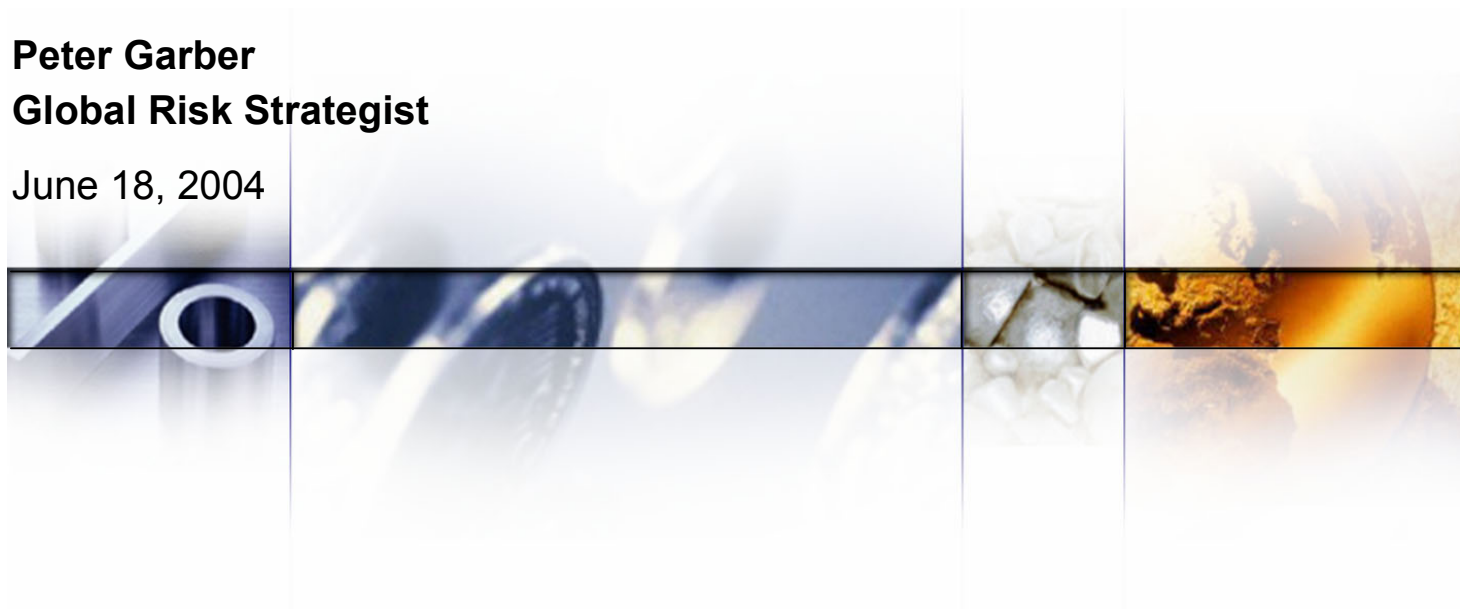

A Map to the Revived Bretton Woods End Game

Peter Garber
Global Risk Strategist

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The international monetary system is determined by the basic economic problem to be solved

- Bretton Woods was an explicit compromise between the US and UK to solve the perceived problems of the depression and WW2
- The current ad hoc system exists temporarily to solve the problem of the emergence of Asia

Standard View

- US Current Account Deficit at 5% of GDP
- Normal upward pressure on the euro and other floaters
- Undervaluation of Fixed Asian Currencies
- Asia overheating adjustment through inflation

If it goes on, it will end badly

- Currency crises
- Banking crises
- Rapid rise in US yields

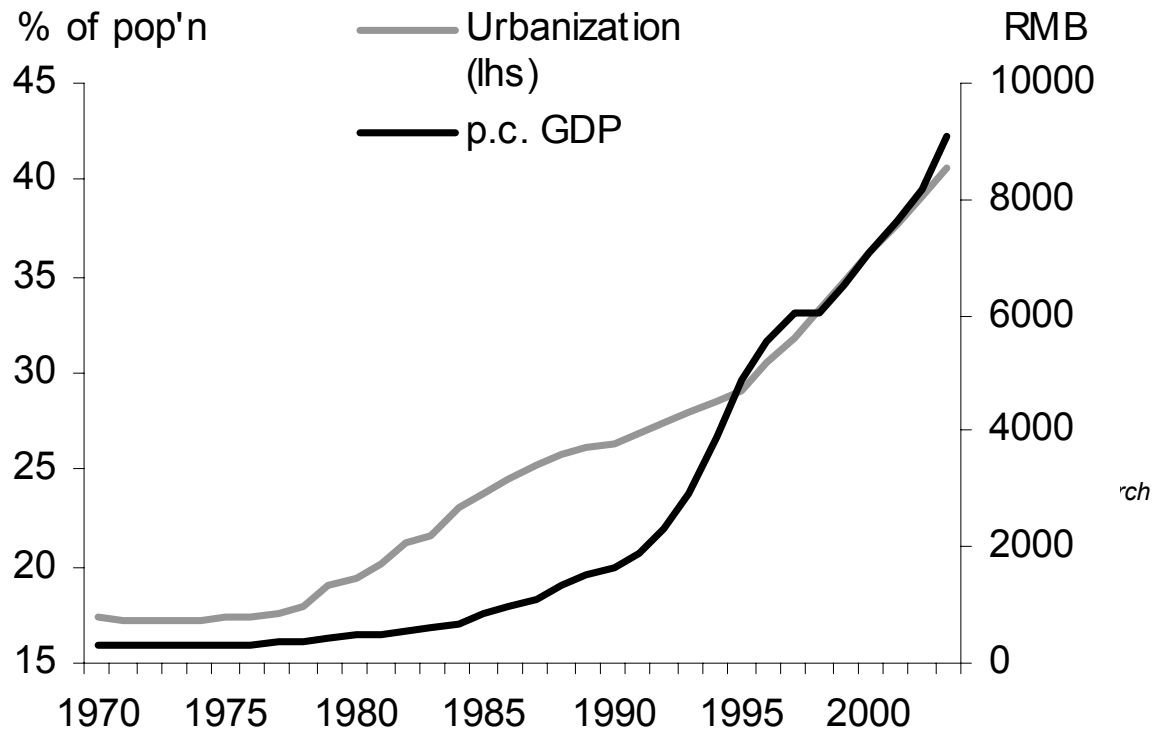
External pressure to appreciate Asian currencies

- Especially from Europe
- Protectionist jargon: burden sharing, currency manipulation, undervaluation, beggar-thy-neighbor.
- But US Treasury, Fed unconcerned

What force drives the global system?

- The key economic problem of our time:
 - To manage the economic emergence of China
 - Employ 200 million underemployed workers

China's demographics: Urban population growth = 20 million p.a.



The political economy tradeoffs

- China chooses an export driven development strategy
- It wants to move workers into industrial sector rapidly but faces increasing costs
- At the end of the game, it wants a viable capital stock
- This leads to a clash with trading partners
- Displaced US workers have to be compensated
- Failure to deal with this externality blocks development.

Solution:

- Set real exchange rate so that initial real wage generates surplus for capital
- Direct investor uses part of the surplus to keep import market open.
- If the real exchange rate generates a net capital outflow this is a small price to pay

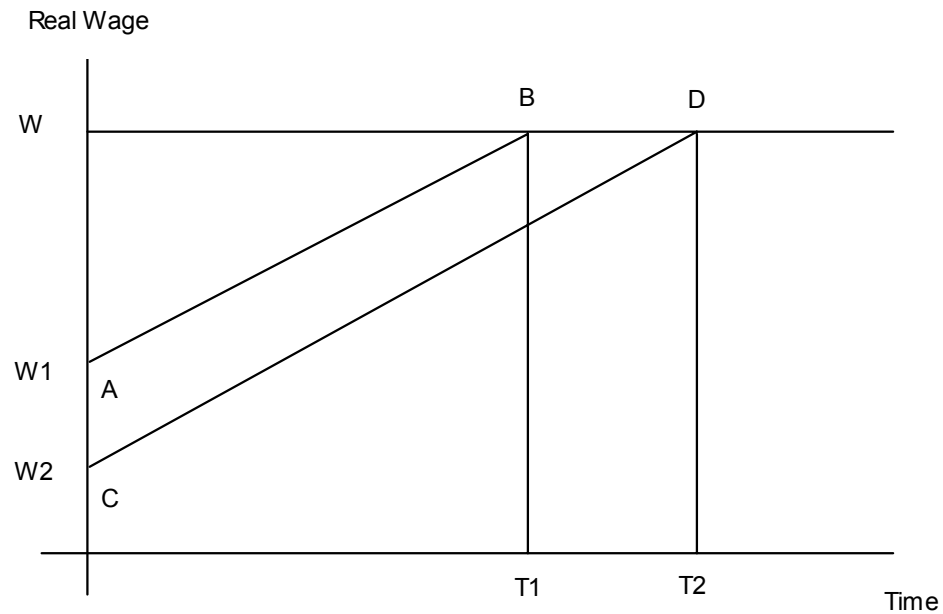
Exhaustible resource model

- Extraction (employment) cost has two parts
- Increasing cost of investment in rate of investment
- Increasing cost of adjustment of US labor force in rate of import growth

Two benefits of extraction

- Labor in idle pool requires expenditure of $-r$ per period
- Labor moved to employed pool yields b per period
- Can think of these as political costs or transfers and tax receipts

Alternative adjustment paths



Central insight of Exhaustible Resources Framework

- The optimal change in the real wage balances the government's desire to employ labor quickly against the increasing cost of providing capital and market access
- This requires a rising real wage/appreciating real exchange rate at rate $r + b$

Stock equilibrium condition

- The full solution to the Hotelling (1931) problem requires that the government sets the initial wage so that the initial stock of labor is employed when the domestic wage rises to the world wage.
- Large initial stock implies low initial wage.
- Large initial stock implies long adjustment period

Can this real exchange rate path be maintained?

- Effective capital controls
- Trade surplus must be sterilized
- Domestic financial repression
- ***BUT*** ER model implies the need for these controls will fade over time.

The current global monetary system is the apparatus to implement this solution

- Asia fixes exchange rates at “undervalued” levels
- Especially against industrial center country with more flexible labor market
- Other industrial countries and some emerging market countries float, appreciate, and have their goods pushed out of US markets
- Generates export growth and current account surpluses, development strategy is to lend to rich countries
- Encourages large scale FDI to assure quality of goods, capital, and to secure export markets
- Intervenes heavily in fx reserves to channel domestic saving through foreign balance sheets
- Gradually lets real exchange rate appreciate, either through inflation or controlled nominal appreciation