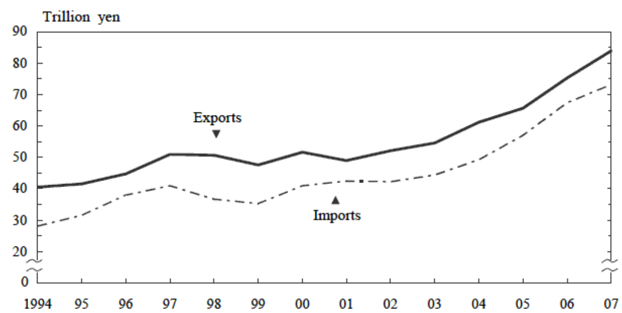
That's when a new monetary arrangement began to emerge. Economists often refer to it as "Bretton Woods II"--not to be confused with the name given this weekend's gathering--but it was not the result of a conference or concerted agreement among the world's major economic powers. Instead, it evolved out of a set of individual decisions--first by the United States, Japan, and Saudi Arabia, and later by the United States and other Asian countries, notably China.

Bretton Woods II took shape during Ronald Reagan's first term. To combat inflation, Paul Volcker, the chairman of the Federal Reserve, jacked interest rates above 20 percent. That precipitated a steep recession--unemployment exceeded 10 percent in the fall of 1982--and large budget deficits as government expenditures grew faster than tax revenues. The value of the dollar also rose as other countries took advantage of high U.S. interest rates. That jeopardized U.S. exports, and the U.S. trade deficit grew even larger, as Americans began importing under priced goods from abroad while foreigners shied away from newly expensive U.S. products. The Reagan administration faced a no- win situation: Try reducing the trade deficit by reducing the budget deficit, and you'd stifle growth; but try stimulating the economy by increasing the deficit, and you'd have to keep interest rates high in order to sell an adequate amount of Treasury debt, which would also stifle growth. At that point, Japan, along with Saudi Arabia and other OPEC nations, came to the rescue.

At the end of World War II, Japan had adopted a strategy of economic growth that sacrificed domestic consumption in order to accumulate surpluses that it could invest in export industries--initially labor-intensive industries like textiles, but later capital-intensive industries like automobiles and steel. This export-led approach was helped in the 1960s by an undervalued yen, but, after the collapse of Bretton Woods, Japan was threatened by a cheaper dollar. To keep exports high, Japan intentionally held down the yen's value by carefully controlling the disposition of the dollars it reaped from its trade surplus with the United States. Instead of using these to purchase goods or to invest in the Japanese economy or to exchange for yen, it began to recycle them back to the United States by purchasing companies, real estate, and, above all, Treasury debt.

That investment in Treasury bills, bonds, and notes--coupled with similar purchases by the Saudis and other oil producers, who needed to park their petrodollars somewhere--freed the United States from its economic quandary. With Japan's purchases, the United States would not have to keep interest rates high in order to attract buyers to Treasury securities, and it wouldn't have to raise taxes in order to reduce the deficit. As far as historians know, Japanese and American leaders never explicitly agreed that Tokyo would finance the U.S. deficit or that Washington would allow Japan to maintain an undervalued yen and a large trade surplus. But the informal bargain--described brilliantly in R. Taggart Murphy's The Weight of the Yen--became the cornerstone of a new international economic arrangement.

Figure 11.1
Foreign Trade



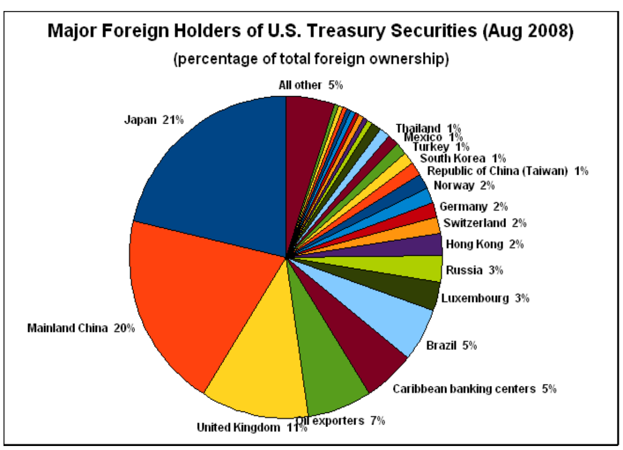
Source: Ministry of Finance.

Japan’s trade surplus

Over the last 20 years, the basic structure of Bretton Woods II has endured, but new players have entered the game. As Financial Times columnist Martin Wolf recounts in his new book, Fixing Global Finance, Asian countries, led by China, adopted a version of Japan's strategy for export-led growth in the mid-'90s after the financial crises that wracked the continent. They maintained trade surpluses with the United States; and, instead of exchanging their dollars for their own currencies or investing them internally, they, like the Japanese, recycled them into T-bills and other dollar-denominated assets. This kept the value of their currencies low in relation to the dollar and perpetuated the trade surplus by which they acquired the dollars in the first place. By June 2008, China held more than $500 billion in U.S. Treasury debt, second only to Japan. East Asia's central banks had become the post-Bretton Woods equivalent of Fort Knox.

Until recently, there have been clear upsides to this bargain for the United States: the avoidance of tax increases, growing wealth at the top of the income ladder, and preservation of the dollar as the international currency. Without Bretton Woods II, it is difficult to imagine the United States being able to wage wars in Iraq and Afghanistan while simultaneously cutting taxes. For their part, China and other Asian countries enjoyed almost a decade free of financial crises; and the world economy benefited from low transaction costs and relative price stability from having a single currency that countries could use to buy and sell goods.

But there have been downsides to Bretton Woods II. Often noted was how the accumulation of dollars in foreign hands--particularly those of a potential adversary like China--threatens America's freedom of action. A hostile nation could blackmail the United States by threatening to cash in its dollars. Of course, if a nation like China actually began to unload its dollars, it would jeopardize its own financial standing as much as it would jeopardize America's. But economists Brad Setser and Nouriel Roubini argue that even the implicit threat of dumping dollars--or of ceasing to purchase them--could limit U.S. maneuverability abroad. "The ability to send a 'sell' order that roils markets may not give China a veto over U.S. foreign policy, but it surely does increase the cost of any U.S. policy that China opposes," they write.



China's and Japan's holdings of US treasuries

To date, however, that strategic impact has been chiefly theoretical. The more tangible drawbacks of Bretton Woods II have been social and economic. Bretton Woods II has perpetuated the U.S. trade deficit, particularly in manufactured goods. Forced to compete against foreign products kept cheap not only by low wages abroad but by the dollar's high value, U.S. manufacturers have had little incentive to expand or even retain their operations in the United States. Since the early '80s, the United States has lost about five million manufacturing jobs. True, the United States has gained some highly skilled manufacturing jobs, but most of the lost jobs have been replaced by low- wage service sector employment. This has been a factor in creating a U.S. workforce with an overpaid financial sector at one extreme and a sprawling low-wage service sector at the other.

In Japan, China, and other Asian countries, there has been a similar downside to the grand bargain. The surplus dollars gained from trade with the United States have not been used to raise the standard of living, but rather have been squirreled away in Treasury securities--"sterilized" is the technical term. Writes Wolf, "China has about 800 million poor people, yet the country now consumes less than half of GDP and exports capital to the rest of the world. " In an odd way, the contrast between the concentration of new wealth in China's coastal cities and the grating poverty of its countryside has mirrored the contrast between the lavish lifestyle of the Wall Street wizard and the plight of immigrant and illegal-immigrant workers in America's barrios.

Of more immediate concern, Bretton Woods II contributed to the current financial crisis by facilitating the low interest rates that fueled the housing bubble. Here's how it happened: In 2001, the United States suffered a mild recession largely as a result of overcapacity in the telecom and computer industries. The recession would have been much more severe, but, because foreigners were willing to buy Treasury debt, the Bush administration was able to cut taxes and increase spending even as the Federal Reserve lowered interest rates to 1 percent. The economy barely recovered over the next four years. Businesses, still worried about overcapacity, remained reluctant to invest. Instead, they paid down debt, purchased their own stock, and held cash. Banks and other financial institutions, wary of the stock market since the dot-com bubble burst, invested in mortgage-backed securities and other derivatives.

The anemic economic recovery was driven by growth in consumer spending. Real wages actually fell, but consumers increasingly went into debt, spending more than they earned. Encouraged by low interest rates--along with the new subprime deals--consumers bought houses, driving up their prices. The "wealth effect" created by these housing purchases further sustained consumer demand and led to a housing bubble. When housing prices began to fall, the bubble burst, and consumer demand and corporate investment ground to a halt. The financial panic quickly spread not only from mortgage-backed securities to other kinds of derivatives but also from the United States to other countries, chiefly in Europe, that had purchased these American financial products.

And that's not all. As American demand for Chinese exports has stopped growing, China's economy has begun to suffer. Roubini has argued that, if China's export-dependent growth drops from 12 percent to 5 or 6 percent per year, China will be unable to provide jobs to the 24 million new workers that join the labor force each year. China would experience the equivalent of a recession, with repercussions throughout Asia. More importantly for the United States, China would no longer have the surplus dollars to prop up the market for U.S. Treasury bills. The Obama administration could, of course, reduce its dependence on China by reducing the budget deficit, but doing that now would deepen the recession, as well as preventing the new president from pursuing many of his domestic initiatives.

China faces rising unemployment

The consequences could be even more dire. In the past, countries in recession could count on countries with growing economies to provide outlets for their exports and investments. The hope this time is that economic growth in Asia and particularly China can backstop a U.S. and European recession. But, as a result of Bretton Woods II, prosperity in the United States is intertwined with prosperity in Asia. China depends on exports to the United States, and the United States depends on capital from China. If that special economic relationship breaks down, as it seems to be doing, it could lead to a global recession that could morph into the first depression since the 1930s.

G-20 leaders meet to repair the global financial order

Economists and Treasury officials might dispute specific parts of this analysis, but the bulk of it is neither original nor controversial. For the last three years, if not longer, Bernanke, former Treasury secretary Larry Summers, Roubini, Setser, Wolf, and other economists have been making similar points. Their concerns did not penetrate the presidential campaign, but the Obama administration will have to address the breakdown of Bretton Woods II in January, if not earlier. Wrote Summers this August, "The next administration faces the prospect of having to make the most consequential international economic policy choices in a generation at a time when the confidence of governments in free markets is being increasingly questioned."

In making these choices, policymakers have to recognize that, while Bretton Woods II is not the product of an international agreement, it is not a "free market" system that relies on floating currencies, either. Rather, it is sustained by specific national policies. The United States has acquiesced in large trade deficits--and their effect on the U.S. workforce--in exchange for foreign funding of our budget deficits. And Asia has accepted a lower standard of living in exchange for export-led growth and a lower risk of currency crises.

Some of the policies that Obama championed during the presidential campaign can help move us to a new system--as long as they are not seen merely as temporary palliatives to get the United States out of a recession. These steps include public investments that would make U.S. industries more competitive; subsidies under strict conditions to U.S. automobile manufacturers; and the encouragement of new "green" industries. (By contrast, Obama's principal proposal--a tax cut for the middle class--would not necessarily improve America's economic standing.)

But China, Japan, and other Asian countries--either on their own or with prodding from the new administration--will also have to play a part. Indeed, China may have already begun to do so by announcing a $586 billion stimulus plan of public investment in housing, transportation, and infrastructure. If China plows its trade surplus back into its domestic economy, it will increase demand for imports and put upward pressure on the yuan, reducing China's trade surplus with the West.

This kind of adjustment--in which the United States commits itself to reducing its trade deficit and China, Japan, and other Asian countries abandon their strategy of export-led growth--is what many American policymakers favor. But there is also growing sentiment, particularly in Europe, that beyond these measures, the world's leading economies have to agree on a new international monetary system--or at least dramatically reform the existing one. British Prime Minister Gordon Brown has explicitly called for a "new Bretton Woods--building a new international financial architecture for the years ahead." Brown would strengthen the IMF so it functions as "an early warning system and a crisis prevention mechanism for the whole world." He would also have it or a new organization monitor cross-border financial transactions. French President Nicolas Sarkozy would go further, replacing the dollar as the single international currency. "The time when we had a single currency, one line to be followed, that era is over," he declares.

Brown's proposals for regulatory reform make sense and are likely to be considered in the new Obama administration, but Sarkozy's are premature. The dollar isn't going anywhere in the short term. The Euro has little presence in Asia; and the Chinese don't want the yen to dominate Asia, let alone the world. The current crisis has, if anything, strengthened the dollar as the least untrustworthy of global currencies.

But adjustments to the dollar's role are certainly needed. The era of the dollar may not be over, but the special conditions under which it reigned during the last decades are being dashed on the rocks of the current recession and financial crisis. In the worst case, the system could descend into chaos, as it did in the 1930s. More likely a new Bretton Woods (call it "III") will emerge, but the question will be whether it does so willy-nilly, as its predecessor did, and invite repeated crises, or whether, like the original Bretton Woods, it will be the product of deliberate agreement and lay the basis for stable growth. Which it is will depend a good deal on the choices the new Obama administration makes.

John B. Judis is a senior editor at The New Republic and the author of The Folly of Empire: What George W. Bush Could Learn from Theodore Roosevelt and Woodrow Wilson.

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