Journal of Economics Library
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Volume 9 December 2022 Issue 4

From Keynes' Clearing Union to the Euro-zone and the Renminbi

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Abstract. The 1944 Bretton Woods agreement provided an international imprimatur for the dollar standard. H. D. White, the lead US negotiator, saw to it that the ability of other countries to obtain commitments from the US (via the International Monetary Fund) for loans or approval for currency devaluations would be limited. J.M. Keynes, representing Britain, in contrast proposed an International Clearing Union that would issue its own currency ("bancor"), intended to reduce systemic dependence on the dollar or on gold. The ICU would be a bank for the world's central banks, which would allow debtor nations to borrow freely. In contrast to White's plan, ICU creditors would be expected to reduce their balances by expanding domestic credit or other means. Insights from Keynes' plan help to understand later developments. An ICU premise was that international reserves should be pooled, and centralized. The Bretton Woods gold-dollar standard was jeopardized during the 1960s – the Triffin dilemma -- when European creditor countries demanded gold reserves from the US. A monetary truce, proposed by Mundell, would have included 1) agreement by Europe and the US on an inflation level, and for US monetary policy to target that level; and 2) Europeans adjust their gold-to-dollar ratios to maintain the US gold stock. Monetary cooperation could thereby have created de facto international reserves. Instead, the Bretton Woods exchange rate apparatus collapsed by 1973, leaving major currencies to float. Against expectation, international demand for reserves soared. Relentless demand for US securities has contributed to deindustrialization and financial fragility, ongoing consequences of the dollar standard. And exchange rate depreciation has done little to correct account imbalances. Clearing Union concepts help to understand the euro experiment – when it nearly failed, and how it recovered. An international currency can succeed only if 1) surplus and creditor countries are both required to adjust; and 2) member countries agree on inflation objectives. Demands on China to revalue have been misguided. From the perspective of 2022, correction of account imbalances will not happen without the approval of the world's now largest creditor – China – which is likely to resist any constrain on its actions. This is and will be a drag on the world economy.

Keywords. Bretton Woods; International Clearing Union; Bancor; John Maynard Keynes; Harry Dexter White; Robert Triffin; Robert Mundell; Triffin Dilemma; Monetary truce; 1966; Euro-zone; Renminbi revaluation; Partial equilibrium models; Multi-lateral clearing; Flexible exchange rates.
JEL. F02; F31; F33; F36; F38; F41; F45.

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Johnson is the author of *Uncommon Arguments on Common Topics: Essays on Political Economy and Diplomacy* (KSP Books, 2022), http://books.ksplibrary.org/978-625-7501-75-0/ A version of this paper was presented as a keynote address at the Eurasia Conference (WCBFE) on October 27, 2022.

1. Introduction

By the 1920s, gold was being supplemented as an international monetary base by foreign exchange, especially by British pounds and US dollars. Informally, the dollar gradually replaced sterling as the world's money standard between the two world wars. The Bretton Woods agreement of 1944 gave US negotiators, led by H.D. White, almost everything they wanted. The dollar standard was more formally inaugurated, and left gold in place as a national reserve. But J.M. Keynes, representing Britain, sought instead an "international" standard, separate from gold, sterling, or the dollar: the standard would be a reserve currency issued by an International Clearing Union – intended as a bank for central banks. Had Keynes gotten more of what he proposed in 1944, the monetary history of the nearly 80 years since would be quite different. European currencies would more quickly have become convertible after the Second World War, there would have been no reserve crisis during the 1960s, and floating exchange rates would never have become a default solution for monetary ills.

The introduction of the euro in 1999 provided a conceptual return to Keynes' plan for an international currency. Reviewing the Clearing Union proposal offers sharp insights into why the euro experiment nearly failed, and why it is now on a better trajectory. Similar concepts suggest approaches to dealing with China on monetary issues.

The paper includes these topics: The Dollar Standard, 2022; Bretton Woods, 1944; Dollar Convertibility, 1960s; Flexible Exchange Rates; The Euro-zone; A Note on China; and Closing: Missed Opportunities. Before we go back to 1944, let's consider where the dollar standard is now.

2. The Dollar Standard, 2022

We now hear less often that the world's dollar standard is, as Charles DeGaulle once expressed, "America's exorbitant privilege." It is true that the US government can borrow easily, does not need to hold foreign exchange reserves, and earns seigniorage (has interest-free liabilities) on dollar currency held around the world. When the US finally ended gold convertibility in 1971, the role of the dollar in world economics was scarcely affected.

The rest of the world obtains dollars by running capital account deficits with the US. The dollar standard has had two dubious consequences. A first has been growth in US debt, both public and private; higher debt ratios increase susceptibility to financial crisis, domestic or international. The current stock of US treasuries is above $30 Trillion, against annual US GDP of about $23 Trillion in 2021. This is a US debt-to-GDP ratio of over 130 percent, higher than it was at the end of the Second World War – the previous high-water mark. Of the amount held by the public in mid-2022, some $23 Trillion, about a third, $7.7 Trillion, is held by non-US organizations or citizens, just over half of it by foreign governments, that portion usually as central bank reserves (CRS, 2022). The world demand for US treasuries is extraordinary, and comes from both private and public sectors. Nevertheless, a sharp increase in interest rates might at some point have a run-on effect on confidence. The 130 percent US fiscal debt-to-GDP ratio is exceeded among major countries only by Italy at around 160 percent, and Japan, where it is over 260 percent. Italian and Japanese sovereign debt are held mostly domestically.

Far more US securities held abroad are issued privately than by the US government; according to the US Treasury, of some $27 Trillion in US securities held by foreigners in mid-2021, over $20 Trillion were issued privately (US Treasury, 2022). The argument is made that smaller US fiscal deficits would reduce aggregate US borrowing, hence increase net US savings. I doubt this. If financial transfers drive current account deficits, then it does not much matter whether foreign lenders hold US government debt or US private debt. In an interesting study, *Trade Wars are Class Wars* (2020), Matthew Klein and Michael Pettis argue that the US government can make better use of incoming funds than can the private sector (by upgrading infrastructure, extending education opportunities) – hence advocate an expanding issue of treasuries (Klein & Pettis, 2020; pp.202-203, 226). But Klein and Pettis also argue for getting major foreign economies to consume more and save less, so that less capital shift to the US would take place (Klein & Pettis, 2020; p.228). The higher debt issue, they believe, should be temporary.

Second, the dollar standard has been a factor in the relative de-industrialization of the United States. Consider the mechanism. The rest of the world transfers money to the US on a net basis, which finances the US current account (and trade) deficits. The US as a whole is materially better off; it consumes more goods, and, because it has expanded purchasing power, it also demands more services. Consequently, a portion of the production capacity in the US that previously went to producing goods will shift to providing services. Meanwhile, the rest of the world produces more than it consumes – so activity there will shift to producing for export. Some US workers who previously produced goods will have lost their manufacturing jobs (McKinnon, 2013; Ch. 6). According to World Bank data, the share of US GDP in manufacturing has fallen from 16 percent in 1997 to below 11 percent by 2021. Comparative data indicates that manufacturing recently comprised 18 percent of GDP in Germany, nearly 20 percent in Japan, and approximately 27 percent in China.

Perhaps the aggregate economic costs of such shift in manufacturing are limited. The political and social consequences are more troubling. Sections of the US that have lost manufacturing jobs have seen in increase in divorce and alcoholism rates, and often a decline in life expectancy (Nosrati *et al.*, 2018). Consider evidence that 89 of the 100 counties in the US most affected by Chinese competition went for Donald Trump in the 2016 Republican primaries (Auteur, 2017).[2] To the extent that the Trump movement had *economic* origins, the drain of manufacturing jobs in predominately white race districts is surely the place to look.

Finance – capital movements -- drive trade, not the other way around. As Nobelist Robert Mundel put it:[3]

> [I]t is inconceivable that fundamental and enduring changes in the balance of trade can be motivated other than by basic financial transfers. It is true that a shift of domestic expenditure from home to foreign goods will worsen the balance of trade and immediately force accommodating finance, a loss of reserves or a change in the exchange rate... [But] major trade deficits and surpluses are nearly always not only accompanied by but induced by voluntary financial transfers of one kind or another (Mundell, 1992; pp.48-49)

[2] Cited in Klein & Pettis (2020), p.2.
[3] Disclosure: years ago, Mundell was my informal dissertation advisor.

This consideration undermines much discussion of the US current account deficit. The mover is not over-consumption or under-saving in the US; the financial transfer to the US comes first. The concept of "comparative advantage" in trade may bring misleading inferences when shifts in trade are driven by prior shifts in finance, not by cost or production engineering factors. Understanding of capital movements is at the center of Keynes' Clearing Union proposal.

The dollar standard may be sustainable, but it is not optimal. The US, one of the world's richest countries, should not absorb so much of the world's capital exports. With a more rational international monetary system, more of the world's savings could support development in poorer countries – rather than subsidize consumption among the relatively wealthy.

3. Bretton Woods, 1944

The lobby of the IMF headquarters in Washington has two busts recognizing the organization's architects from Bretton Woods, New Hampshire, in 1944: Harry Dexter White for the US and J.M. Keynes for Britain. White was an upper-mid level US Treasury economist who had gained the confidence of Treasury Secretary Henry Morgenthau. Keynes, then in declining health, was understood to be the world's leading theoretical economist; he represented the British Treasury without portfolio, and apparently without being paid.

Despite the equal placement in the lobby, White and the US got their way on almost everything. The IMF, in the mold of White's proposal, was established as a fund to provide temporary help to balance of payments deficit countries. Members subscribed – with paid-in capital -- using either gold or national currency. Countries in distress could borrow up to their quota amounts. By IMF rules, countries were allowed to depreciate their currencies only in limited steps, and only with Fund approval. This structure would allow the US, by far the world's largest creditor country at the time, protection against large unexpected bills for war damaged countries, and would protect US industry against more than modest foreign currency devaluations. The dollar would be convertible to gold (by foreign central banks), and other currencies' values would be pegged to the dollar. White, and the US negotiating position, were broadly unconcerned about "global imbalances" in 1944 or in the years afterward (Steil, 2013; p.136).

White proposed a quasi-gold standard. Diplomatically, the role of gold was a packaging over what was understood by most to be a world dollar standard. Symbolically, White thought, gold represented economic discipline, hence would be reassuring to US legislators. But White did not want an "automatic" gold standard of the pre-WWI model – in which gold exports could lead to monetary contraction. White wanted the US Federal Reserve to be able to sterilize (that is, neutralize) the monetary impact of gold losses, hence to be able to pay out gold without affecting domestic monetary conditions. In contrast to what he had observed of the Great Depression over much of the previous decade, he wanted a *managed* monetary system. With few exceptions, the world has not backtracked since to allow gold movements to constrain domestic monetary policy.

Keynes picked up conceptually where White stopped. His framework for a Clearing Union and an international money was discussed among British

officials during the three-year run-up to Bretton Woods. Many, although not all, British officials were on-board; demurral from the Bank of England (skittish about "competition" from an international bank) weakened Keynes' bargaining position in negotiations with the Americans (Triffin, 1957; pp.107-108).

Keynes' plan was anticipated in the final chapter of his 1930 *Treatise on Money*, "Problems of Supernational Management." His foremost objective at that point was to "abolish the Credit Cycle" (Keynes, 1930; II, p.394); in more recent language, that meant he wanted to use monetary policy to prevent both recession (or depression) on one side and economic over-heating on the other. The Great Depression of the interwar period had been international in scope, caused in first approximation by a systemic shortage of gold (Keynes, 1930), II, p.290).[4] A multinational collapse needed a multinational corrective. A paired objective for the Supernational Authority, as Keynes called it in 1930, was to stabilize the value of its issue, an international currency, and by extension, the value of gold. But Keynes, unlike White, wanted to fade-out the monetary role of gold. The gold standard concept was automaticity – which might itself drive the Credit Cycle rather than soften it. Keynes thought we knew enough to bring the supply and demand for money into balance, hence to stabilize the cycle.

Keynes' International Clearing Union was intended to operate on a "banking principle." Country-members would make deposits in their own currency or in gold, which would become reserve backing for the new international money, "bancor."[5] (the French word for bank-gold). Unlike the case for White's Fund, they would not have paid-in capital. Members would be able to borrow from the Clearing Union, at interest, up to their quota amounts. Surplus countries would pay penalties on reserve accumulation – that is, on bancor balances -- above a specified level (British Information Service, 1943; Section 2, Par. 6(7)).[6] The point was to get surplus countries to take action to reduce their balances, hence: they should open trade (by removing tariffs), raise wages to encourage consumption, take measures to expand credit, make loans to "backward" countries, or revalue currencies upward (Keynes, 1989; xxv, p.120).[7] The combination of the banking principle and demands on surplus countries would allow a relatively small volume of reserves to support a large volume of transactions. Keynes' reasoning hearkened back to the Bank of England before the First World War, when he dubbed it the "conductor of the international orchestra" – when it could affect interest rates and liquidity conditions around the world even though Britain's monetary gold stock was smaller than that of several other countries. As a central bank, it consolidated reserves for the British domestic banking system. The Clearing Union, by analogy, was to be a bank for managing central bank reserves. It would be capable of deliberate expansion and contraction to offset deflationary and inflationary pressures in effective world demand. Gold would be included in the balance sheet of the Clearing Union, but it would not be paid out in exchange for bancor, dollars, or anything else. Gold would survive

[4] Also, Johnson (1997), Chs. 3, 4.
[5] "Bancor" is the French word for bank-gold.
[6] British Information Service (1943), Section 2, Par. 6(7).
[7] Also, British Information Services (1943), Section 2, Par. 9.

as a "constitutional king," kept on to symbolize continuity and international cooperation (Keynes, 1930; II, p.292).

Let's highlight several concepts from the Clearing Union plan:

- the effort to pool, hence to economize, reserves
- *manage* international supply and demand for money (end *automatic* standard)
- convert gold from a national to an international reserve
- expectation that surplus countries should take action to move closer to balance; (an international currency cannot work without achieving this)
- countries' internal balances (including wages, availability of credit, and income distribution) are areas of potential international intervention
- put finance before trade – hence seek some direction over the volume of capital movements, including "speculative" flows

In a moment, I want to consider some implications for the use of these concepts, or for their neglect, in international finance since 1944. (Note that Keynes did *not* include common fiscal policies as a condition for having an international currency. Indeed a 1943 draft was specific that "the plan must be capable of application irrespective of… the economic - policy existing in the prospective member States" (British Information Service, 1943; p.3). But before we go to more recent events, let's add context on the Keynes and White Plans.

Keynes moved fluidly between theory and advocacy; sometimes any line between the two was blurred. In perhaps the two areas where Keynes' arguments are most recognized, three generations on, he was almost certainly wrong. Contrary to Keynes' argument in *Economic Consequences of the Peace* (1920), Germany could have paid significant reparations after the First World War. Keynes assertion that transfers to France, Britain and others would have required lower German wages and a weakening in the terms of trade between Germany and recipient countries neglected expenditure effects. Transfers to recipient countries could raise the latter's aggregate demand without changing German export or import prices. Bertil Ohlin demonstrated these economics in his 1929 debate with Keynes (Ohlin & Keynes, 1929). Keynes' made an even more prominent argument in his *General Theory* (1936) that monetary expansion could not boost demand under depressionary circumstances – hence the call for government spending and fiscal deficits. In fact, historical instances Keynes identified as ineffective monetary expansion are better understood as instances of monetary contraction. I elaborated this argument a few years ago in my paper "Did Keynes Make His Case?" (Johnson, 2022; Ch.1).

But Keynes was in his groove in advocating for the Clearing Union. His obvious foil was the US argument at the time that trade and investment should be open, and that deficit countries had no claim on surplus countries' resources or reserves. Keynes' response was that failure to deal with balance of payments shortfalls of Britain and European countries after the War would prevent the recovery of trade and investment, and throw the world economy back into 1930s-style stagnation. By 1947, the Truman Administration concluded that war-damaged European countries needed capital transfers. Keynes had recognized that large capital transfers, something like what became the Marshall Plan, would be necessary; he had hoped to do it through what would be routine "banking" operations of his Clearing Union. The

Marshall Plan was administered outside the IMF – which damaged the latter's prestige from its earliest years (Mundell, 1969; p.476).

Another context for the Clearing Union at the time, and another foil, was the spread of bilateral trade, and hence of bilateral clearing arrangements, in the years before and during the Second World War. Britain had deployed bilateral mechanisms to expand trade within the Empire following the Ottawa Conference of 1932. Germany had recovered from economic collapse in the early 1930s under guidance from Hjalmar Schacht and his successor at the Ministry of Economics and the Reichsbank, Dr. Walther Funk, who were joint architects of a German "New Order" – whose international prestige was high in the early years of WWII. It offered a blueprint, indeed a trading system, that could work without gold, in fact without the need for reserves or even money; it was cross-border barter. Keynes himself, in November 1940, spoke well of a Funk draft (Keynes, 1989; XXV, p.2).

Looking ahead, a portion of British officials wanted to continue with bilateral payment schemes. But Keynes wanted the *postwar* world to move beyond such Depression-era schema. Presented with the argument that his Clearing Union offered no assurance that debtor countries would make good on their borrowings, he turned to the alternative offered by German bilateralist architects to make his case. He wrote in December 1942:

> 91. It is a great advantage of the proposed Currency Union that it restores unfettered multilateral clearing between its members; so that no action is necessary except where a country is out of balance with the system as a whole.
>
> 92. Compare [our proposal] with the difficulties and complications of a large number of bilateral agreements.... If the argument is used that the Clearing Union may have difficulty in disciplining a misbehaving country and in avoiding consequential loss, with what much greater force can we urge this objection against a multiplicity of separate bilateral payments agreements (Keynes, 1989; p. 122).

The prospect of default by deficit countries was nevertheless daunting to US officials, and could furnish a pretext – not that they needed one -- for outright rejecting the Keynes Plan. In Keynes' defense, he was concerned in 1944 about an international shortage of liquidity. He frequently noted in memoranda leading up to Bretton Woods that a balance would have to be struck between "rules" and "discretion" for managing the Clearing Union (Keynes, 1989; XXV, eg pp.73, 233-235). The Clearing Union's governors might introduce more leverage against debtors over time. Economist Robert Triffin noted later that managing this risk was not an economic problem – it would be analogous to the management and credit decisions that any private sector bank faces -- but rather a political and diplomatic one (Triffin, 1960; pp.92-93).

The White Plan had more serious drawbacks. Its adoption was slow out of the gate. Absent a muti-lateral clearing mechanism, bilateral arrangements were in full-swing following the end of the War in 1945 (Triffin, 1957; pp.143-145). Even these were preferable to autarchic outcomes likely in their absence. Only with the European Payments Union of 1950 was multilateral clearing systemically attempted; even that was intra-regional, hence discriminatory toward non-European countries that would have been included in Keynes' ICU. By 1959, nearly 90 percent of intra-European trade was conducted without quantitative restrictions, and negotiations to lower or remove tariffs were underway (Triffin, 1957; pp.204-207).

The US, led by White, seemed to anticipate that the US would remain a creditor-nation indefinitely. So the US showed scant interest in any symmetry between expectations for debtors and those for creditors. But as the monetary order took shape, it would not be possible for the US both to supply the world with dollars and to maintain sufficient gold reserves to meet a convertibility commitment. External demand for dollars could be satisfied only through ongoing US trade and current account deficits. As more dollars were supplied to the world, US and foreign demand for gold reserves would increase. This Triffin Dilemma, with roots in the White Plan and spelled out in US Congressional testimony in 1959, noted the world economy's dependence on the US current account deficit. Without liquidity, the world economy could revert to 1930s-era economic contraction. But if the deficit continued, dollar liabilities would soon exceed US gold reserves – and at some point the US would have to shut the gold window, which in theory could capsize confidence in the dollar, the key international money. Triffin noted "the present, and totally irrational, use of *national* currencies as *international* reserves" (Triffin, 1960; p.90). Even now, in 2022, national currencies continue as international reserves.

4. Dollar Convertibility, 1960s

The world moved on following the Second World War with the dollar standard at full mast. By 1960, history was repeating: as had happened in the 1920s, European central banks wanted to augment their reserve levels. US dollar liabilities did not rise from 1964 to 1967 – additional dollars acquired abroad were converted to gold. By the mid-1960s, the US was down to about 400 million ounces of gold reserves (about $14 Billion in prices then) and European countries as a group had 460 million ounces ($16 or $17 Billion). US consumer and wholesale price indexes were beginning to bubble upward. Bretton Woods issues were back on the table, and there was new interest in having an international currency. The IMF Articles of Agreement were revised in 1969 to make Special Drawing Rights (SDR's) a supplemental official reserve, and to require member countries' central banks to accept it. But by recent count, only about 3 percent of world reserves are held as SDR's. They were issued in ways that limited their use, and left developed *countries* preferring to hold dollars or other hard currencies. The US was unenthusiastic, and preferred to continue to earn seigniorage, and to borrow abroad in its own currency. For the moment, Triffin-dilemma risks to reserves and the costs of offshoring manufacturing were pushed aside (Coats, *et al.*, 2017; p.2). Another complication was the unpopular war in Vietnam; some European leaders were less than enthusiastic about helping the US deal with strains of war finance. SDR's arrived too little, too late.

Even without a more viable international currency, there was a way to deal with the Triffin dilemma of the 1960s. While not quite lost to history, it is not much remembered. Professor Mundell proposed a monetary truce in an academic article, "The Crisis Problem," in 1966 and in an address to the New York Federal Reserve Bank the following year. (Mundell, 1968; "The Crisis Problem," pp.282-288) Keep in mind that the Federal Reserve was not allowing gold losses to generate US deflation; the old gold standard "automatic" rules had died in phases by the time of Bretton Woods in 1944. Despite falling reserves, the US was committed by IMF Article IV-4-b to buy and sell gold at

the set price of $35/ounce. The private market for gold at the time was small relatively to central bank holdings in the US and abroad; the central banks, among them, could easily have maintained the $35 price. What happened instead was that US cyclical monetary policy and European gold reserve policy were uncoordinated, indeed in conflict. US monetary policy became more expansionist as Vietnam war spending heated up; meanwhile, Europe as a whole by 1965 had tightened monetary policy to control price increases there. European officials, concerned about reserve adequacy, and led by France, presented more dollars to the Federal Reserve in exchange for gold – putting the US gold stock under pressure. Much talk about allowing gold prices to go higher added to speculation against US gold holdings, and to more European conversions. The US ended gold convertibility in August 1971.

Better monetary policy would have required central bank coordination. The US and various European authorities would better have agreed to collaborate on meeting two targets: first, a suitable rate of price inflation (or perhaps a related target of aggregate demand growth); second, agreement to maintain – control – the market gold price at $35/ ounce. For the second target, only the US was committed to the IMF rule requiring it to buy or sell gold. The US was, therefore, not able to set conditions in the gold market; it could only react to them. To maintain the $35 price would hence require that European central banks demand gold from the US only when the price fell below $35, and sell gold to the US when the price rose above that. In contrast, the US was in a better position to stabilize the first target, the inflation rate. An increase in US money in circulation would mean a larger US current account deficit, which increases liquidity in other parts of the world. Europeans would agree to stabilize the gold market only if they could agree jointly with the US on an inflation level. It would have been in both the American and European interest to have reached the monetary truce proposed at the time (Mundell, 1968; "A Monetary Truce," pp.288-297).

Consider this proposed truce in view of concepts underlying Keynes' Clearing Union plan. For European central banks to stabilize supply and demand for gold – without deliberately adding to their own gold reserves – is effectively to economize and pool reserves. The joint effort to stabilize the price of gold moves a step toward *internationalizing* what had been US reserves. Coordinating with foreign central banks to agree on a world inflation target works to stabilize the international balance between supply and demand for money. It also implies that surplus countries during the 1960s, perhaps including Germany and the Netherlands, would have needed to synchronize their monetary policies with deficit countries. A practical consequence of the truce would have been that monetary and finance issues could have been sorted out prior to engaging on trade or investment rule negotiations – again in line with Clearing Union premises.

5. Flexible Exchange Rates

Flexible exchange rates appeared as a conceptually elegant solution to all of the left-over issues from Bretton Woods and the rising inflation and gold reserve pressures during the 1960s. In concept, "the market" would determine the price of currencies, based on supply and demand. Countries would no longer need to hold reserves, and gold could be de-monetized. Any uncertainty arising from foreign exchange cost fluctuations could be mitigated

or removed through futures markets, which were soon opened in New York, London, Chicago and elsewhere.

The usually underlying objective for having flexible exchange rates is to allow national management of monetary policy; impacts on trade and competitiveness are second-order. The important consequence of the British depreciation in 1931 and the US depreciation in 1933 was for each country to relieve reserve pressures, hence to ease monetary policies, and thereby increase aggregate demand. To illustrate, US industrial production rose by over 50 percent in the four months following President Franklin Roosevelt's decision to de-link the dollar from gold in March of 1933 – simply on anticipation of higher selling prices.[8] White and Keynes both understood a decade later that an automatic gold standard, or a gold exchange standard as it existed between the Wars, had deflationary potential.

Under conditions of unemployment and deflation – where demand for money exceeds the supply – exchange depreciation can be part of a corrective policy package. Triffin (1960, p.85) noted the "hard core of validity" in the flexible exchange rate case:

> [E]xchange rate readjustment to "realistic" levels is preferable to vain and costly attempts to preserve "unrealistic" exchange levels through persistent reserve losses, foreign borrowings, or trade and exchange rate restrictions.

But often, depreciation has the consequence of ratifying inflationary pressure. In the post-Bretton-Woods period, Britain in 1949 undertook a major devaluation (from $4/pound to $2.80/pound) – despite already excessive domestic liquidity and bubbling inflation. The devaluation generated still more liquidity, which contributed to aggravated cost and wage pressures in Britain for at least the next couple of decades (Mundell, 1968b; pp.135-136). I suspect that something similar would have happened if Greece had left the Euro-zone a decade ago.

Rather than tally up instances where depreciation was effective, or not, consider the mechanism of the way economies adjust to exchange rate fluctuations (Triffin, 1960; pp.84-85). If the central bank targets a certain level – suppose it is the Bank of England, and it targets the pound at $1.50 – then the Bank will buy dollars and sell pounds if the pound strengthens to $1.51. If the pound weakens to $1.49, the Bank of England will sell dollars and buy pounds. These central bank interventions will themselves move British money quantities in the direction required to keep the pound at $1.50.

Now suppose the Bank of England is passive in the face of market-driven movements of the pound above or below $1.50. As the pound weakens, speculators might buy dollars and ride the downward wave – to $1.49, 1.48 etc., as sterling is dumped on the market. The stabilizing effect for domestic money conditions of having the Bank of England intervene at a fixed level, as described a moment ago, is suppressed at its roots. Exchange rate passivity by central banks – that is, floating exchange rates -- almost in its essence generates price instability. Either a weaker pound, or a stronger pound, will have knock-on effects on other British costs and prices.

An inference from looking at today's capital movements, and a premise of Keynes' Clearing Union proposal, is that current account imbalances are generally *not* driven by cost and price patterns. Central banks around the

[8] For background, see Sumner (2015), Ch. 7.

world do not want their currencies to be stable, and will hold reserves as a war chest to accomplish that. An obvious consequence of the floating rate regime in place since 1973 is that the world's official monetary reserves have soared (nominally) from $77 Billion in 1969 to over $12 Trillion in 2022, according to IMF data (IMF Reports). It is clear that the shift to flexible exchange rates in 1973 has not solved the reserve puzzle that was at the center of plans and negotiations in 1944!

An effort to deal with imbalances by allowing exchange rates to rise or fall – hence focused on marginal cost and price patterns -- diverts attention from the real financial shifts underneath (McKinnon, 2013; p.13).[9] Indeed, this part of the flexible rate agenda repeatedly displays partial equilibrium fallacies. Consider the claim that an exchange depreciation improves the trade or the current account balance.

- A first problem with this concept is that the consequence of depreciation for the trade balance depends on price elasticity of imports and exports.
- A second is that exchange depreciation can ease monetary conditions, which raises domestic demand, and can thereby raise demand for imports – and hence increase the current account balance, not reduce it.
- A third is that a lower currency makes capital assets and real estate cheaper for foreign buyers, and hence increase capital inflows and thereby, again, increasing the current account imbalance.

It is almost predictable that despite years, even decades, of dollar depreciation relative to the Japanese yen and the pre-euro German mark, bilateral US current account deficits with those countries hardly budged.

Now, as before, consider the world's almost 50 year-old flexible exchange rate regime in light of concepts underlying Keynes' Clearing Union plan. Far from pooling reserves internationally, countries have built up their own reserve hoards. For US interests, the situation should be unacceptable – public and private debts are built up, manufacturing shifts abroad. Flexible rates have done nothing to improve the underlying capital account imbalances (the flip side of current account deficits) in the US and to a lesser extent in Britain, Canada and Australia.

6. The Eurozone

The euro is an international currency. Unlike bancor, which was intended to be used to settle balances among central banks, the euro is used for everything. But the case for introducing a euro, for replacing national currencies, draws on arguments similar to Keynes' of in 1944. Mundell was an early advocate for a European currency, and is sometimes called the "father of the euro." Short of an ideal world currency, Mundell argued that a Europe-wide currency, as an intermediate solution, could help to reduce pressure on the US gold stock. His argument for the euro draws directly on the "monetary truce" reasoning noted earlier, and indirectly on the 1944 case for a Clearing Union. He said this at a conference in Madrid in 1970:

> The United States is powerless to correct its deficit, short of forbidding other countries to buy or use dollars, which would be absurd. Hope for correcting or reducing the US deficit lies with Europe. Only by creating a substitute for the dollar can Europe free itself from

[9] Also, Triffin (1960), p.82.

> dependence on it, and only through this means can the United States correct its balance of payments....
>
> ... In the long run [creation of a European money] would enable Europe, eventually in equal partnership with the United States, to develop instruments for the rational monetary management of the world economy (Mundell, 1973; p.155).

Decode this for a moment. European capital transfers to the US during the 1950s and 1960s financed the US current account deficit, indeed made it nearly inevitable. Mundell in 1970 was building on his proposed "monetary truce" of 1966. US current account deficits during the 1960s resulted from European capital exports (and trade surplus), at the time related to Europe's relatively tight money policies. (In 1970, Europe's relative role in world capital flows was larger than it is now.) A "substitute for the dollar" would have provided an alternative for holding both world official reserves and private sector liquidity; looking forward, some 20 percent of the world's official monetary reserves are now held as euros. A common currency, as an alternative to having more than a dozen continental currencies floating against each other in value, would also encourage cross-border investment.

Having a common European currency continues to raise questions about cultural and political integration that I will not try to answer. Let's focus here on the economic issues. It was, and is, frequently said that Europe could not have successful monetary union without fiscal union, meaning a common Euro-zone budget, replacing a large portion of what have been separate national budgets. But Mundell's proposed monetary truce -- a common US-Europe inflation target and gold policy during the 1960s -- would have maintained the fixed rate system -- *entirely absent a common fiscal policy.* (Similarly, of course, the pre-WWI gold standard worked without common fiscal policies among leading economic powers.)

Following the 2007-2009 financial crisis and related "great recession," economic conditions in the Euro-zone "periphery" countries – including Spain -- were stressed to the point that many anticipated break-up of the common currency. What had gone wrong? In a couple of sentences, policy before the crisis allowed over-borrowing and boom conditions in the deficit (periphery) countries; after 2009, policy reversed -- for the short-term benefit of surplus economies at the Euro-zone's "core," hence bringing distress to deficit countries.

A common currency must not require that all sovereign debt within the currency arena be treated as having equal risk. Alas, the European Central Bank telegraphed just that, with the consequence going into 2008 that financial markets yield levels nearly converged between German sovereign debt and that of countries to the south. The knock-on effect was that Greek, Italian and other governments were encouraged to issue more debt during the early years of the euro than the market could support, an issuance situation that flowed over to the private issue market. Private borrowing soared in Spain, Italy, Greece, Portugal, Ireland and Slovenia, often deploying resources from German banks (Klein & Pettis, 2020; p.163-164). Meanwhile, performance in the Euro-zone "core" countries around Germany and the Netherlands remained subdued. Euro-zone monetary policy hence favored deficit countries during much of its first decade – an unsustainable situation.

The correct finance decision after the 2008 market implosion would have been to put unserviceable debt in default; instead the ECB and European

Commission maintained a no write-off stance. Periphery countries were expected to service the bad debt via fiscal austerity measures, regardless of consequences for private sector demand or employment. By 2009, aggregate demand had collapsed in periphery countries, hence appropriate monetary policy for them should have been far more relaxed. Instead tighter policies stayed in place -- policies that might in isolation have suited surplus countries. (Observe the Taylor Rule slide, which indicates sharp differences in appropriate interest rate policy in the core and periphery countries during 2001-2011.) To make analogy to Keynes' 1944 plan, what happened to periphery countries after 2008 was the equivalent of cutting off access to bancor.

Over the next few years, the ECB, European Commission and on occasion the IMF joined to soften the no debt write-off policy (Johnson, 2022; pp.46-47).[10] And the ECB moved, largely under Mario Draghi's leadership, toward monetary policy that would balance the needs of all 19 Euro-zone countries. We hear much less often than a decade ago that the euro should be abandoned, or confined to a smaller group of users. Keynes' advocacy for an international currency in 1930, and again at Bretton Woods in 1944, was contingent on agreement among member countries about monetary goals. It also required that surplus countries adjust, not only deficit countries. Without those understandings, an international currency would fail.

7. A Note on China

China's leadership might welcome an opportunity to weaken the international role of the dollar. And, as I argue here, overuse of the dollar strains US capacity to carry debt and leads to outsourcing of manufacturing. China is now a major world creditor, with over $3 Trillion in official reserves, a position in some ways comparable to the US creditor position in 1944. Whatever the purported economic advantage might be, China is unlikely to agree to any restraints on what creditors can do; as we have noted, without that kind of debtor-creditor symmetry, an international currency will not work.

From 1971 to 1996, the Japanese yen was revalued repeatedly against the dollar, from 360 yen/ dollar to 80 yen/ dollar. The ever-rising yen ensured tight money, hence it suppressed demand growth in Japan. Economist Ron McKinnon argued that the yen-appreciation policy "knocked Japan off its high-growth path into semi-stagnation and deflation" (McKinnon, 2013; pp.154, 197). An interesting question is of whether the US *deliberately* knocked Japan off its growth path so to weaken an economic competitor[11] – or whether the US gave bad advice because its economists did not understand the way the international adjustment system works. Persistent of support among economists for flexible exchange rates makes it likely that demands for Japan to appreciate the yen were more misguided than cynical.

Chinese economic officials are aware of the damage yen-appreciation policy did in Japan, and China was never going to follow Japan's currency appreciation path, no matter how many Western economists encouraged them to do it. Consider the damage that a more determined renminbi appreciation policy might have done.

[10] Also, Sandbu (2015).

[11] Mundell made this argument to me in 2005. To my knowledge, he never published it. He advised Chinese officials on monetary issues, and very likely shared his view with them.

- A higher RMB would lower China's import costs, which taken alone would encourage Chinese consumption. But an effect of a higher RMB, especially combined with the expectation of further RMB appreciation, would have been to create uncertainty that would discourage wage increases sufficient to match productivity improvements (McKinnon, 2013; pp.150ff.). This parallels what happened in Japan by the early 1970s.
- Anticipation of a higher RMB would have driven Chinese interest rates downward relative to US or European rates. As US and European rates were already zero-bound, such pressure might have created a liquidity trap, discouraging lending.
- Many Asian economies linked their currencies to the dollar. A revaluing RMB would have upset price relationships, and hence credit cycles, throughout the region (Consider that a decline in the exchange value of the yen during the sharp dollar recovery of 1995–97 upset trade and investment patterns, left nearby currencies over-valued, and helped trigger the regional financial crisis that began in 1997).

The deeper weakness in the advice that China appreciate the renminbi is that it would do little or nothing to change the distribution of domestic resources; it would not increase Chinese consumption as a portion of output. Chinese investment – public goods, manufacturing for export, etc. – has long run at about 45 percent of GDP, an unusually high ratio, which implies a matching low ratio of consumption (McKinnon, 2013; pp.132-133). The Chinese power structure appears to become more rigid under Xi Jinping's directives, which (at first approximation) makes a substantial increase in the rate of consumption unlikely.

The US should offer to link dollar and renminbi exchange rates; doing so would remove the potential downside of renminbi revaluations or threats of revaluations (Similar offers could be made to link the dollar to the euro or the yen). Linked exchange rates would require at least tacit agreement on an inflation target – as establishing a clearing union in 1944, or subsequently, would have done. We can go through the concepts embodied in the 1944 Keynes Plan to determine what the US (or other monetary collaborators) might seek in return. China as a current account surplus country should find a way to increase domestic consumption, hence to reduce its lending to the US – and to others. As a matter of international economics, correcting finance should come before negotiating trade commitments.

The US should offer to stabilize the dollar-renminbi exchange rate, as doing so would be in both countries' interests. Perhaps the offer could be cloaked as a "concession," but it really would not be. A broader agreement, something moving toward a monetary truce, seems unlikely -- given the New Cold War context. Going forward, lack of agreement will be a drag on the world economy.

8. Closing: Missed Opprtunities

We can draw attention again to insights from the never-adopted Keynes Plan about subsequent monetary developments.

Under the dollar standard, the US runs ongoing current account deficits to provide systemic liquidity. And a portion of the world's savings is deployed every year in support of consumption in the US.

The Keynes Plan would have made demands on surplus as well as on deficit countries. It would invite attention to domestic balance and to influencing the trade cycle.

Keynes anticipated – absent his Plan -- something like the 1947 monetary crisis in Europe, when bilateral clearing arrangements reached their limit, and which could not be overcome by national governments acting on their own. The European Payments Union, which was established in 1950, moved toward multilateral clearing. The Clearing Union plan (ICU) proposed a parallel arrangement years earlier.

The Triffin Dilemma, whose roots were implicit in the White Plan, arose from the use of a gold-backed national currency as an international reserve. The Keynes' Plan, in contrast, sought to make gold an international reserve, and to replace dollars and pounds as reserves with an international currency, bancor.

A monetary truce, proposed in 1966, could have overcome the Triffin Dilemma. The truce would have pooled gold reserves between the US and European countries, while agreeing on an inflation target. These two steps would have been central activities for the Clearing Union, had it come to be.

A common European currency – structurally parallel to the ICU's bancor -- would require in order to succeed: 1) that monetary policy be suitable across the currency zone (eg, for favorably influencing the trade cycle); and 2) that both deficit and surplus countries adjust to current account imbalances. Well into the second decade of the euro experiment, these requirements were not met; the future of the currency was in some doubt. More recent ECB and European Commission policies of writing off bad periphery country sovereign debt and better adapted monetary policies have made the euro more sustainable. These moves take the Euro-zone in the direction of a regional monetary truce.

Flexible exchange rates since 1973 have done little or nothing to correct international account imbalances, and have meant the US continues to provide liquidity to the world by running payments deficits. Apparent failure to understand these dynamics have led to usually destructive pressure on Japan, and then on China, to appreciate their currencies.

China's massive savings and related capital exports have suppressed Chinese consumption. In consequence, the key-currency US absorbs more capital, carries more debt, and loses manufacturing. The Keynes Plan would have provided some leverage over the domestic balance of a major creditor (China).

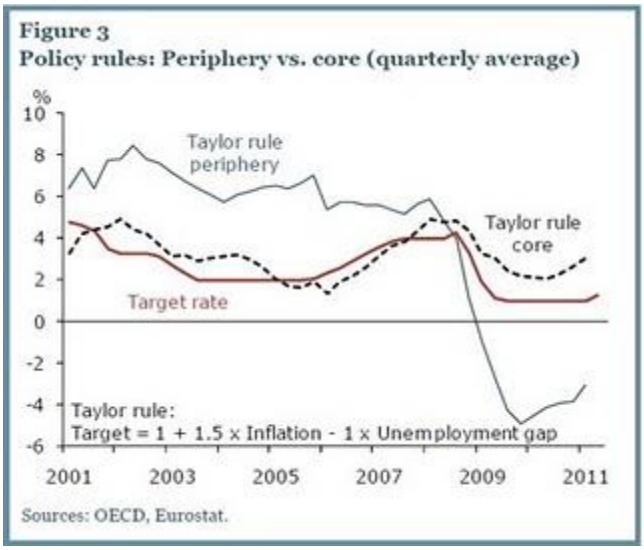

Figure 1. *Taylor Rule*

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