A Resolute Faith in the Power of Reasonable Ideas

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Preface

David P. Calleo is Dean Acheson Professor of European Studies at SAIS and University Professor of the Johns Hopkins University. He entered Yale at age sixteen, receiving his BA in 1955 and Ph.D. in 1959. He founded (in 1968) and directed (until 2012) the preeminent American graduate program for the study of contemporary Europe. SAIS European Studies has formed hundreds of professionals working today in government, business, academia, and the press.

Calleo is one of the most thoughtful, multi-faceted, and original scholar-commentators of his generation. His interests have ranged from the international economy to transatlantic relations to European integration to the history of ideas. Few contemporaries can match the grace and elegance of his prose. His books include Follies of Power: *America's Unipolar Fantasy (2009); Rethinking Europe's Future (2001); The Bankrupting of America (1992); Beyond American Hegemony: The Future of the Western Alliance (1987); The Imperious Economy (1982); The German Problem Reconsidered (1978); America and the World Political Economy (with B. Rowland, 1973); The Atlantic Fantasy (1970); Britain's Future (1968); The American Political System (1968); Europe's Future: The Grand Alternatives (1967);* and *Coleridge and the Idea of the Modern State (1966).*

As director of European Studies at SAIS, he shepherded some forty doctoral dissertations to their successful completion (see Appendix to this volume). His Ph.D. students remember him as a demanding and generous teacher, an intellectual mentor-companion ever-present in spirit when not in the flesh, and a steadfast friend.

On October 19-20, 2012, many of David's friends, colleagues, and former students gathered in Bologna to honor him for his accomplishments, partake of his wisdom and special company, and, as the papers published here demonstrate, to reflect on and discuss his ideas. Thanks to the presence of Pierre Hassner, Gianfranco Pasquino, Robert Skidelsky, Paolo Calzini, Simon Serfaty, and Vera and Stefan Zamagni, among others, the meeting was also a reunion of the Bologna's Center's distinguished 1970s faculty.

The title of the conference, and of this collection of papers, comes from a letter written by David, and captures something essential about his approach: a belief in the importance of the creative political imagination, a temperamental optimism, and an impatience with unreasonable ideas and clichés.

For their indispensable support of the conference, I would like to express my gratitude to Cole Frates, BC class of 1994, and to the director of the Bologna Center, Kenneth Keller. For her indefatigable efforts in organizing the conference I once more thank Alessandra Nacamù.

For their help in the publication of this volume, I would like to acknowledge Dea Di Furia and Laurentina Cizza.

John L. Harper
Bologna, October 2013

Matthias M. Matthijs

The Dollar Paradox: America Caught between Managing Decline and Enjoying Exorbitant Privileges

No man ever steps into the same river twice, for it is not the same river and he is not the same man. – Heraclitus (535-475 BC)

The reports of my death are greatly exaggerated. – Mark Twain (1897)

INTRODUCTION: THE DOLLAR PARADOX. Since the end of World War II, the world economy – led by the United States – has expanded at a rate unparalleled in human history and America's currency, the U.S. dollar, has played a dominant role in financing this growth by functioning as the indispensable lubricating oil of the global financial system. From the point of view of international monetary relations, it is useful to distinguish between two successive postwar periods. The first period – the "Thirty Glorious Years" of Keynesianism – lasted from 1944 to 1973. The bedrock of this period was the Bretton Woods system of fixed exchange rates anchored by the U.S. dollar, defined by an activist state, relatively free trade in goods and services but state controlled international capital flows. The second period – the post-Bretton Woods system of Neoliberalism – started in 1973 and broadly remains in effect today. The latter period is characterized by a retreat of the state from the economy, floating exchange rates, relatively free international capital flows, and the persistence of the U.S. dollar as the dominant global reserve currency.

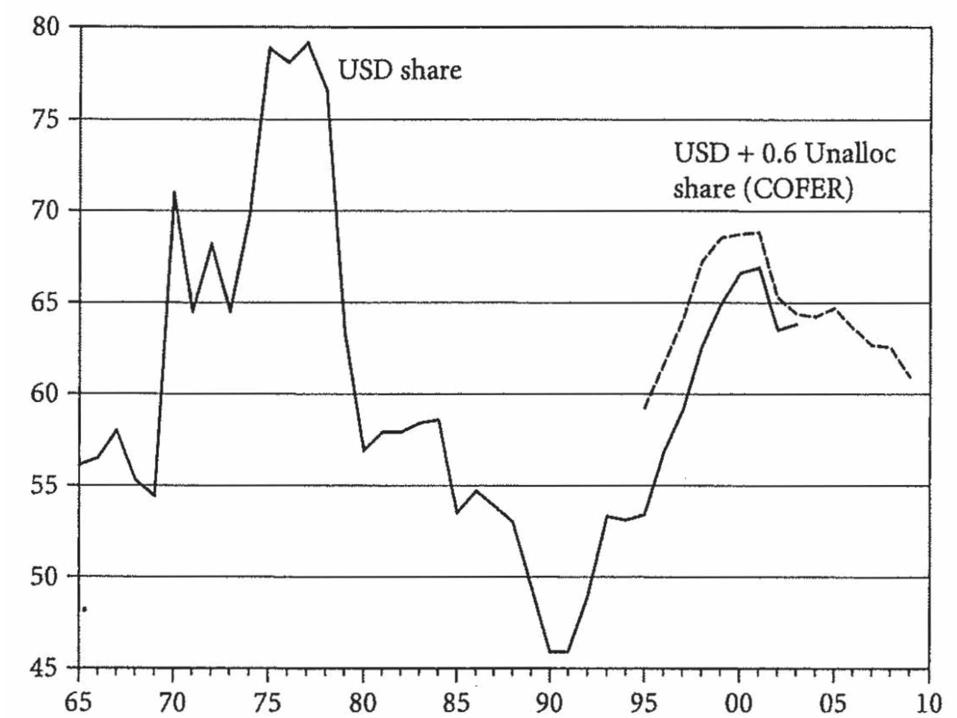


Figure 1: U.S. Dollar Share of Total International Reserves (1965-2010)
Source: Barry Eichengreen, Exorbitant Privilege (Oxford University Press, 2011), p. 64

The collapse of the Bretton Woods system in the early 1970s did not lead to an end of the dollar's hegemony, as was widely predicted by IPE scholars at the time, even though there were some notable dissenting voices.[1] Figure 1 shows the U.S. dollar's share of the world's total international reserves. From the mid-1960s to the late 1970s, the dollar's share actually increased from 55 percent to almost 80 percent, but fell rapidly during the 1980s to just over 45 percent by 1990. With the end of the Cold War, however, the dollar's share in the world's international reserves increased again to just over 70 percent by the year 2001. According to the IMF, the U.S. dollar comprises roughly 62 percent of all the world's official foreign exchange reserves in 2012.[2] However, it is hard to find anyone today who has been completely satisfied with this dollar-centric monetary arrangement; even while the dollar has been central to the smooth functioning and rapid growth of the world economy for the past seventy or so years.

Indeed, few subjects have invited more academic debate in postwar international political economy than the role and (in)stability of the U.S. dollar in the international monetary system. The fall of the greenback from its hegemonic position has been repeatedly predicted, starting in the early 1960s with the first signs of military overstretch due to America's existential fight with communism during the Cold War. Yet every time the dollar's fate seems sealed, either domestic or international political events have come to its rescue. Even as the global financial crisis--which started in the U.S. housing market in 2007--hit the world economy in September 2008, the dollar initially strengthened and international investors rushed to its perceived status as safe haven. It was around that time that two IPE scholars, Eric Helleiner of the University of Waterloo and Jonathan Kirshner of Cornell University, brought together a group of economists, historians and political scientists to debate the future of the dollar. The resulting book underscored the profound disagreement about the currency's future among experts who had studied the dollar's international role for several decades.[3] The authors' dissenting views on the future of the dollar, Helleiner and Kirshner observed, heavily depended on the overall approach they took, distinguishing between a "market-based," "instrumental" and a "geopolitical" approach.

One of the contributors to the edited volume, *The Future of the Dollar*, was David Calleo, who combined a market-based with a geopolitical approach. Seeing persistent dollar weakness and volatility due to recurring budget and current account imbalances during the postwar period, and relative decline caused by unipolar overstretch and rising powers in the East, he naturally fell into the 'declinist' camp.[4] According to Calleo, the dollar's supremacy had endured during the Cold War because various U.S. administrations had been creative enough to develop their own unique formulas to manipulate the dollar in an effort to reconcile the twin demands for guns and butter. The Cold War meant that the U.S.' geopolitical allies were willing to support the dollar in return for American military protection, in effect paying an indirect "imperial tax."[5] However, Calleo pointed out, the end of the Cold War brought an abrupt end to the common Soviet threat and witnessed the birth of a new global currency in Europe--the euro--with the signing of the Maastricht Treaty in 1992. This would make it harder for future U.S. administrations to repeat the old Cold War trick of manipulating the value of the dollar. Calleo insisted a more plural world would require a more balanced multipolar monetary system, which would come about by rising economic powers, not just in Europe but also in emerging Asia.

The prospects for this new multipolar monetary order after the global financial crisis of 2008 will be examined in this paper. But before we look at the current situation, we first need to briefly review how we got here, starting with the U.S. global economic vision at Bretton Woods in 1944.

DOLLAR INSTABILITY FROM BRETTON WOODS TO THE GLOBAL CRASH OF 2008. In 1944, as World War II entered its final phase, the United States found itself in the unexpected position of most powerful country in the world. With over 40 percent of the world economy's total income and producing about 50 percent of global industrial output, the magnitude of America's economic primacy at the end of World War II dwarfed Britain's 9 percent of world output fifty years earlier, when it had been at its relative peak in 1899.[6] As delegates from 44 allied countries gathered in New Hampshire to discuss how to rebuild the international monetary and financial order after the Great Depression, it should therefore be no surprise that the compromise reached between Harry Dexter White and John Maynard Keynes would be much closer to the American position.[7] The final deal was a balancing act between reconciling a commitment to both an open multilateral world economy and domestic political priorities of full employment and social welfare. Key elements of the agreement included the institution of a "gold exchange" standard with currencies pegged to the U.S. dollar (whose value was set at $35 per ounce of gold), currency convertibility for current account transactions and capital controls designed to manage speculative and "disequilibrating" private financial flows, as well as the establishment of the IMF and the World Bank, with *de facto* U.S. veto power over both institutions.[8]

By 1947, with the Cold War heating up, Washington's policy elites realized that Europe and Japan were experiencing serious dollar shortages and would be unable to pay back their war debts without American support. The Truman administration decided to step in with the "Marshall Plan" for Europe and the "Dodge Plan" for Japan. Both programs were simultaneously in America's self-interest as well as acts of genuine American generosity--the Marshall Plan alone comprised close to 10 percent of the U.S. federal budget in its first year of operation. Sold to Congress as a necessary measure to stave off communism in strategically important parts of the world, the plans allowed Western Europe and Japan to rebuild their infrastructure and jumpstart their export industries, and laid the foundation for both regions' economic growth miracles of the ensuing thirty years.[9] But until 1958, the Bretton Woods system was in "virtual cold storage."[10] The currencies of European countries were not convertible and the U.S. government and regional institutions were playing the roles of the IMF and World Bank. All in all, the Bretton Woods system of fixed exchange rates would only last for 13 years, from 1958 (when European currency convertibility began) until 1971 (when Nixon closed the gold window). While the Republican administration of Dwight Eisenhower during the 1950s showed relative restraint both at home and abroad--starting with the end of the Korean

War in 1953, which had triggered a first worldwide spell of inflation, and resulted in a quasi-balanced fiscal budget over the 1950s business cycle--that would not be the case for his Democratic successors in the 1960s. As Calleo observed in his 1987 book, *Beyond American Hegemony*, "the problems of America's extended geopolitical posture have found a ready parallel in the strains of its international economic position. The Atlantic military alliance and the global economic system are complementary parts of the same *Pax Americana* and often affect each other directly."[11] Various U.S. domestic policies, such as the rearmaments for the Korea and Vietnam Wars, the Kennedy tax cut of 1964, and Johnson's "Great Society" programs of 1965, had consequences for the world economy, such as worldwide inflation and growing financial instability. Given that the U.S. started running persistent fiscal deficits in the 1960s (see figure 2), often accompanied by current account deficits, subsequent U.S. administrations needed to come up with a formula to finance those deficits amidst changing international economic conditions.

In effect, Calleo detected three different recipes for managing the U.S. dollar during the Cold War: Lyndon Johnson's combination of fixed exchange rates with expansionary fiscal and monetary policies; Richard Nixon's blend of floating exchange rates with loose mon-

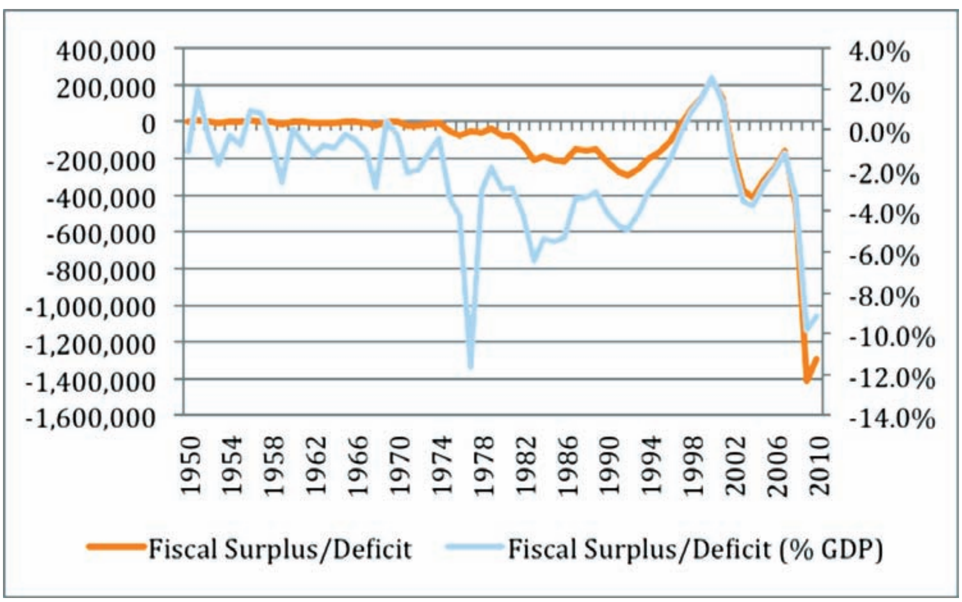


Figure 2: U.S. Fiscal Deficit (1950-2010)
Source: U.S. Government, The White House, Office of Management and Budget (2012)

ey and fiscal expansion ('benign neglect'); and Ronald Reagan's tax cuts and increased military spending in close coordination with Fed Chairman Paul Volcker's tight monetary policy to fight runaway inflation. The switch from fixed to flexible exchange rates in the early 1970s had long been in the making. At the heart of the Bretton Woods arrangement of the gold-exchange standard had been the "Triffin Dilemma," first noted in 1947 by the Belgian economist, Robert Triffin.[12] If the world economy relied on the U.S. dollar to be the single reserve currency, Triffin argued, the system would either suffer a dollar credibility problem or a dollar liquidity problem. The U.S. would have to issue lots of financial assets (i.e., government bonds) to grease the wheels of global commerce and meet the growing demand for reserves. However, the more treasury bills the U.S. issued, the less likely it would be to honor its debts in the future. As *The Economist* once summed it up: "In the end, the world's insatiable demand for the "risk-free" reserve asset will make that asset anything but risk-free."[13] No surprise that de Gaulle's favored economist, Jacques Rueff, saw the Bretton Woods system as the main source of worldwide inflation.[14]

Figure 3: USD Nominal Effective Exchange Rate (1970-2011)
Source: Bank for International Settlements (Note: 2005=100)

Ever since Richard Nixon embraced a floating dollar in 1971, the U.S. nominal effective exchange rate experienced wide swings characterized by long periods of depreciation (1970s, early 1990s, and 2000s) and long periods of appreciation (late 1970s-mid 1980s, second half of the 1990s), as illustrated in figure 3. Nixon, who had started out as every Chicago economist's dream president--campaigning on a platform of deregulation and less government control of the economy--eventually embraced Keynesian fiscal expansion combined with wage and price controls to fight inflation. With monetary policy relatively loose, the U.S. was exporting dollars freely into world markets, and with a weakening dollar and the 1973-74 oil shocks, inflation only became more exacerbated. Monetary tightening to counter inflation would begin under Jimmy Carter, with Paul Volcker at the Fed, and continue under Ronald Reagan.[15] Reagan's formula of supply-side tax cuts, increased military spending and continued tight money, resulted in exceptionally high interest rates and an overvalued dollar, and saw the emergence of the "twin deficits" (large fiscal and current account deficits). The U.S. in effect began importing back from abroad the dollars it had exported before, and then using those funds to finance a growing external deficit.[16] Under Reagan, the U.S. went from a global creditor to a global debtor nation after 1985 (see figure 4). For many declinist thinkers, the writing was on the wall. For Calleo, the significance of the progression of the various formulas from Kennedy to Reagan was that the U.S. had managed to live beyond its means for well over three decades, resulting in persistent budget and widening current account deficits. The main reason for this situation, Calleo argued, was geopolitical. The rationale went as follows: as long as the bipolar strategic confrontation between the Americans and the Soviets lasted, the Western allies in Europe and Japan could not let the dollar crash, and were thus compelled to keep paying their "imperial tax" and prop up a flawed system that for many declinist thinkers had become unsustainable by the late 1980s.[17] But of course, as we know now, it would be the Cold War itself that would prove untenable, with the Soviet Union imploding first.

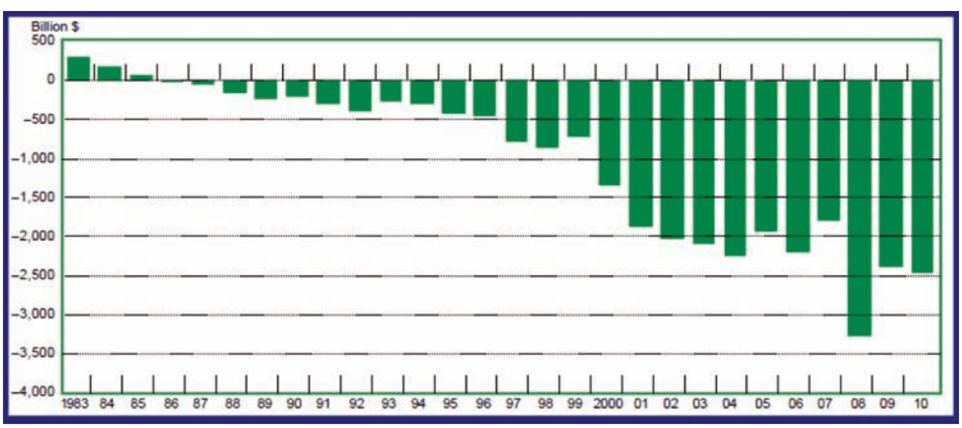
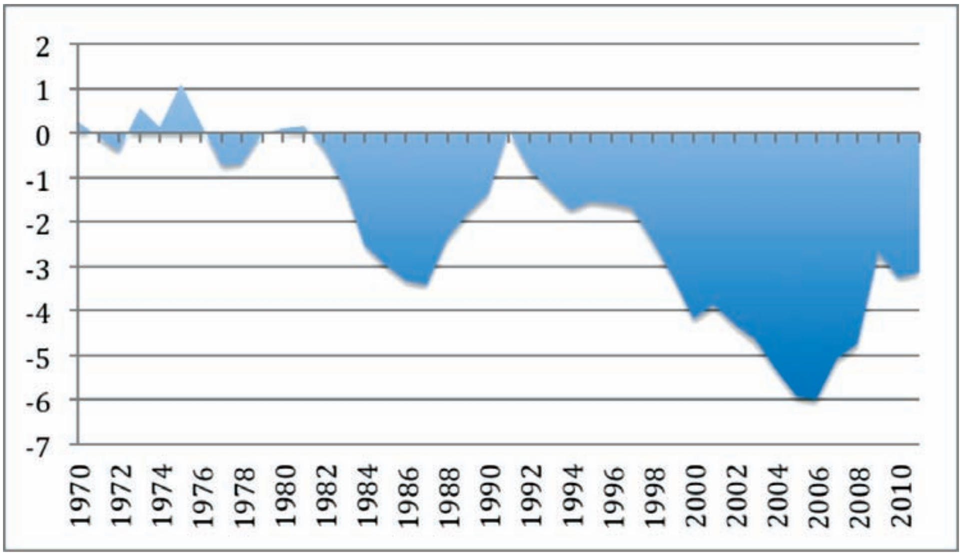


Figure 4: United States: Net International Investment Position (1983-2010)
Source: U.S. Department of Commerce, Bureau for Economic Analysis (2011)

The unexpected events of the late 1980s and early 1990s--the fall of the Berlin Wall, German Reunification, and the collapse of the Soviet Union--brought with them a renewed enthusiasm among U.S. elites for American prosperity and power. After all, from Washington's point of view, America had won, and most of the world's power was now in the U.S.'s democratic hands. In the end of the Cold War, Calleo observed, lay the kernel of America's dangerous unipolar imagination.[18] This would take two forms: the idea of an economic superpower under the Clinton administration, fueled by the technology boom of the "new economy," and the renewed enthusiasm to be the sole military superpower under the administration of George W. Bush, triggered by the tragic events of 9/11 and the ensuing War on Terror, with 'hot' wars fought simultaneously in Afghanistan and Iraq. But the disintegration of the Soviet Union also meant the evaporation of the common geopolitical threat to the West. It would be harder for the Americans to finance their twin deficits now that there was no longer an urgent need for Europe and Japan to underwrite the dollar's stability. In addition, with the signing of the Maastricht Treaty, the European Union pursued its own internal dreams of completing its Common Market with a common currency, the euro, and its own foreign policy, CFSP.[19] The Clinton administration responded by finally addressing the federal budget deficit with initial tax increases--already started under the George H.W. Bush administration--and significant reductions in military spending thanks to the "peace dividend" enjoyed at the end of the Cold War. The 1990s saw the U.S. economy experiencing a classic economic boom, with record growth fueled by the application of information and communications technology, increasing productivity, falling unemployment and record tax revenues which eventually closed the federal budgetary gap by 1998 (figure 2), resulting in a strong dollar that helped keep inflation in check. The 1990s were also marked by a relatively peaceful foreign policy with the exception of the interventions in the Balkans. Combining fiscal austerity with Fed Chairman Alan Greenspan's relative monetary restraint, the Clinton administration seemed to have found the ideal formula for a post-Cold War world.[20] However, with record current account deficits (figure 5), the U.S. basically kept living beyond its means, and grew increasingly dependent on cheap imports from Asia for its consumption, and accompanying cheap Asian capital inflows to finance its consumption binge. The continued success of the Clinton formula also depended on continued fiscal and monetary restraint. By 2000, the Clinton-Greenspan boom had turned into the 'irrational exuberance' of the dotcom bubble and burst, and the economy slid into recession. To make matters worse, America's sense of invulnerability was forever tarnished with the Al-Qaeda terrorist attacks of September 11, 2001. The administration of George W. Bush responded vigor-



<u>Figure 5</u>: U.S. Current Account Deficit (1970-2010)
<u>Source</u>: IMF, International Financial Statistics (2012)

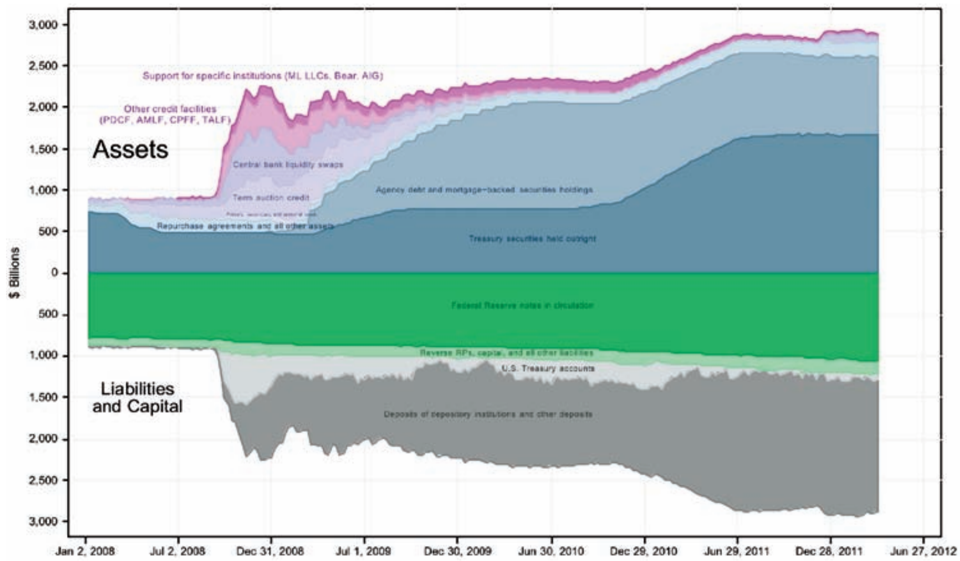
ously with two rounds of income tax cuts in 2001 and 2003, and massive increases in defense spending to finance the pending War on Terror. Bush had inherited a $236 billion surplus from Clinton in 2000; by 2004, the U.S. federal deficit reached $413 billion--one of the most extreme turnarounds in the country's fiscal balances in U.S. history.[21]

At the same time, Greenspan slashed interest rates and would keep the federal funds rate at the historically low rate of 1 percent for most of 2003 and 2004, known as the "Greenspan put." This fiscal and monetary activism quickly led to a new economic boom, this time fueled by the U.S. housing market. Together with a much more permissive financial environment, driven by the neoliberal policies of financial liberalization initiated during the Clinton administration, combined with a much more open global capital market, this led to a further widening of the current account deficit which reached a record 6 percent of GDP by 2006 (figure 5) and to a steep decline in the value of the U.S. dollar (figure 3). Given this dramatic reversal in the dollar's fortunes vis-à-vis the 1990s, and a world economy growing increasingly multipolar, with fast-growing Asian giants China and India, and an enlarged European Union with a single currency, the world economy seemed ready for a substantial overhaul of its international monetary system. Even more so after the great crash of 2008, which originated in the U.S., it was clear to most observers, including British Prime Minister Gordon Brown and French President Nicolas Sarkozy, that the dollar-centered world economy was badly out of balance, and in desperate need of reform. Calls for a "new Bretton Woods" were rife in almost all corners of the world economy, and many analysts held out hope that the G-20--the new international body self-tasked with reforming the international economy, which included representatives of the twenty most important economies in the world--would take on the task.[22]

THE OBAMA-BERNANKE FORMULA: BALLOONING FISCAL DEFICITS AND PUSHING ON A MONETARY STRING. Even though there are still significant disagreements as to the causes of the global financial crisis in 2008, the broad sequence of events is well known by now.[23] Once the credit bubble in the U.S. housing market started to burst in late 2006 and early 2007, it was apparent that this was not going to be your everyday economic crisis. Through a giant maze of collateralized debt obligations (CDOs) made up of mortgage backed securities (MBSs), many of them 'subprime,' and insured by credit default swaps (CDSs), the whole global financial system was exposed multiple times to the risk of a U.S. housing collapse. With house prices falling by 20 percent over the course of 2008, the world economy faced its 'black swan' moment in September 2008 with the collapse of Lehman Brothers, which put an extraordinary amount of pressure on the U.S. and world financial system.

Stock markets plunged, and the financial crisis soon translated into a massive slide of the real economy, leading to falling output levels, rapidly increasing unemployment, and increasing savings resulting in a Keynesian liquidity trap. Governments and central banks worldwide would soon step in, but they would be unable to avoid the world's first global economic contraction since World War II in 2009. As soon as the crisis was underway, the blame game began, and everybody had their favorite culprit, depending on one's position along the political spectrum: from greedy bankers, regulators asleep at the wheel, reckless monetary policy, excessive government intervention in the housing market, deregulation of financial markets, too high Chinese saving or too low American saving, to global capitalism itself.

One of the more peculiar aspects of the global financial crisis was the initial strengthening of the U.S. dollar as institutional investors worldwide sought refuge in the perceived American safe haven (figure 3). With the new Democratic administration of Barack Obama in power in January 2009 and Ben Bernanke at the helm of the Federal Reserve, the new "Obama-Bernanke" formula to deal with the crisis began to take shape. On the fiscal side, the Obama administration passed a large budgetary stimulus of close to $800 billion in early 2009, combining various tax cuts with big increases in federal spending, which came on top of an almost equally big federal bank bailout enacted under the Bush administration in September 2008. Naturally, this would lead to ballooning fiscal deficits (figure 2): from 2009 to 2012, the U.S. federal deficit would exceed $1 trillion for four consecutive years, adding up to a total of $6 trillion in four years, all of which had to be borrowed on domestic and international financial markets.



<u>Figure 6</u>: Federal Reserve Bank – Assets and Liabilities (2008-2012)
<u>Source</u>: Jaime Marquez, Ari Morse, and Bernd Schlusche, "The Federal Reserve's Balance Sheet and Overnight Interest Rates," FED Finance and Economics Discussion Series (September 2012)

On the monetary side, Fed Chairman Bernanke responded to the crisis with a series of unconventional measures (see figure 6). Initially cutting the federal funds rate to close to zero, but also trying to unfreeze the credit markets with a whole alphabet of "other credit facilities" and support for specific institutions, such as insurance giant AIG and investment bank Bear Stearns. As the initial responses seemed to stop the slide into despair, the Fed started to focus on reigniting growth in the U.S. economy, with multiple rounds of "quantitative easing", the last one open-ended, and a "twist" of the yield curve (i.e. buying long-term assets in return for short-term assets without printing additional money, hoping to lower long-term interest rates). As illustrated on figure 6, from the fall of 2008 to the fall of 2012, the Federal Reserve balance sheet exploded, nearly quadrupling from $800 billion to just over $3 trillion.

Most troublesome from a monetary policy point of view was the vast increase on the assets side of "agency debt and mortgage backed securities holdings" and on the liabilities side of "deposits of depository institutions" on the Fed's balance sheet. In other words, the Fed was buying toxic assets from American banks in order to clean up their balance sheets and infuse fresh and much needed cash into the system, while at the same time those banks, refusing to lend to the real economy, just deposited those funds back at the Fed for an overnight interest rate of anywhere between 0 and 25 basis points. John Maynard Keynes could not have wished for a better illustration of his idea of interest rates as a piece of string: easy to pull during a boom, but difficult to push and therefore largely ineffective during a severe recession.

Given the dollar's unique status in the international monetary system, the irony is that the United States has been able to finance its gigantic fiscal deficits at record low interest rates, making the case for long-term fiscal reform at home seem much less urgent. With a U.S. Congress in full election mode at the end of 2012, in complete gridlock as to the fiscal way out, the Federal Reserve kept the show on the road. But rather than seeing a new international monetary order, reflective of the new and undeniably multipolar reality of the world economy, the status of the dollar seems, paradoxically, to have been enhanced by the global financial crisis. In order to make sense of this puzzle, we need to go back to David Calleo's two main reasons for why the dollar's exorbitant privilege would be unsustainable: the end of the Soviet threat would make it harder for the U.S. to finance persistent deficits from its Cold War allies and the creation of the euro meant a rival global currency that in some ways was more attractive than the dollar given its independent central bank and sole commitment to price stability.

In the next two sections, I will argue that America's paymasters in Europe and Japan have been replaced by a fast growing China together with the rest of emerging South and North East Asia, countries which deliberately undervalue their exchange rates, resulting in global economic imbalances; and that the internal contradictions and design flaws of the euro are more acute than the perennial weakness of the U.S. dollar.

GLOBAL IMBALANCES AND BRETTON WOODS II. After the Asian crisis of 1997-98, most Asian economies appear to have learned five valuable lessons. First, you open up your economy's financial account at your peril; gradual financial liberalization with occasional capital controls is a much more prudent way to proceed. Second, build up your central bank's foreign exchange reserves so massively that no international investor will see the benefit in shorting your currency. Third, diversify your medium-term economic strategy between investment-led and export-led growth, with the best way to stimulate exports and discourage imports being to artificially undervalue your currency.

Fourth, balance your investment portfolio between domestic and international sources in order to limit the fall-out from any 'crony capitalism.' Fifth, under no circumstances let the International Monetary Fund back into your country.

Together with America's voracious appetite for cheap Asian imports and continually deficient household and government saving, the result has been the emergence since the late 1990s of global macroeconomic imbalances. As shown on figure 7, the chronic U.S. and U.K. current account deficits are mirrored by current account surpluses in China (and the rest of emerging Asia), Japan, Germany and Saudi Arabia. Since most of Germany's current account deficit is with the European periphery, and Europe is practically in balance with the world economy, we need to focus on Asia.

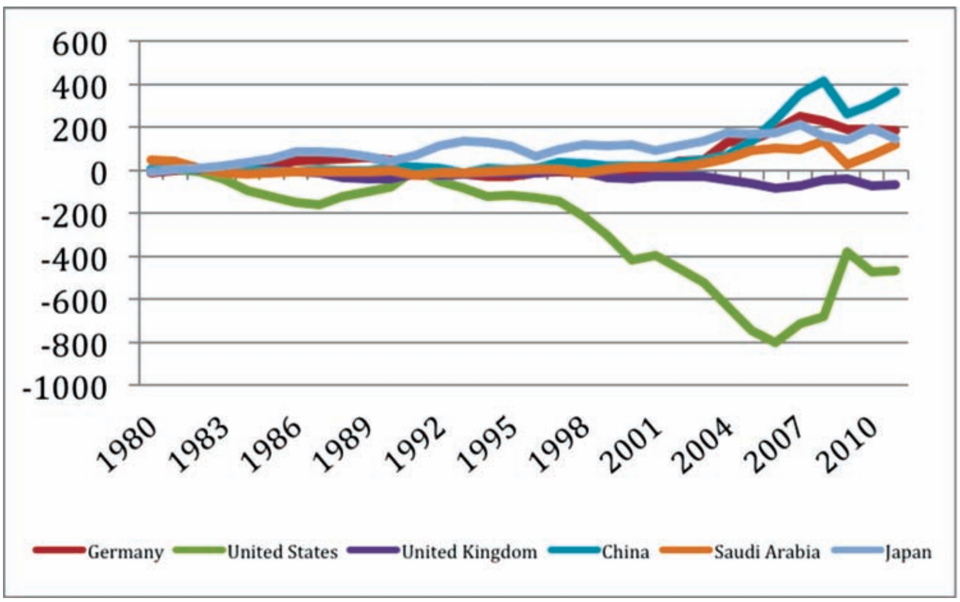


Figure 7: Persistent Current Account Imbalances in the G-20
Source: IMF, International Financial Statistics (2011)

There are various views on the emergence and role of global economic imbalances, summarized by Barry Eichengreen in "The Blind Men and the Elephant" as four different though not mutually exclusive views: U.S. savings are too low (Nouriel Roubini), U.S. investment is unusually high (Richard Cooper), Asian investment is too low (Niall Ferguson) and Asian savings are too high (Ben Bernanke, Martin Wolf).[24]

The more interesting point is that some views are closer to the truth than others at specific points in time; with the deficient U.S. savings view in combination with the global savings glut view closest to reality from the early 2000s onwards. In other words, emerging Asian economies, led by China, are happy to export their way to faster growth, even if that means they are foregoing current consumption and investment opportunities, with their excess savings ending up financing the United States' consumption of their goods. The case of China is extreme: with just below $200 billion in foreign reserves in the year 2000, it managed to accumulate a total of $3.24 trillion in foreign exchange reserves by the summer of 2012.[25]

In an influential NBER working paper published in September 2003, Michael Dooley, David Folkerts-Landau and Peter Garber argued that "the economic emergence of a fixed exchange rate periphery in Asia [had] reestablished the United States as the center country in the Bretton Woods international monetary system."[26]

The authors noted that any "normal" evolution of the world's monetary system included a periphery that keeps its exchange rate undervalued by accumulating reserve asset claims on the center country. During the original Bretton Woods system, Western Europe and Japan played the role of the periphery, with the U.S. at the center. But now, since both Western Europe and Japan had "graduated" to the center themselves, the emerging economies of East Asia had filled the void. For Dooley, Folkerts-Landau and Garber, the current arrangement was "sufficient to keep the system intact for the foreseeable future." As Helleiner and Kirshner pointed out, this is one aspect of the "instrumental approach" which some scholars argue will maintain the dollar's current position in the international system.[27]

Of course such a *de facto* Bretton Woods II sponsored by never ending Asian savings brings with it all kinds of risks. It is not at all certain that either side will uphold its part of the bargain. On the one hand, the U.S. market--especially if it continues to linger in its current low growth equilibrium--could become less important for Asian exports, lessening the need for Asian countries to continue supporting the dollar, especially as the growing Chinese middle class starts to develop its own appetite for consumer goods. On the other hand, anti-trade sentiment and protectionist temptations in the U.S. might slow down American enthusiasm for cheap Asian imports. Also, one cannot deny the fragile geopolitical dimension of the arrangement. It is hard to believe that China will continue to maintain the dollar's international reserve status in the likely event of growing strategic tensions whether in the South China Sea, over Taiwan, North Korea, or the battle for energy resources. While all of those risks are there, Bretton Woods II helps to explain why the United States has continued to finance its deficits at record low rates, and the dollar remains the reserve currency of choice in most of the world today.

FRAGILE GLOBAL CURRENCY: THE EURO AND LOCAL IMBALANCES. In the global beauty pageant between the euro and the dollar, the latter still looks less ugly, at least for now, and hence is likely to prevail for the foreseeable future. While the creation of the euro was supposed to unify Europe further politically by bringing about convergence economically, it seems to have done the exact opposite. This has become painfully obvious over the past few years since the euro crisis broke, triggered by the admission of Greece, the euro-zone's weakest member, that its deficits were much worse than initially feared. The sovereign debt crisis that continues to shake the euro-zone and took Brussels-based policy elites by surprise in the spring of 2010 was in many ways the logical consequence of the global financial crisis, but has raised serious questions as to the original design and long-term viability of Economic and Monetary Union (EMU). The initial focus of the financial crisis during the autumn of 2008 was on those countries with heavily developed and exposed financial sectors, mainly the United States and the United Kingdom. There was even some veiled *Schadenfreude* in Continental Europe, with economic and political elites in Paris and Berlin to some extent feeling vindicated. In their minds the crisis was laying bare all the shortcomings of the Anglo-Saxon model of financialized capitalism. In Britain, there was even brief talk of the 'missed opportunity' of not having signed up to Europe's Economic and Monetary Union in the late 1990s.[28]

However, not for long: the crisis quickly spread from the United States to Continental Europe and to the rest of the developed and developing world. In order to stem wholesale financial collapse, all advanced industrial states of the euro-zone were forced to pass large bailouts of their financial sectors and put in place fiscal stimulus plans to stave off severe recessions. By mid-2009, financial markets were worried that many governments in Europe--with the Southern European countries around the Mediterranean and Ireland up front (the PIIGS)[29]--faced the consequences of a triple fiscal punch: a collapse in government revenue due to the recession, a rapid increase in spending due to rising unemployment and large stimulus bills, plus the extra cost of taking on all the bad private debt on the public sector balance sheet. This triple punch translated into ballooning budget deficits, and a steep rise in sovereign debt.

As Carmen Reinhart and Kenneth Rogoff reminded us in *This Time Is Different*, we should not have been surprised that financial crises often lead to fiscal and sovereign debt crises.[30] Yet, the financial markets somehow did seem surprised that governments, after having bailed out their financial sectors with an unmatched infusion of public money, found themselves with all the bad debt they had taken on from those private sectors;

as the initial focus of financial market participants shifted from private debt in 2008-2009 to sovereign debt in 2010, concerns about the long-term fiscal solvency of Europe's periphery led to the collapse of confidence in PIIGS bonds and a subsequent capital flight to safety. Bond traders sold risky Mediterranean sovereign debt and purchased perceived risk-free assets such as German *Bunds* and United States *Treasuries*. This led to widening sovereign debt yield spreads within the euro zone (figure 8).

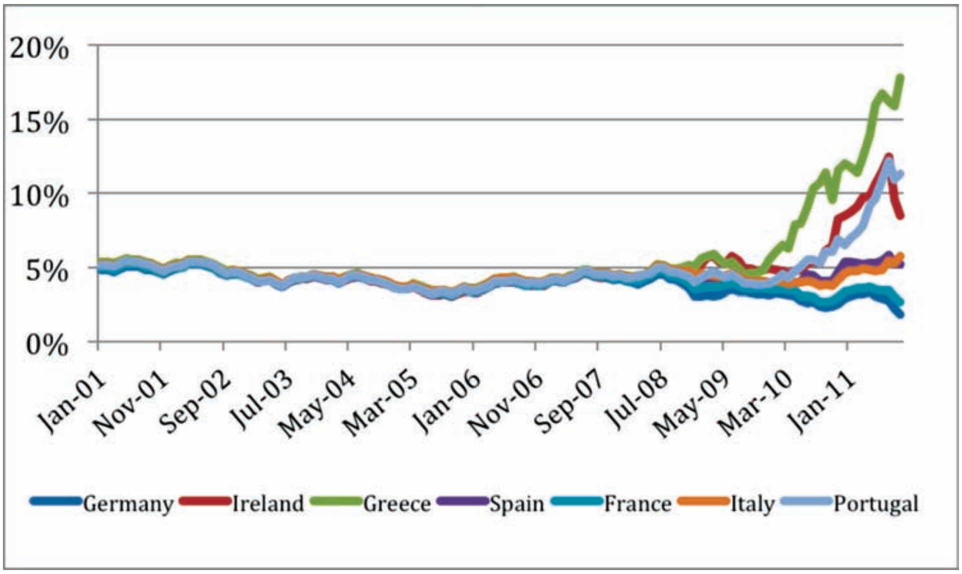


Figure 8: Ten-Year Bond Yields for Selected Euro Member Countries (2001-2011)
Source: Bloomberg (2012)

As during the global financial crisis in 2008, there were multiple competing crisis narratives and explanations of the EMU sovereign debt crisis of 2010. For American economists, it was a crisis of design, given that Europe was not an Optimum Currency Area and no monetary union would function properly without a fiscal and a banking union. For many German (and Northern European) policy elites, this was a fiscal crisis, due to unsustainable welfare states and ageing populations, while German business leaders saw it as a crisis of competitiveness in the Mediterranean. The most intriguing explanation for the crisis is that of the existence of persistent intra-EU imbalances-- Europe as a mini-world with "competitive" export-led Germany in the role of China and the "profligate" Mediterranean countries and former Celtic tiger Ireland in the role of the United States, though of course lacking similar exorbitant privileges.[31]

The rationale behind the 'local imbalances view' goes as follows: Initial bond spreads in the 1990s allowed financial market participants to buy higher yield Mediterranean bonds and sell their lower yield Northern European bonds. This flooded Southern European countries with capital, fueling a cycle of housing booms and consumer spending, causing their current accounts (and goods markets) to adjust. The evidence for this view seems overwhelming.[32] According to Eurostat, while Germany's trade surplus with the rest of the EU was €46.4 billion in 2000, it had grown to €126.5 billion in 2007. Looking at the evolution of Germany's bilateral trade surpluses with the Mediterranean countries, between 2000 and 2007 Greece's annual deficit with Germany grew from €3 billion to €5.5 billion, Spain's almost tripled from €11 billion to €27.2 billion, Italy's doubled from €9.6 billion to €19.6 billion, and Portugal's quadrupled from €1 billion to €4.2 billion.[33] Similarly, a IMF working paper by Claire Waysand, Kevin Ross, and John de Guzman on "European Financial Linkages" reveals Germany and France to be the two biggest net creditors within the Eurozone in 2008 with intra-Eurozone net investment positions of +€735 and +€764 billion respectively, the exact mirror image of Portugal (–€136 billion), Greece (–€199 billion), Italy (–€334 billion) and Spain (–€794 billion).[34] So, it was the capital flows that attended nominal interest rate convergence in the late 1990s and early 2000s that caused the current account divergences across Europe.[35] We need to look at private capital flows and private debt in order to understand the EMU crisis.

The only solution therefore is for Europe to re-balance its economy, which could be brought about by inflation in the north and deflation in the south. However, that solution is only politically possible once all parties accept the need to adjust.[36] Also, a solution to the euro crisis requires a significant leap forward in integration, including some kind of fiscal, banking and political union to deal with asymmetric shocks, a process that will take many years. There is also no guarantee that Europe will succeed. It will depend on the political will of Europe's elites. And as long as Europe continues to struggle to emerge stronger from its sovereign debt crisis, the euro does not look like a plausible alternative to a weak dollar.[37]

CONCLUSION: HERE TO STAY. Like Mark Twain's death, the reports of the dollar's impending collapse are greatly exaggerated. We can conclude that even though the United States has been in relative economic decline since the end of World War II, it has continued to enjoy the "exorbitant privilege" Valéry Giscard d'Estaing first assigned to it during the 1960s. During the Cold War, as David Calleo has argued, various U.S. administrations dealt with persistent dollar weakness and volatility in imaginative but often contradictory and unsustainable ways. With the main underpinning elements during the Cold War being the 'imperial tax' paid by America's allies, and the absence of any global alternative, the dollar's status was upheld without too much effort.

But to paraphrase Heraclitus at the beginning of this paper, no U.S. administration ever steps into the same river twice. Every American administration comes to office facing new domestic and international circumstances and usually has different ideas on how to respond to them. With the end of the Cold War, both conditions that had kept the dollar going had vanished, but the endurance of the dollar as the dominant global currency was made possible by emerging Asia taking over the imperial tax from the Europeans and the inherent weakness--especially starting with Europe's sovereign debt crisis in 2010--of the euro as a potential rival global currency. Whether the current dollar arrangement is sustainable beyond the medium term is doubtful. In the longer run, a more balanced world monetary system with multiple leading currencies still seems desirable, not just for the United States, but for the world economy at large.

ENDNOTES

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[4] See David P. Calleo, "Chapter 8: Twenty-First Century Geopolitics and the Erosion of the Dollar Order" in Helleiner and Kirshner (eds.), *The Future of the Dollar* (Cornell University Press, 2009), pp. 164-190
[5] David P. Calleo, *Rethinking Europe's Future* (Princeton University Press, 2001), p. 331
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[8] Barry Eichengreen, *Globalizing Capital* (Princeton University Press, 2008), pp. 51-54
[9] Barry Eichengreen, *Exorbitant Privilege* (Oxford University Press, 2011), p. 47-51
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[13] The Economist, "The Global Monetary System: Beyond Bretton Woods 2," November 4, 2010
[14] Calleo, *Beyond American Hegemony*, p. 85
[15] For this period, see David P. Calleo, *The Bankrupting of America* (New York: Avon Books, 1992)
[16] Calleo, "Twenty-First Century Geopolitics," in Helleiner and Kirshner (eds.), p. 169
[17] Ibid., p. 170. See also Paul Kennedy, *The Rise and Fall of the Great Powers* (New York: Random House, 1987).
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[23] Matthias Matthijs, "Crying Wolf Again?" *The International Spectator* 47 (3), September 2012, pp. 40-42
[24] Barry Eichengreen, "Global Imbalances: The Blind Men and the Elephant," *Brookings Institution*, Issues in Economic Policy, Number 1, January 2006. Online available at: http://www.brookings.edu/research/papers/2006/01/01macroeconomics-eichengreen
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[26] Michael P. Dooley, David Folkerts-Landau, and Peter Garber, "An Essay on the Revived Bretton Woods System," *NBER Working Paper Series* 9971, September 2003
[27] Helleiner and Kirshner (eds.), *The Future of the Dollar*, pp. 12-13
[28] Author interviews in London in October and November 2008
[29] Those countries were soon dubbed the "PIIGS" (Portugal, Italy, Ireland, Greece, and Spain)
[30] Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009)
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[33] Eurostat, *External and intra-EU trade – Statistical Yearbook (Data 1958-2009),* Brussels: European Commission, 2010, p. 145
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