The fallacy of the revised Bretton Woods hypothesis: Why today's international financial system is unsustainable

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THE FALLACY OF THE REVISED BRETTON WOODS HYPOTHESIS

Why Today’s International Financial System Is Unsustainable

THOMAS I. PALLEY
THE FALLACY OF THE REVISED BRETON WOODS HYPOTHESIS

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THOMAS I. PALLEY
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Preface

The stability of the international financial system is in doubt. Analysis of the system has focused mainly on the sustainability of financing the U.S. trade deficit and has failed to understand the microeconomics of transactions within the system. According to this brief by Thomas I. Palley, the international financial system is unsustainable for reasons of demand, not supply. He recommends a global system of managed exchange rates to replace the current system before it crashes, along with the U.S. economy.

East Asian economies are pursuing export-led growth and running huge trade surpluses with the United States by actively pursuing policies aimed at maintaining undervalued exchange rates. Their governments continue to accumulate U.S. financial assets in order to support and stabilize the international financial system. While East Asian policymakers are correct in their belief that they can improve economic outcomes through exchange rate intervention, the system is undermining the structure of income and aggregate demand and eroding U.S. manufacturing capacity.

According to Palley, the core problems concern capital mobility and exchange rates. The U.S. Treasury is actively promoting liberalization of China's capital markets, along with floating exchange rates—a process that could eventually trigger a depreciation of the renminbi. Capital market openness and renminbi depreciation would adversely affect the U.S. industrial base, so the Treasury’s policies are the diametric opposite of U.S. needs today.

Palley conjectures that the real reason why the international financial system is unsustainable may lie with the U.S. domestic credit market. The system depends on continuation of the U.S. consumption boom, yet circumstances such as recession and reductions in lending and in voluntary consumer spending could end the boom. The bottom line is that the global financial system is vulnerable to a crash originating from within the United States—and East Asian economies, which would experience a reduction in
exports, foreign direct investment, and employment, can do little about it. Escaping a consumer-led recession in the United States will be difficult, because the options that were employed to overcome recession in 2001 are no longer available. Moreover, the dollar may not fall very much against other currencies, so there could be a prolonged economic slump.

Palley calls for a new financial system that addresses both the root cause of the 1997 East Asian financial crisis (destabilizing capital mobility) and current exchange rate problems that have created today’s global financial imbalances. In reality, both the periphery (East Asia) and the center (United States) need to agree about the rules of intervention to protect target exchange rates. Furthermore, the onus of exchange rate intervention needs to be reversed: the country with the stronger currency should be responsible for preventing appreciation, rather than the country with the weaker currency being responsible for preventing depreciation.

As always, I welcome your comments.

Dimitri B. Papadimitriou, President

June 2006
The Fallacy of the Revised Bretton Woods Hypothesis

Introduction
Dooley, Folkerts-Landau, and Garber, to whom I refer as DFG, suggest in a series of papers (2003, 2004a, 2004b) that today’s international financial system has structural similarities with the Bretton Woods arrangement that held sway between 1946 and 1971. Export-led growth by developing countries figures heavily in their analysis, and the authors have done the economics profession a major service by reminding us that export-led growth can have significant international macroeconomic effects.¹

This brief agrees with DFG’s emphasis on export-led growth, but challenges their comparison of today’s financial system and Bretton Woods. This brief also differs from DFG’s conclusion that today’s system is sustainable in the medium term, and I argue that the system is prone to crash. Other authors (Eichengreen 2004, Goldstein and Lardy 2005) have also argued that the system will crash, but they use different arguments, which focus on sustaining the financing of the U.S. trade deficit. I focus on the demand-side inadequacies of the current financial system and recommend a global system of managed exchange rates to replace the current system before it crashes, along with the U.S. economy.

The Revised Bretton Woods Hypothesis
The DFG hypothesis is that today’s international financial system structurally resembles the post–World War II Bretton Woods system, which included fixed exchange rates and was, according to their analysis, a center-periphery system, where the United States was the center and war-ravaged Europe was the developing periphery. Within this framework, the United States proceeded to run progressively growing trade deficits with Europe that eventually caused a slow demise of the system.
DFG argue that today’s global financial system still has the United States at the center of the system, but East Asia (especially China) has replaced Europe as the developing periphery. China has an explicitly fixed exchange rate vis-à-vis the U.S. dollar, while other East Asian economies actively manage their exchange rates to limit appreciation against the dollar. Additionally, the East Asia region is currently running huge trade surpluses with the United States.

The economic logic behind today’s financial system is that East Asian economies are pursuing export-led growth. Because these economies lack robust domestic demand, exports are needed to keep their factories operating. Export success then serves to attract large-scale foreign direct investment (FDI) that creates jobs, builds manufacturing capacity, and transfers technology. Foreign investors finance this capital accumulation by providing the foreign exchange to purchase capital goods. They also transfer, install, and operate the installed capital. In this fashion, countries acquire jobs and a modern, internationally competitive, manufacturing sector.²

The price that the developing periphery must pay, however, is exports to the center. This arrangement explains why savings flow north from poor to rich countries, rather than from rich to poor countries, as predicted by conventional, intertemporal, consumption-smoothing models of the international economy. Since international competitiveness is the key to export-led growth, countries actively pursue policies aimed at maintaining undervalued exchange rates. This explains why China has refused to revalue its exchange rate despite a massive and growing trade surplus, and why there is an accumulation of dollar-denominated official reserves throughout East Asia.

**The Misplaced Analogy with Bretton Woods**

DFG’s analogy of the present international financial system with Bretton Woods rests on a number of similar macroeconomic patterns, including quasi-fixed exchange rates and persistent and growing U.S. trade deficits that are financed by the periphery. However, the analogy is wrong because it ignores the fundamentally different microeconomic regimes that characterize the two systems.

Three significant differences mark today’s international financial system and Bretton Woods. First, today’s trade deficits are the result of
export-led growth, predicated upon undervalued exchange rates. Bretton Woods was designed to prevent “beggar-thy-neighbor” trade, based on competitive devaluations that had afflicted the international economy during the Great Depression. Although Germany’s exchange rate alignment became significantly undervalued in the Bretton Woods system, that result did not apply to the British pound. Furthermore, the Bretton Woods system had formal provisions that allowed countries with structural trade deficits to devalue their currencies.

Second, under today’s financial system, multinational corporations are establishing state-of-the-art export platforms in China, where production is exported back to the center (the United States). This arrangement contrasts with the European situation in the 1950s and 1960s, when American multinationals established production facilities in Europe to supply the European market. Companies such as Ford, General Motors, and IBM produced in Europe for Europeans, rather than for export to the United States. Likewise, European capital accumulation was primarily intended for European markets.

Third, the growing U.S. trade deficits in the 1960s were driven by full employment in the United States, along with higher wages, a growing manufacturing sector, and increasing manufacturing employment. These deficits contrast with current U.S. trade deficits, which are driven by debt-financed consumption spending (supported by a housing price bubble), and imports are displacing U.S. manufacturing. Whereas U.S. trade deficits in the 1960s were consistent with the generation of robust and stable aggregate demand, the current financial system is undermining the structure of the income and aggregate demand process and eroding manufacturing capacity.

**Why the Current Financial Regime Will Fail**

DFG maintain that the current financial system is sustainable and can last for a long while. The system is sustainable, they say, because the current arrangement suits both U.S. and East Asian interests—particularly the Chinese. The steady flow of imports that constitutes the U.S. trade deficit provides cheap consumption goods that lower consumer prices and contain inflation, enabling the Fed to hold the line on interest rates despite reduced unemployment rates. In addition, East Asian countries contribute to the
favorable interest-rate environment by recycling their trade surpluses into U.S. Treasury bonds, as part of their strategy to maintain undervalued currencies vis-à-vis the dollar.

East Asia benefits from exporting to the United States, as its factories are fully employed. Export success spurs domestic investment and FDI in manufacturing, which fuels further growth and development. These benefits are especially important to China, which needs to create jobs rapidly in order to absorb rural migration to its cities; if jobs are not forthcoming, social and political unrest could erupt to threaten Communist Party rule. The benefits mean that East Asian governments are willing to continue accumulating U.S. financial assets, thus ensuring a steady stream of financing for the U.S. trade deficit at current interest and exchange rates. For East Asian countries, portfolio risk and return are not the driving force of financial investment decisions. The driving force is economic growth.

This configuration of national economic interests is underwritten politically by U.S. multinational corporations. Given their East Asian investments and the profitability of subcontracted production, these corporations are willing to lobby Washington against “protectionist” pressures that are generated by the U.S. trade deficit and deindustrialization in the United States. The fact that the dollar is no longer officially convertible into gold adds extra stability to the current system and avoids the weakness that brought down the original Bretton Woods system.³

A. The Current System Is Unstable
DFG’s claim regarding the stability of the international financial system has been challenged by several authors. Eichengreen (2004) argues that the system will collapse because of inconsistencies between the system and the financial interests of individual countries. While it is true that the current system delivers export-led growth for East Asian economies, those countries are obliged to accumulate massive dollar reserves. These accumulations are unwise from a portfolio standpoint: they lack diversification and expose countries to massive capital losses if the dollar falls in value (equivalent to several percentage points of GDP). As a result, individual countries have an incentive to diversify their reserve holdings, even though they benefit from the system as a whole. In effect, this is a classic cartel problem, because there are incentives to cheat the system.
Eichengreen’s analysis raises two objections. The first concerns his argument that placement of reserves elsewhere by East Asian countries will bring down the system. The principal option is the euro. Purchase of East Asian currencies, especially the yen, is also an option, as is buying gold, commodities, or real assets, such as equities. Diversification, however, does not necessarily kill the financial system.

Selling dollars and buying euros will appreciate the euro vis-à-vis the dollar, undermine European international competitiveness, and export deflation and unemployment to Europe. The dollar, however, will retain roughly the same parity against East Asian currencies. Since the United States is their principal export market, all East Asian economies have an incentive not to let their currencies appreciate too much against the dollar or against the currencies of rival East Asian economies. This incentive provides a centripetal force that stabilizes the system. Similarly, purchases of commodities and equities may cause commodity and asset price inflation, but these purchases also leave the dollar exchange rate essentially unchanged. And to the extent that East Asian countries sell Treasury bonds, such sales drive up U.S. interest rates and provide an incentive to remain invested in dollars.

A second objection concerns Eichengreen’s assumption that East Asian economies ultimately face capital losses on dollar-reserve holdings. This amounts to tacitly concluding that the international financial system is unstable. In fact, China could reap large capital gains on its holdings. The logic of this speculation is as follows: China is resisting exchange-rate appreciation to preserve its export-led growth model, while gradually opening its capital markets to the international marketplace. This opening could eventually trigger a depreciation of the renminbi if Chinese wealth holders exit their domestic system for the purposes of economic and political portfolio diversification. This speculative scenario would enable China to make large capital gains on its reserve holdings and also get a second wind for its export-led growth program.

The above scenario should be extremely troubling to U.S. policymakers who are concerned about the U.S. industrial base, yet the U.S. Treasury is actively promoting this development by demanding capital-market openness. Once China liberalizes its capital markets and floats its exchange rate, the United States can no longer claim that China is manipulating its exchange rate, and the case for international legal action against China will
disappear. Capital market openness and renminbi depreciation are the diametric opposite of U.S. needs today. The U.S. trade balance and exchange rate problems call for an upward revaluation of the renminbi without capital market openness, yet the U.S. Treasury’s policy runs the risk of promoting the opposite outcome, similar to the mistakes made with Japan in the early 1980s. At that time, Japan was running a large trade surplus and was relatively closed, financially, to the rest of the world. The Treasury pushed Japan to open its financial markets, resulting in undiversified Japanese wealth holders investing overseas, which caused the yen to fall and increased Japan’s trade surplus.

Goldstein and Lardy (2005) provide another criticism of DFG’s sustainability claim. Their analysis combines positive and normative arguments that the system will break down because of China’s high cost of maintaining it, and asserts that a breakdown is in China’s best interests. The principal focus of their analysis is the high cost to Chinese authorities of sterilizing monetary inflows into China. To prevent exchange-rate appreciation, China’s central bank sells renminbi, which increases the money supply and poses inflationary dangers. In order to sterilize an increase in the money supply, the bank sells domestic bonds and soaks up excess liquidity. However, this action drives up interest rates and distorts financial signals. To counter these effects, the central bank has turned to administrative controls, such as higher reserve requirements on commercial bank deposits, and higher administered deposit rates to attract and retain bank deposits. Goldstein and Lardy believe, however, that these measures are inadequate and that China will suffer from a combination of costly inflation and financial system distortions that misallocate and waste resources. Such costs, they say, will compel China to abandon its undervalued exchange rate.

Goldstein and Lardy’s other arguments against stability and sustainability include challenging the underlying premise of the DFG hypothesis (that export-led growth driven by FDI is critical for China’s industrialization), the capital-loss-on-reserves argument put forward by Eichengreen, and an argument that revaluation leads to large terms-of-trade gains for China. These gains will lower the domestic cost of commodity and capital goods imports and will not have a large effect on Chinese manufactured exports, which consist mainly of processed products based on imported inputs.
However, Goldstein and Lardy’s arguments are subject to important counterarguments. First, the sterilization-cost argument is essentially a monetarist case, yet the empirical link between the money supply and inflation is known to be highly variable and operates over a long time horizon. China’s administrative controls have worked well so far and they may continue to work with the assistance of minor adjustments. Second, China’s stiff resistance to revaluation provides a “revealed preference” position by China’s economic policy authorities regarding the importance of export-led manufacturing growth. Third, as noted above, we cannot simply assume that China will suffer capital losses on its reserve holdings. Fourth, China has an alternative plan for dealing with financial sector resource misallocation: partial privatization of banks. The goal is that Western banks will modernize and improve the banking system’s credit allocation function. The financial sector can thereby be modernized, while simultaneously persisting with export-led manufacturing growth.

B. A New Explanation of Instability

DFG, Eichengreen, and Goldstein and Lardy all focus on the sustainability of financing the U.S. trade deficit. While DFG believe the supply of financing is sustainable because it meets the needs of supplier (surplus) countries, Eichengreen and Goldstein and Lardy believe the supply is unsustainable. This brief argues that the international financial system is, indeed, unsustainable and will crash. But it is unsustainable for reasons of demand and not for reasons of supply. Existing analyses have overlooked the weakness on the demand side because of failure to understand the microeconomics of transactions within the current system.

An outline of the structure of U.S. and East Asia borrowing is shown in the figure. The key insight is that the process of financing export-led growth and the U.S. trade deficit is a two-part, intermediated transaction. One part involves a domestic transaction between U.S. banks and ultimate U.S. borrowers (consumers). The other part involves an international transaction between foreign governments and financial intermediaries (banks) in the U.S. financial markets. The domestic transaction can be loosely identified with the demand for and provision of credit within the U.S. economy, and borrowers use these funds to purchase goods. The international transaction can be loosely identified with the supply of credit from East Asian economies.
to the U.S. economy, with East Asian economies taking American IOUs as payment for the goods they have supplied. The system can break down in either the international or domestic credit markets. Attention so far has focused exclusively on the international credit market and the possible withdrawal of financing by foreign lenders. The real reason the system is unsustainable, however, may lie with the domestic credit market.⁴

The Structure of U.S.–East Asia Borrowing

Export-led growth relies on selling goods in the U.S. market, which has been described as “the buyer of last resort.” U.S. consumer spending has been significantly financed by borrowing, which, in turn, has been supported by a housing price bubble. In effect, U.S. consumers borrow from U.S. banks and buy Chinese goods, and China ultimately ends up accepting those borrowed dollars as payment for its goods. The system is therefore dependent on continuation of the U.S. consumption boom, yet circumstances could end that boom. First, the Fed may overshoot its interest rate–tightening campaign and trigger recession. Second, local U.S. banks may tighten lending standards and reduce lending, because households are financially overextended and housing collateral is overvalued. A third possibility is that consumers may reduce spending voluntarily. An end to the housing price bubble would eliminate future financial gains that consumers could use as collateral, and adverse wage and income pressures generated by international outsourcing could spread from the manufacturing sector to the service sector, which is relatively larger in size.

If U.S. consumption spending falls, East Asian exports would also fall, and the willingness of East Asian economies to finance the U.S. trade deficit would become redundant, as international financing would no longer be a binding constraint. Instead, the constraint would lie with the U.S. goods and domestic credit markets, and East Asian economies could not force transactions within those markets by providing credit to U.S. banks. Rather, the borrower (the U.S. consumer) and the local U.S. bank must seal the deal. The bottom line is that the global financial system is
vulnerable to a crash that originates from within the United States, and East Asian economies can do little about it. Indeed, the competitive pressures unleashed by export-led growth and outsourcing form part of the constellation of forces contributing toward a possible crash.

What Happens If the U.S. Economy Sinks into Recession?
In the event that the United States falls into a consumer-led recession, East Asia is likely to be affected significantly. The initial impact would be felt via reduced exports, which would lower employment. A further impact would be felt through reduced FDI. With excess capacity and diminishing exports, multinationals would reduce new investments. These results would contrast with the effects of the 2001 U.S. recession, which was investment led and left U.S. consumption spending intact. Consequently, East Asia was relatively unscathed because its exports are mainly consumer goods.

The United States will find it difficult to escape a consumer-led recession. The 2001 recession was overcome by the combination of a budget U-turn (from surplus to massive deficit), a significant reduction in interest rates (which spurred mortgage refinancing and reliquified household balance sheets), and consumer borrowing (which was collateralized by a housing price bubble). The budget U-turn option is no longer available, so the only significant source of policy stimulus is for the Fed to cut interest rates. Such cuts, however, will likely be much less effective than in the past. One reason is that the stock of high-interest mortgages has already been depleted and refinanced. Another reason is that lenders will be less inclined to lend, given the financially stretched position of households. A third reason is that house prices have already risen and are more likely to decline than continue to rise. The net result is that interest rate reductions by the Fed could end up akin to “pushing on a string.”

And what will happen to the dollar? Diminished U.S. economic prospects will likely promote some portfolio shifting toward Europe and Japan, who also rely on exports to the United States. This means that Europe and Japan will be adversely affected by a U.S. recession, so the incentive to invest in euros and yen will be diminished. East Asian countries will be keen to retain their competitiveness to diminish the impact of lower exports. This suggests that they will continue to restrict the appreciation
of their currencies against the dollar. The net result is that the dollar may not fall very much, which will make it even more difficult for the United States to overcome recession. The prognosis, therefore, is a prolonged economic slump.

**Wanted: A New Global Financial Architecture**

Not only do DFG see a stable international financial system, but they also see significant welfare benefits for all participants. In one paper (2004b), they argue that the surpluses earned by East Asian economies represent a means to acquire foreign exchange collateral that is needed to underwrite FDI. From DFG’s viewpoint, the system should be left intact.

One problem with the collateral argument is that Japan continues to accumulate collateral when it clearly has no need for such collateral. More important, DFG’s argument does not accord with the historical record about the formation of the current international financial system. The system is a product of recent events that were spurred by the East Asian financial crisis in 1997. East Asian countries were forced to accept the currency devaluations imposed by the panicking financial markets, but have subsequently benefited from the impact of devaluation on exports. The resulting increase in their trade surpluses then enabled them to build up massive foreign exchange reserves as protection against future financial panics.

Several important conclusions follow from an assessment of development after 1997. First, the accumulation of official reserves has not been driven by a desire for collateral in order to underwrite FDI. Rather, the accumulation has been driven by a desire to protect against the possibility of future capital flight. Second, the current financial system is a product of state policy responses to unwelcome market developments, rather than a product of optimizing markets, which is the view of many modern economists. Third, the system is problematic on a global scale for reasons discussed in Blecker (2000) and Palley (2003). In particular, the system promotes global deflation by emphasizing exports excessively; this focus hollows out the income and aggregate demand–generation process in the United States via deindustrialization and outsourcing.

The core problems of the international financial system concern capital mobility and exchange rates. Destabilizing capital mobility was the main
problem behind the East Asian financial crisis, while exchange rates are the main problem behind today’s global financial imbalances.

A new financial system is needed to address both the root cause of the 1997 East Asian financial crisis and the exchange rate problems that have subsequently emerged. A contemporary financial architecture will need to manage both capital mobility and exchange rates. Finally, it is important to recognize that the existing system is a problem for both the periphery and the center. After the East Asian crisis, the system focused on changing the periphery. In reality, both the periphery and the center need to change.

There have been many proposals for redesigning the global financial architecture. Blecker (1999), Griffith-Jones and Kimmis (1999), and Palley (1999) provide solutions for governing and improving the quality of capital flows. Their solutions include improved prudential regulation, Chilean-style speed bumps that implicitly tax short-term inflows, currency transaction taxes, domestically imposed reserve requirements on lenders, and obligations for lenders to hedge foreign currency lending on behalf of borrowers.

The 1997 crisis was centered on capital mobility. Today’s problem is gross trade imbalances, which have elevated the significance of exchange rate misalignments and created the need for a more stable system of managed exchange rates. The obvious candidate to solve the problem is a system with a crawling band target zone, as proposed by Williamson (1985, 1999), Bergsten et al. (1999), Grieve-Smith (1999), and Weller and Singleton (2002). This system involves choosing a number of parameters that would need to be negotiated by participants: a target exchange rate, the band size in which exchange rates can fluctuate, a hard or soft band, and the rate of crawl. A hard band is automatically and decisively defended, while a soft band allows for temporary marginal deviations outside the band with a commitment to return within the band when market conditions are favorable. The rate of crawl involves determining the rules governing the adjustment of the target and band. These rules concern the size and periodicity of adjustment to the target nominal exchange rate.

A sensible candidate regarding the target exchange rate is the notion of fundamental equilibrium exchange rates proposed by Williamson (1994). His basic notion is that participating countries select a set of exchange rates consistent with their targeted current account and GDP outcomes.
Finally, there needs to be agreement about the rules of intervention in order to protect the target exchange rate. In the past, any country with a weakening exchange rate was required to sell foreign exchange reserves in order to protect the exchange rate. This system is fundamentally flawed because countries have limited reserves and the market knows it. Speculators therefore have an incentive to try and “break the bank” by shorting the weakening currency, and they have a good possibility for success, given the scale of low-cost leverage that modern financial markets can muster.

The onus of exchange rate intervention needs to be reversed. The country with the stronger currency (where the central bank’s exchange rate is appreciating) should be responsible for preventing appreciation, rather than the country with the weaker currency being responsible for preventing depreciation. Since the central bank with the stronger currency has unlimited amounts of its own currency for sale, the bank can never be beaten by the market. Once this rule of intervention is adopted, speculators will back off and the target exchange rate will be viable. This procedure recognizes and addresses the fundamental asymmetry in the defense of weak or strong currencies.

**Conclusion: Beyond Policy Passivity**

Today’s global financial system is a haphazard and suboptimal creation. Whereas East Asian policymakers strategically manipulate their exchange rates, U.S. policymakers reject intervention on the grounds that the market knows what is best, so the exchange rate should be left alone. This asymmetry between economies has allowed East Asia to pursue neomercantilist policies that have contributed to massive global financial imbalances.

The mentality of U.S. policy is at odds with reason and the evidence. Theoretical reasons abound for the belief that foreign exchange markets are prone to herd behavior. Strong empirical evidence also indicates that exchange rates depart from theoretically warranted equilibrium levels, whether or not they are defined as purchasing power parity or as exchange rates consistent with sustainable current account deficits. From the standpoint of realpolitik, it is unwise for any country to be outgamed by another.

East Asian policymakers are correct in their belief that they can improve economic outcomes through exchange rate intervention. As Williamson
(1999) observes, policymakers who use theory to devise and manage sensible exchange rates do better than those who employ unregulated, floating exchange rates. The problem is that East Asian countries have been intervening in an uncooperative manner, which risks an outcome that could be disastrous for the current international financial system.

Notes
2. DFG emphasize the connection between exports, foreign direct investment (FDI), and growth. Goldstein and Lardy (2005) have rightly criticized them for overemphasizing the contribution of FDI to China’s growth. However, that said, FDI is a critical component of China’s capital and technology accumulation strategy. More important, the link that should be emphasized is between exports and industrial investment in general, with exports spurring both FDI and domestic manufacturing investment. Exports provide the classic “vent for surplus” in China’s economy. China’s entrepreneurial tradition makes it highly efficient at organizing capital accumulation. However, China has not yet put in place a domestic consumption market that can absorb its production. I emphasize this point in Palley (2006a).
3. In the face of large gold conversions, especially by France, President Nixon suspended the right of countries to convert official dollar reserves into gold on August 15, 1971.
4. Chinese wealth holders will want to diversify for standard economic reasons, as well as political reasons resulting from concerns about rule of law in China and the potential for future political instability.
5. These arguments are developed in greater detail in Palley (2006a).
6. These arguments are developed in two of my policy briefs: Palley (2006b) and Palley (2005).
7. Operationally for the single-country case, this is done as follows: The first step is to empirically estimate a current account equation of the form $CA = \alpha_0 + \alpha_Y Y + \alpha_e e + \alpha_X X$, where $CA = \text{current account}$, $Y = \text{GDP}$, $e = \text{exchange rate}$, and $X = \text{vector of exogenous variables}$. 
The equation is then solved to yield the fundamental equilibrium exchange rate \((e^*)\) consistent with the target current account \((CA^*)\), target GDP \((Y^*)\), and given levels of exogenous variables: 
\[
e^* = \frac{-\alpha_0}{\alpha_2} - \frac{\alpha_1 Y^*}{\alpha_2} + \frac{CA^*}{\alpha_2} - \frac{\alpha_2 X}{\alpha_2}.
\]
In a multicountry exchange rate system, these equations must be estimated and solved simultaneously across countries to ensure a consistent set of exchange rates. It is necessary for countries to agree on a consistent set of national current account targets, since all countries cannot run trade surpluses simultaneously.

References


About the Author

Thomas I. Palley is an economist living in Washington, D.C. He was formerly chief economist with the U.S.–China Economic and Security Review Commission. Prior to joining the commission, he was director of the Open Society Institute’s Globalization Reform Project and assistant director of public policy at the AFL–CIO. He is the founder of Economics for Democratic and Open Societies, which seeks to stimulate public discussion about the kinds of economic arrangements and conditions needed to promote democracy and open societies.


Palley holds a B.A. degree in modern history and economics from Oxford University and an M.A. in international relations and Ph.D. in economics from Yale University.
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