Mitchell's Musings 5-23-11: IMF Doesn't/Can't Deal With a Major US Issue

Recent unfortunate events – unrelated to world monetary affairs – have put a spotlight on the International Monetary Fund (IMF). So let's bypass the current scandal and instead ask what the IMF is supposed to be doing and why it isn't doing it.

Some history is required. The IMF was set up in the waning days of World War II as an international agency to administer a new world monetary order known as the Bretton Woods system, so-named after the New Hampshire town in which its arrangements were negotiated and ratified. An old newsreel gives some background:

http://www.employmentpolicy.org/1944-bretton-woods-conference-first-video-associated-mitchells-musings-5-23-11

Although the newsreel suggests broad international agreement on what emerged, in fact the Bretton Woods system was primarily the product of a negotiation between Britain - in the person of John Maynard Keynes – and a US Treasury official – Harry Dexter White. Although you have undoubtedly heard of Keynes and probably not heard of White, given the balance of power, the White-US view of what the IMF should be prevailed.[1] Essentially, the Keynes-British view was that the IMF should be a kind of international central bank with the authority to created money. The White-American view was that the IMF should be a relatively weak financial intermediary – a kind of international savings and loan – with only a limited power to borrow and lend to governments and national central banks. Given the balance of power in 1944 between Britain and the US, the American approach prevailed.[2]

The Bretton Woods system involved fixing two kinds of prices, currency exchange rates and the price of gold in dollars. The US dollar was to be the world international currency with all currencies maintaining a fixed exchange rate to the dollar. Neither Keynes nor White thought that gold need play a role in the Bretton Woods system in theory. However, since the world was used to gold as part of the monetary order, the US would maintain the official price of gold at $35/ounce, an arbitrary price that had been set by the Roosevelt administration during the Great Depression. If every world currency was pegged to the dollar and the dollar was pegged to gold, then indirectly every currency had an implicit gold value.

Bretton Woods was a fixed exchange rate system. Exchange rates can be fixed providing someone is willing to buy and sell currencies at the fixed rate in unlimited quantities. If the official price of the British pound is, say, $2.80 (as it was at one point), someone must be willing to stand ready to buy and

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[1] White was supposed to head the IMF at its inception but was accused of being a Soviet agent. There is an interesting tale there, but you can investigate it on Google.

[2] The US had a long history of domestic politics revolving around suspicion of banks and British finance reflected, for example, in the free silver movement of the late 19th century. There was no way Congressional approval for a world central bank could be obtained. Symbolically, the IMF's headquarters – unlike the UN's – was put in Washington, DC, i.e., where the US government could keep an eye on it and not near the financial center of New York City.

sell dollars for pounds and pounds for dollars at that rate. Essentially, it was left to countries to see to it that their currencies stayed at the fixed value.

Note that there is an asymmetry built into any fixed rate system. If, say, the pound was in excess demand (tending to appreciate above the fixed price), the British central bank could sell pounds and buy dollars, preventing the rise. Since the British central bank can create pounds, it essentially has an unlimited supply of pounds with which to buy dollars. But when the reverse is true, i.e., when the pound is in excess supply (tending to depreciate), Britain needs dollars – which it can't create – to buy up the excess pounds. The IMF was supposed to be able to lend those dollars to Britain. However, as a weak institution, the IMF did not necessarily have sufficient dollars. It was, therefore, easy for countries to deal with excess demand for their currencies (since no aid was needed) but tough to deal with excess supply.

When a country found its currency in excess supply, the usual remedy was to raise interest rates (to attract an inflow of foreign funds and thus increase demand for its currency). High interest rates and other austerity measures would also slow the domestic economy. Recessions are a great way to cut back on imports (and therefore decrease the supply of your currency to the world), if you are willing to tolerate the other nasty consequences of the resulting economic slump. To the extent that the IMF lent funds to countries with such crises, it tended to demand austerity as a condition of the loan.

However, there was one country over which the IMF had little influence: the US. In the 1960s, the dollar tended to be in excess supply against other currencies. But the US was not particularly interested in austerity. Indeed, the incoming Kennedy administration had been elected on a platform of stimulating economic growth. Growth was seen as important, not just for the obvious domestic reasons, but because the US was seen as slipping in growth relative to the Soviet Union at the time. Pro-growth policy was part of the Cold War.

Under Bretton Woods, Kennedy administration was regularly confronted with dollar and gold crises which threatened its growth efforts. Perhaps the best illustration was provided by accident during an international demonstration of the first television communications satellite, Telstar. A special international broadcast was arranged in which people in North America and Europe would see such touristic sites as the Statue of Liberty and the Eiffel Tower via satellite.

Since Telstar was not geo-fixed, there were periodic intervals of 18 minutes when the satellite was over the Atlantic and transmission was possible. In the midst of the first demonstration broadcast, a Kennedy administration news conference was shown. During that random 18 minutes on essentially a random day, there was an international gold/dollar currency crisis brewing. Actually, it was not a surprise since such crises were regular events. President Kennedy dealt with the crisis on the broadcast:

http://www.employmentpolicy.org/telstar-us-golddollar-crises-1960s-second-video-associated-mitchells-musings-5-23-11

Such gold/dollar crises continued during the Johnson and Nixon administrations until President Nixon unilaterally ended the Bretton Woods system in August 1971:

http://www.employmentpolicy.org/nixon-ends-bretton-woods-system-third-video-associated-mitchells-musings-5-23-11

Basically, the kind of austerity policy that the IMF would have prescribed for other countries with overvalued currencies was not in accord with the Nixon administration's policy goals. Neither Kennedy nor Johnson nor Nixon had much tolerance for allowing Bretton Woods commitments to interfere with domestic objectives.

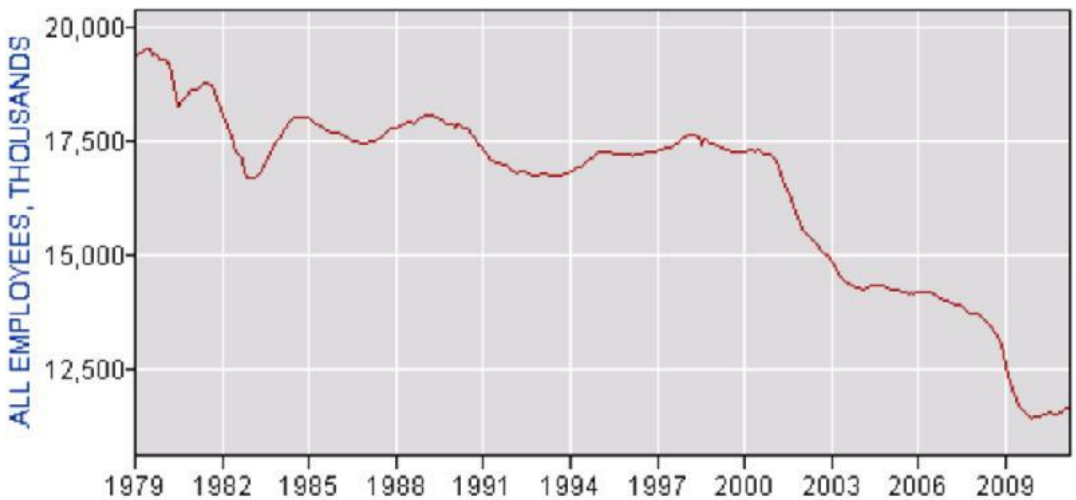
In late 1971, there was an attempt to recreate elements of Bretton Woods as part of the Smithsonian accord. But that Bretton-Woods-lite system lasted only 13 months and again failed when there was renewed pressure on the dollar which the US was not in a mood to resist. The world moved to flexible exchange rates in early 1973, seemingly leaving the IMF with no purpose to exist. It had been created to administer the Bretton Woods system which no longer existed.

Of course, the IMF did not go out of business. Even with flexible exchange rates, governments can get into trouble if they borrow or otherwise acquire obligations denominated in other countries' currencies. The IMF moved toward arranging loans to such countries, typically with austerity conditions. Its operations in that field have been subject to considerable criticism, but are not the subject of today's musings. What is the subject is a) the observation going back to the creation of the IMF and Bretton Woods that the IMF seems to have authority over every country except the US and b) the observation that surplus countries don't need IMF aid and thus are not subject to its influence.

Those two observations take us to the current situation in which the US has become the world's largest debtor and runs chronic large trade deficits. As earlier musings have noted, the impact on the US labor market falls heavily on manufacturing jobs, which have been in long run decline as Chart 1 on the next page illustrates. But this situation is precisely the kind of circumstance in which the IMF has little influence. It cannot tell the surplus countries – notably China – what to do since they don't need anything from the IMF. The old asymmetry continues. China can continue with an undervalued currency so long as it is willing to accumulate dollars.

The US is not as much the influence it was at the IMF at the end of World War II. But it still dominates and is free to ignore IMF policies it does not like. In short, the world's biggest international monetary problem seems to be beyond the reach of the IMF – the agencies ostensibly charged to deal with such matters - given current economic and political arrangements.

Chart 1: US Manufacturing Nonfarm Payroll Employment



There has been a tendency to downplay the job decline in US manufacturing with the comeback that what is occurring is actually a remarkable growth in productivity in that sector. Under this argument, employment is declining because fewer workers are needed, thanks – presumably – to rapid technological advances not found in other sectors. That argument has been called into question by a recent paper pointing to biases in the price estimates for imported inputs into manufacturing which overstate production and productivity advance.[3] But even apart from such data problems, a move toward balanced trade would have a substantial job-creating impact on US manufacturing. A trade surplus – the only way the US can begin to pay off its vast debt to the rest of the world – would have an even bigger impact.

What is clear from history going back to World War II is that the IMF cannot solve the international monetary problems of the US. Solutions in the past have come from unilateral US action when a crisis arises. Most likely, so will solutions in the future; there seems at present to be no taste among US policy makers to work seriously on the trade deficit problem in advance of a crisis.

[3] Susan Houseman, Christopher Kurz, Paul Lengermann, and Benjamin Mandel, "Offshoring Bias in U.S. Manufacturing," *Journal of Economic Perspectives* (Spring 2011), vol. 22, no. 2, pp. 111-132.