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Should Developing Countries Support the US Dollar? By Way of Introduction

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One of the advantages of being innocent and curious is that you wonder why things are as they are and then, by searching for answers, increase your knowledge. Obviously, you can be innocent in some areas and wise in others. For example, you may not know how to repair a bike while your understanding of fellow human beings is highly developed. Innocence may turn into wisdom if it prompts you to deeply examine an issue. This is possible for many fields of human understanding, and it is certainly possible for one of the pressing issues of these days, the problems of US debt and global economic imbalances – the topic of this book.

The US debt problem is currently an issue of intense discussion. However, it was an issue of intense debate as well in the 1960s and early 1970s as I discovered some 24 years ago.

In 1982, I spent half a year in Latin America and in my meetings with economists the debt problems of Latin American countries were one of the topics we discussed – at the time an increasingly hot issue, and a few months after I arrived the debt crisis broke out in August 1982. Towards the end of my stay, my lack of intimate knowledge about the post-war history of the international monetary system became painfully clear in an interview I had with a famous Brazilian economist. My lack of knowledge provoked what I just said: it prompted me to explore the history of the international monetary system and, in particular, the key role the US dollar was, and still is, playing in the system.

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What happened?

One evening in October 1982, I was lucky enough to have an interview with Brazilian professor of economics Maria da Conceição Tavares, whom I knew was admired by her followers and feared by her opponents. When I began the interview, I asked her, in a broad, open question, to give a brief account of the origins of Brazil's debt problems. To my surprise, she shouted to me, undignified, that the problem of Latin America's debt crisis had not started with the oil crisis of 1973-74, or with the irresponsible borrowing by governments and the irresponsible lending by commercial banks, but with the debt problem of the United States!

I was flabbergasted.

"What do you mean?" I stammered.

"Don't you understand?" she said, softening her tone. "You should read Robert Triffin. As early as 1959, Triffin wrote that it was a crazy thing to have the dollar as the key currency of the world. He said, 'This is a lunatic way of organising the system, the US is going to be imbalanced, the dollar will be in crisis and at some point in time the whole system of fixed exchange rates will collapse.' Triffin even criticised the world's monetary system when the sterling pound was the dominant money. He was always against, as Keynes was, this idea of having an international system with the dominant power in meeting the money. So was Prebisch in 1947, when the IMF established its rule. Triffin and Prebisch said, if it went wrong with England, then with the US it would be worse. The US is a continental and closed economy whose pattern of imports and exports and production will be incompatible with a central role in the system. In the new division of labour that is likely to emerge all kinds of countries will industrialise."

I will not reproduce here in full Tavares' explanation, on which she later elaborated when I interviewed her again, in the Netherlands and England. Instead, I will highlight some of the thoughts of Robert Triffin and other experts, and report on developments in the 1960s and 1970s that form the history and background for today's debt problems of the United States. In a third section, I will place the current debate about global economic imbalances in the context of the financing of US deficits. The rest of the world, including poor developing countries, are financing these deficits and thus maintaining the US dollar as the key currency of the system.

The History of the US Debt Problem

Upon my return in the Netherlands in the fall of 1982, I started reading books about the history of the international monetary system. At the same time, I consulted a historical archive on world political and economic events (Keesings Historisch Archief) to get a feeling for the thinking and decisionmaking of the day. The archive, inherited from my grandfather, reported on a weekly basis about events between 1914 and 1973. By coincidence, 1914 was the year the gold standard came to its end after almost a hundred years of existence, and 1973 was the year the 1944 Bretton Woods monetary system came to its end.

I learned many things from Keesings Historisch Archief, and it was fascinating reading. It was as if I was reading today's newspaper with the knowledge of what would happen later. A few of the things I learned from the issues published between 1959 and 1965 were that: (1) the balance of payments problems of the United States (i.e. its foreign debt problems) were already considered "serious" towards the end of the 1950s; (2) the US deficits of the 1950s were mainly the result of US aid, US military activities around the world, and foreign investments by US companies; (3) concern about the stability of the US dollar, and the international monetary system based on it, was widespread among rich Western nations throughout the 1960s and early 1970s; (4) in 1961, ten of those rich nations put together a large sum of money to help the world monetary system to survive, thus establishing the G-10; (5) the French minister of finance Giscard D'Estaing said two years later, in October 1963, that the Bretton Woods world monetary system, based on the willingness of the United States to exchange gold for dollars, could only survive if the US would stop running balance of payments deficits; (6) the proposals for reform of the world monetary system by Robert Triffin and other experts, aimed at solving this gold-dollar exchange problem and other problems of the system, prompted financial authorities of the G-10 to study the functioning of the system; (7) as a result, the G-10 financial authorities declared in August 1964 that even though reform was not necessary, multilateral surveillance of balance of payments disequilibria (i.e. the US running deficits and other countries running surpluses) would be highly useful, echoing today's "new" IMF mission of surveillance of global financial imbalances; (8) at the annual meeting of the IMF in September 1964, the French minister of finance Giscard D'Estaing advocated the creation of a new international reserve currency – his proposal met fierce opposition from the United States and England; (9) in its 1964 annual report the IMF observed that it had increased its lending to industrial countries to "unexpected levels", the United States and England taking 78 percent of the drawings and 69 percent of the stand-by loans; (10) from August 30, to September 10, 1965, the US Secretary of the Treasury Henry Fowler visited France, Italy, Western Germany, Belgium, the Netherlands and England to discuss the problems of the world monetary system; (11) on 1 September 1965, the Joint Economic Committee of the US Congress published a report that advocated a reform of the international monetary system and the creation of a new international reserve currency; (12) on 7 September 1965, the US Undersecretary of the Treasury Robert Roosa launched his book "Monetary Reform for the World Economy", which proposed the creation of new international reserve units by countries depositing part of their currency with the IMF.

With this, I stop quoting of the notes I made when reading Keesings Historisch Archief some 24 years ago. I hope that my selection of the few years mentioned above (1959-65) shows how useful it can be to go back to earlier days and find out "on the spot" what policymakers, business people and academics were thinking and doing at the time. In my case, I found it very helpful to do so since it provided me the details I looked for in order to understand how decisionmakers in the rich countries had reacted to sensible plans for reform of the international monetary system put forward by Robert Triffin and others. It also gave me a clue as to why policymakers had preferred to not adopt them but, rather, maintain the dollar as the key currency.

Of the numerous books and articles I read, I will mention just four, to give an idea of the insights they provided.

A first book was authored by Dr. H.M.H.A. van der Valk, who dedicated most of his professional career to international monetary issues, including 19 years as a Board member of the IMF. The book, "The International Monetary System in a Period of Innovation", published in Dutch in 1972 by Kluwer, originated from the author's desire to come to grips with the crisis of the US dollar and the concomitant crisis of the world monetary system in 1971. Van der Valk provided an extensive account of the monetary system's history since 1816. In his preface, he gave as a reason for this detailed historical account: "The principal aim of this study is to shed light on today's international monetary crisis. In this way, it has also become a historical exposé on pre-war and post-war developments in the international monetary field. These days, people tend to disregard history. However, history contains very useful lessons that are all too often forgotten."

Another book I read was "U.S. International Monetary Policy: Markets, Power, and Ideas as Sources of Change" by John S. Odell. This book, published in 1982 by Princeton University Press, aimed at explaining and anticipating foreign economic policy changes. At the same time, it provided a fascinating account of three US policy shifts that transformed the post-war international monetary system. The author, associate professor of international relations at the University of Southern California, drew on interviews with almost all the key US decisionmakers. In his view, international monetary policy could only be understood if it was placed in the wider context of foreign policy objectives.

A third book was Robert Triffin's classic study "Gold and the Dollar Crisis", published in 1960 by Yale University Press. Triffin, a Belgian economist who had done his dissertation with professor Joseph Schumpeter at Harvard University, became a professor of economics at Yale University in 1951. In 1960, when "Gold and the Dollar Crisis" was published, Triffin had already gained international prestige as chief of the Latin American Section of the Federal Reserve System (the US central bank), and as "father" of the European Payments Union established after World War II.

Triffin's book contained two parts – an explanation of the successes and failures of international monetary arrangements in the 19th and 20th century, and an outline of an international monetary system that would remedy a basic flaw in the system that was established in 1944 at Bretton Woods. That flaw was, as Maria da Conceição Tavares observed, that the system was based on the currency of one country, the United States, and on the promise of that country to convert dollars held by foreign central banks into gold, if those central banks wished so. Triffin predicted that a time would come in which the US could no longer live up to this promise, simply because its gold stock would not be sufficient.

In a nutshell, the plan Triffin proposed was to turn the IMF into a world central bank for central banks that should be able to create loans and deposits and expand continuously the reserve base for the world's monetary system. Central banks' deposits at the IMF should substitute the US dollar and other national currencies as reserves, and such deposits should be just as usable as gold in international settlements.

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IMF deposits would carry exchange rates and convertibility guarantees that would make them safer for reserve investment than any national currency holdings.

In his preface to "Gold and the Dollar Crisis", Triffin said he was confident that the basic problems analysed in his book would remain valid for policymakers for a long time to come. With a dose of realism he added, "Whether or not the concrete proposals developed here to meet these problems have any chance to be negotiated in time to avoid a major crisis in the international monetary system, is an entirely different matter which history alone can, and will, answer."

The fourth and last book I would like to mention here is "The Imperious Economy" by David Calleo, published in 1982 by Harvard University Press. Calleo, a professor of European Studies at the Johns Hopkins University, analysed the foreign economic policy of the Kennedy, Nixon, Johnson, Ford and Carter administrations during the 1960s and 1970s. He observed that a good part of US foreign economic policy was inspired by the desire to make the international system serve the US policies pursued at home.

I learned many things from the books, articles and historical archive I read. The story that unfolded page after page was fascinating. Here was a country, a big country, which had become the political centre of the world, a country that had an army with military bases and troops around the world – in Asia, in Western Europe, in Latin America. Here was a country that had helped war-devastated Western Europe rise from the ashes by giving it the money it needed to reconstruct and develop. Here was a country whose firms went abroad to create global corporations that had the organisation, technology, money and ideology to conquer the world economically. Here was a country whose money was accepted by the world as a means of payment and store of value. Here was a country that hosted the two main multilateral financial institutions established after World War II, the International Monetary Fund and the World Bank, and became its most powerful shareholder.

How on earth could this huge, rich and highly industrialised country get into trouble with its balance of payments? Why was it increasing its foreign debt year after year? The answer was simple. Every dollar held by a foreigner meant by definition that the United States owed a dollar to that foreigner, since a dollar bill is nothing else than a piece of paper that says, 'I owe you'. Sure, something else was needed to make US' foreign debt a problem. As long as the United States spent as much abroad (providing aid, importing goods, having military forces abroad, having multinational corporations investing abroad) as it received from abroad (foreign firms and countries investing in the United States, US firms exporting goods, US multinational corporations receiving money from abroad), its net debt to foreigners would be nil. However, as the first and second note from Keesings Historisch Archief above had already told us, the United States was spending more than it earned. It was 'living beyond its means'.

Robert Triffin was one of the first experts who saw that this 'living beyond its means' by the United States could become a problem – for the United States, and for the world at large. Triffin was also the expert who predicted that a time would come that the United States would no longer be able to give gold to the foreign central banks who wanted to change their dollars into gold. Why was Triffin so clairvoyant? And, more importantly, did people listen to him?

By coincidence, I heard that Robert Triffin had moved back to Belgium, after more than 40 years living and working in the United States. So, rather than limiting myself to reading his books and articles, I decided to go and visit him at the Catholic University of Louvain in Louvain-la-Neuve, the university that invited him to work once again in his homeland.

During the long conversations I had with Robert Triffin in 1984 and 1985, he tried to answer all my questions. Was he clairvoyant? He laughed. "Anyone who would have seriously examined the issue of future convertibility of dollars into gold could have come to the same conclusion. Maybe it helped that my first training was in pure theory. I wrote 'Monopolistic Competition and General Equilibrium Theory' (Harvard University Press, 1940) with Professors Schumpeter and Leontiev. … I began to develop my reform plan in 1957, in my first book on that kind of subject, 'Europe and the Money Muddle'. Already then I saw that the gold production would not be enough to create the amount of international monetary reserves needed to take advantage of the maximum potential growth of the economy and of international trade."

Did people, in particular financial policymakers of the United States and Western Europe, listen to him?

Sure, they did, Triffin told me. During the almost thirty years he was at Yale University (1951-80), he had continuing consultations with central banks and governments. However, listening was one thing, putting his reform plan into practice quite another.

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"I remember a meeting in 1963 at the IMF in Washington, where I was developing my views for my reform plan and also for a joint discussion with the Europeans. Bob Roosa, who was the Under-secretary of the Treasury at that time, came to see me and said, 'Robert, you see what you are doing? Do you want to weaken us in relation to the Europeans? As long as we can approach the Europeans separately, we are in no problem. Don't forget the old slogan, *divide ut tempera*, but if we have to confront them jointly we will be much weaker.' At that point, he left and Emminger (Germany's central bank president) was waiting to take his place to join me. He said, 'Triffin, are you realising what you are saying? Now, when the United States asks us to take more dollars we can say, 'Yes, with pleasure, but at the moment we have some special problems in Germany, couldn't you address yourself to Italy or Belgium?' But if we have to confront the United States jointly, then we cannot say 'no' without putting in danger the Atlantic Alliance.'"

I looked at Triffin with amazement – well, I was not really amazed, but my eyes asked for an explanation.

Triffin continued: "I think that part of the dollar problem is related to the fact that the United States assumed the joint defense of Europe. In a sense, the United States and some Europeans accepted, without ever saying so openly, the view that this was a form of financing of joint defense. And this is still true today, I think."

Triffin's explanation for European support to the dollar coincided with an observation by Willem Duisenberg, president of De Nederlandsche Bank (the Dutch central bank), who told me in an interview in 1984 that since 1980 US budget deficits had increased rapidly because of high military expenditures. "Military expenditures increased in real terms by 7-8 percent a year. That's how the United States has acquired these tremendous budgetary deficits," said Duisenberg. And he added, laughing: "It won't be the first time they let other countries pay for their arms expenditures. The war in Vietnam was in fact not financed by the United States either, but by other countries."[1]

In 1971, Triffin's prediction became reality when international concern about continuing US deficits and massive conversion of dollars into gold held by foreign central banks led to the depletion of the US

[1] The Duisenberg quotes can be found on page 361 in: Jan Joost Teunissen, "The International Monetary Crunch: Crisis or Scandal?", Alternatives, Volume XII, No. 3, July 1987, pp. 359-95.

gold stock. It prompted President Nixon to declare on August 15 on television that the United States would no longer be able to convert dollars into gold. One of the pillars of the world monetary system agreed in 1944 at Bretton Woods tumbled. The United States simply did not have enough gold to keep its promise that central banks could convert their dollars into gold at any time. US foreign debt had grown too large. From then on, the value of the dollar was no longer based on gold, but on "confidence" in the economic power and capital markets of the United States.

Two years later, in 1973, the other pillar of the Bretton Woods system, fixed but adjustable exchange rates, tumbled too. As with the dollar crisis of 1971, speculative buying of strong currencies appreciating vis-à-vis the dollar preceded this second and important shift in the international monetary system. On February 12, 1973, the US Treasury Secretary announced another major devaluation of the dollar by 10 percent. The devaluation did not restore confidence in the dollar. Currency traders continued their flight from the dollar into gold and European currencies and, as a result, European countries decided to float their currencies. From then on, the world was going to live with floating exchange rates that could both settle "unviable" exchange rates as well as unsettle viable exchange rates. The de-linking of the dollar from gold and the free floating of currencies created a system ("non-system" in the view of Triffin and others) that laid the basis for today's global financial imbalances.

However, before this non-system became sacrosanct for Western policymakers there were several attempts to reform the international monetary system. Had they succeeded, they would have put an end to the "exorbitant" privilege of the United States that it could spend as much as it wanted – on its military operations, imports, or whatever – since the world kept supporting the US dollar as the key currency of the system and, thus, kept financing US deficits.

The first, serious attempt at reform occurred in 1972-74, shortly after Nixon's announcement that the United States would "temporarily" stop the conversion of dollars into gold. The IMF established a committee of twenty nations (the so-called Committee of Twenty) that had to come up with a detailed reform plan. After two years of negotiations, the Committee presented a plan that would have ended dollar supremacy. In the meantime, however, another event dramatically changed the international monetary and financial system: the so-called oil crisis of 1973. Oil-producing countries quadrupled the price of oil, and suddenly dollars flooded the world. They were "recycled" by commercial banks operating internationally. The reform plan of the Committee of Twenty, which originally suggested basing the world's monetary system on a truly international reserve currency, became obsolete. The US dollar remained king.

A second attempt at reform happened towards the end of the 1970s. Again, there were heavy, speculative attacks against the dollar, causing a drop in the international value of the dollar. Investors feared that the dollar would devalue quickly and that its key role in the system might end. This time it was not the quadrupling of the oil price that rescued the dollar, but the steep rise in US interest rates in 1979. From one day to the next, the prime interest rate set by the Federal Reserve (the US central bank) rose to 15 percent. As a result, the dollar became again very attractive to foreign investors.

In the 1980s and 1990s, there were no serious attempts at reforming the system. However, the Asian financial crisis of 1997-98 stimulated a new debate on its malfunctioning and, during the late 1990s and early years of 2000, commissions of financial experts and individual experts came up with proposals to improve "the architecture" of the world's monetary and financial system.

Recently, the staggering and ongoing increase in US deficits (foreign debt) has stirred a new debate about the need for reform of the world's monetary system. As usual, there are various camps among academics and policymakers. Some argue that the huge and increasing US deficits are not a problem, while others are deeply concerned about them and fear the day the world is no longer willing to finance them. Also, the blame is easily shifted from the one country or continent to the other. Some say that Asia, particularly China, is to blame because it depends too much on exports to the United States, keeps its currency too low, saves too much and does too little to develop a domestic market for its products. Others say that the United States does too little, or plainly nothing, to reduce its deficits.

The Financing of US Deficits by Developing Countries

It is now easy to understand why Professor Maria da Conceição Tavares shouted to me in 1982 that Latin America's debt crisis had started with the foreign debt problem of the United States. I mean, her statement, not her shouting – although I understand her shouting as well because I share her anger.

Briefly, Tavares' argument was that because Western countries maintained the dollar as the key currency of the system, and "petrodollars" were recycled through the private banking system, in the 1970s commercial banks were able to increase their role in the world financial system and lend huge sums of money to Latin American and other emerging market countries. Then, when the US central bank sharply increased its prime interest rates in 1979, to halt inflation and make the dollar attractive again to foreign investors, commercial banks extended new loans to Latin American countries so that these countries could continue to service their debts. These new loans were necessary because the interest rate on old loans had increased sharply – in line with the Federal Reserve's prime rate. In technical terminology, the new loans were "roll-over credits". Instead of financing development in Latin America they went straight back to the banks. This was another reason for Tavares' anger.

Let us now look at the issue of today's financing of US deficits by other countries, including poor developing countries.

Talking about this issue, Mervyn King, governor of the Bank of England, pointed recently to two disquieting facts: "First, the rise in the US current account deficit to more than 6 percent of national income has raised fears of how the inevitable correction will eventually be achieved. Second, for much of the past twenty years, as evidenced by the Asian crisis of the late 1990s, we have worried about emerging market countries accumulating excessive dollar *liabilities*. Now we seem to be worried about their accumulating excessive dollar *assets*. Capital has flowed 'uphill' from poor to rich countries. The invisible hand of international capital markets has not successfully coordinated monetary and exchange rate policies."[2]

Although King's critical view may surprise you, it is not an uncommon view among central bankers. For example, in 1984, Willem Duisenberg used almost the same words when he told me, "The situation we are in now is completely absurd. A sound situation would be that the rich countries lend or give money to the poor countries. There should be an export of capital in the form of loans and grants from the rich to the poor countries. But, surprisingly, the richest country in the world, the United States, actually imports capital from all over the world. In this

[2] Mervyn King, "Reform of the International Monetary Fund", Speech at the Indian Council for Research on International Economic Relations, New Delhi, India, February 20, 2006.

sense the United States is being financed by the rest of the world, including the developing countries."[3]

The two facts mentioned by Mervyn King in his New Delhi speech are worrisome and call for action. However, since academics disagree among each other as usual, and most policymakers tend to limit their concern to issues of immediate relevance and concern to them, no serious action has yet been taken to address the US debt problem and the 'uphill' financing of US deficits by poor countries.

About this Book and the Next Volume

This book is the first of two volumes that emerge from a conference held in The Hague on February 27-28, 2006. The chapters that follow in this first volume examine the issues in-depth and, mainly, from the viewpoint of developing countries. The developing country focus is uncommon and highly useful since most analyses depart from the perspective of rich countries. The contributing authors in this volume are policy-oriented academics, most of them associated with think tanks and universities in various parts of the world, and two of them with the United Nations and the World Trade Organization. The authors of the second volume also include policymakers.

In this first volume, some of the contributing authors stress the need for international monetary reform while others seem to be more reluctant, passive, pessimistic or "realistic" about the need for or the possibility of such reform – I leave it to you to decide what term you would prefer.

My own experience is that, in general, the more I study an issue, the less easy it is to maintain a simple view against or in favour of a certain policy stance – even though my view on the need for international monetary reform has not changed since the moment I started to increase my knowledge about the malfunctioning of the world's monetary system. My experience is also that I sometimes find myself defending a moderate position when someone else presents a radical view, and vice versa. On the one hand, this has to do with my natural tendency to raise questions when a social scientist pretends to possess the truth (in social, economic, political and cultural affairs there is usually not one exclusive, single truth), and on the other hand, with the complexity of the issues. Talking about complexity, radical views can

[3] Jan Joost Teunissen, "The International Monetary Crunch: Crisis or Scandal?", *Alternatives*, Volume XII, No. 3, July 1987, page 361.

spring from in-depth analysis.

I would welcome your critical and curious reading of the analyses and views presented in this volume. Both the chapters that you may agree with and those you may disagree with are worth reading. I have learned a lot from the authors whose policy stance I do not (fully) share. Equally, I have learned a lot from the authors I agree with. In both cases, they have provided me with arguments and details I was not, or not fully, aware of.

The second volume looks further ahead and deals more at length with the issue of international monetary reform. However, in that volume the same occurs as in this one: some economists advocate the need for reform of the system and suggest concrete proposals, while others seem to be happy with the current (non)system and see the plea for reform of their colleagues as utopian dreams.

I believe that any serious policymaker or academic should always be open to the possible need for alternative policies and reform of the system, especially if there are good reasons for change. In my Epilogue to this book I will highlight the policy options available to the US, Europe and Asia for resolving global imbalances as presented by the contributing authors in this volume. In the next volume, I will return to the issue of system reform and policy change. Then I will also return to some of Tavares' insights, as well as those of Triffin and other experts who have inspired me to found the international forum for discussion on finance and development Fondad.