

## **A New Triffin Paradox for the Global Economy<sup>1</sup>**

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In the 1950's Robert Triffin warned of the breakdown of the Bretton Woods international monetary system. Economists are not well known for the accuracy of their predictions. Triffin is one of the few economists to have made a correct prediction. Yet, no one took any heed of his predictions, even when it was clear that they were coming true. His analysis produced what has come to be known as the "Triffin paradox" or the Triffin dilemma. I am going to suggest that there is a similar "paradox" inherent in the globalisation of the international trading and financial system, and that it threatens the breakdown of the system.

### **I Triffin's Paradox**

Under the Bretton Woods Agreement, countries were given the choice of setting the par value of their currencies for current account transactions in terms of gold or dollars. Since virtually all belligerent countries finished the war in debt to the US for aid or supplies, the US held virtually all the gold or a claim on it. Thus, the US was the only country able to fix the par value of its currency in terms of gold, while all other countries set their par values in terms of the dollar. The dollar thus effectively replaced gold in the Bretton Woods System and the value of the dollar was determined by the holdings of US gold reserves. Since all other countries had set par values against the dollar, they required dollar reserves to ensure current account convertibility. This meant that the stability of exchange rates was the result of intervention in terms of dollars by all central banks except the US. It made the US dollar the only intervention currency and placed the stability of exchange rates on the willingness and ability of non-US central banks to intervene in foreign exchange markets to defend the value of the dollar. (It also meant that the US dollar enjoyed an intervention band that was double that of the other currencies since all cross rates were traded and calculated by trading against the dollar.) As a result the US dollar became the source of international liquidity and the basis for the reserves of the international monetary system. It thus effectively replaced gold. However, under the Bretton Woods System, unlike the operation of the gold standard, where the supply of gold was determined by mining and the dishoarding and jewelry, the supply of dollars was determined by the balance of payments position of the US.

Immediately following the war, nearly all of the world's monetary gold was in the US, most of the signatories of the Bretton Woods treaties owed money to the US. Further, their reconstruction depended on imports from the US, the only economy not damaged by war, so the US was in balance

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of payments surplus. Thus, not only was gold scarce outside the US, the dollar was also scarce. Although “Dollar Scarcity” was thought by some economists to be a permanent condition, the US external position soon reversed and the US was creating the dollar liquidity that the international system so badly needed to allow central banks to build the dollar reserves necessary to preserve exchange rate stability. However, the amount of dollars held outside the US eventually surpassed the gold reserves held by the US evaluated at the official Bretton Woods parity. Thus the Triffin paradox: the successful operation of the international financial system depended on an expansion of dollar reserves to keep international liquidity growing in step with rapidly expanding world trade. But, this could only be achieved by a US payments deficit that continually increased foreign claims on the fixed US gold supply. Once these claims exceeded the dollar value of the gold supply at the \$35 parity, the convertibility of the dollar into gold at the official parity depended on the willingness of foreigners to refrain from converting dollars into gold. This created a dilemma for foreign holders of dollars, in particular foreign central banks who were responsible for stabilising the dollar and thus had to accumulate ever-larger dollar balances as non-official holders converted dollars to other currencies, in particular DM. A recognition of the appreciation of the dollar value of gold – a depreciation of the dollar relative to the other currencies – would mean capital losses on the dollar reserves. Thus foreign holders of the dollar faced a catch-22 situation reflected in the Triffin paradox. If they converted the dollars into gold at the US Treasury (they could not sell the dollars for other currencies since they were responsible for fixing the rates of their currencies relative to the dollar, which was already in chronic excess supply in foreign exchange markets) this would further reduce the gold backing the outstanding dollar balances and make it more likely that the dollar would be devalued, depreciating all of their dollar reserve holdings and producing large foreign exchange losses on their balance sheets. If they converted excess dollar balances they risked precipitating a devaluation, and if they did not they risked even larger losses if the devaluation occurred in any case.

Many countries (especially France) argued that the problem of excess dollar balances could be resolved if the US tightened its domestic policies and ran balance of payments surpluses, but this remedy for the dollar surplus would simply have reduced the growth of international liquidity and created the risk of global recession – it was just such a case that Keynes had warned against when he pointed out the necessity of avoiding “asymmetric balance of payments adjustments” in the new Bretton Woods system.

The result was a series of ad hoc measures to prevent dollar conversion into gold and to increase foreign demand for dollars, while at the same time countries put pressure on the US to absorb some of the outstanding dollars by reducing growth in order to produce a balance of payments surplus. The US resisted, mainly because John Kennedy had already pledged to close the

ICBM missile gap, and most importantly the GNP gap through expansionary fiscal policy, both of which were incompatible with the domestic policies required to stabilise the value of the dollar, which he had also pledged to defend in the closing days of his campaign. Most of the subsequent difficulties of the Bretton Woods System were due to the attempts by the US to preserve the gold value of the dollar in the presence of a US expansion that continued to produce US deficits and expanding foreign claims on the US. The result was a menagerie of ad hoc policy measures including two-tier gold markets, interest equalisation taxes, operation twists, liquidity balances of payments and the birth of the policy of benign neglect that eventually showed that the internal contradictions elucidated in the Triffin paradox could not be resolved. The problem, as Triffin had pointed out, was the use of a national currency as the international means of payment and liquidity. To be an international currency it had to meet the needs of international trade financing, but as a national currency its international supply was determined by domestic demand conditions which would not necessarily produce changes in supply in step with world demand. Since the issuing country would be unwilling to subordinate its domestic economic policy to the needs of the international economy, the currency would be inherently unstable.

There were three ways out of the Triffin Dilemma, a truly international currency issued by a global central bank to replace the dollar at the center of the international system, a global deflation produced by an attempt to reduce the supply of dollars to the US gold supply, or the default by the US on its foreign debts through the elimination of the convertibility of the dollar, devaluation of the dollar and the introduction of flexible exchange rates. The last remedy was chosen (note that the US had never allowed residents to own gold for monetary purposes, so that there was no domestic indebtedness in either gold or other foreign currencies and the devaluation thus had no direct impact on domestic balance sheets).

The introduction of flexible exchange rates did not prove to be a solution, for it did not remove the basic paradox, the use of a single national currency as the international reserve and vehicle currency. It also produced a profound change in the international system. The Bretton Woods System was founded on recognition of the incompatibility of a system of fixed exchange rates and free international capital flows. Although the gold standard had survived what were extremely free and integrated international capital flows to the end of the century, the experience of hot money flows in the interwar period and the difficulties encountered by the major economies had convinced most economists that free capital flows and fixed rates were incompatible. With the introduction of flexible rates there was no longer any theoretical impediment to allowing capital flows, and the most vocal adherents of the floating rate system argued that international speculation would in fact make the floating rate system behave as if it were stable.

There are a large number of factors that accompanied the liberalisation of international

capital markets, such as the oil crisis, the declining profitability of banks in the segmented US system, the creation of financial futures and options to hedge the fluctuations in flexible exchange rates, the growth of the Eurodollar market in response to the restrictions introduced in the US in the 1960s, financial deregulation, the Volcker revolution in monetary policy and the increasing globalisation of the economy. They are all directly or indirectly the result of the attempts to escape from the horns of the Triffin dilemma.

## **II. The 21<sup>st</sup> Century Triffin Paradox**

What I would like to argue today is that the current globalised international financial system has produced a new strain of the Triffin paradox in which developing countries have replaced the US, but since they do not issue an international currency they are forced to undergo the solution to the Triffin paradox that the US avoided: deflation and recession to insure that the international supply of their currencies does not exceed global investment demand. The rest of this paper will attempt to give a brief outline of this 21<sup>st</sup> Century Triffin paradox.

Let us start by recalling that one of the objectives for the reform of the international monetary system raised by Lord Keynes, the representative of the British Treasury, was that the new system should not jeopardise domestic policies objectives. Keynes was in particular concerned to defend the right of countries to full employment. As noted above, the breakdown of the gold standard system, indeed of the entire political system in Europe was due to the high levels of unemployment that were generated by what were judged to be excessively mobile international capital flows under the gold standard. In order to protect national policy autonomy Keynes's proposals for reform argued that the design of the international system should produce "the least possible interference with internal national policies ... [and] operate not only to the general advantage but also to the individual advantage of each of the participants, ... No participant must be asked to do or offer anything which is not in his own true long- term interest " (IMF, pp. 19-20). Indeed, Keynes went further and insisted that the plan "must be capable of application, irrespective of the type and principle of government and economic policy existing in the prospective member states" (*ibid*, p. 19).

In addition, Keynes argued that fixed exchange rate systems, such as the gold standard, produced what he called an "asymmetric" international adjustment burden that penalised countries in balance of payments deficit. Since a deficit eventually depletes foreign reserves, an adjustment policy would be required if the country were to remain on the gold standard. Because a deficit country usually had a public or private sector deficit, the elimination of the foreign imbalance meant reducing current public or private spending, thereby reducing total demand, and income and employment. It was usually argued that such countries were "living beyond their means" and thus

the “belt tightening” was also morally justified.

But, the international economy is a zero sum game; for every country with a balance of payments deficit there is a balance of payments surplus in some other country or group of countries. By analogy with the deficit countries, these countries may be classified as having excess savings. However, these countries are seldom accused of living *below* their means. Saving is morally justified, promoting growth and employment is not.

Since the international economic system is simultaneously determined it is impossible to determine whether balance of payments disequilibria are caused by the excess saving or the excess spending countries – one could not exist without the other . However, in a fixed exchange rate system the fact that the country with the balance of payments deficit eventually runs out of foreign exchange reserves means that it is forced to adjust its internal policies to accommodate the policy of the excess saving countries. Since this can only be done by reducing imports (increasing exports would require the rest of the world to spend more, which it is unwilling to do) it involves reducing income and employment. Since the excess savers are never forced to reduce their saving due to an excess accumulation of international reserves, only one group of countries, those in deficit, has to adjust – thus the adjustment is asymmetrical. And since the adjustment always requires lower employment, it not only jeopardises national employment policy, it also produces a reduction in employment and unemployment for the global economy. Under asymmetric adjustment the global economy could never reach full employment of labour and would suffer from excess saving. But, for Keynes, this was not morally justified since unemployed labour was just as inefficient a use of resources as the misallocation of capital.

In the present international economic environment the differences go beyond different national employment policies and extend to growth rates. Developed countries, with relatively high levels of per capita income and wealth are more interested in ensuring the economic efficiency of the international economic system; this is expressed as policies designed to preserve their capital and maximising the rate of return on capital. Thus, exchange rate and asset price stability and allocative efficiency of financial markets carry a high priority. This is achieved by ensuring that prices are stable – and the only successful inflation fighting policies that developed countries appear to have discovered is to keep growth below potential, i.e. conditions of excess supply.

Developing countries, on the other hand, with much lower per capita income and wealth levels, might be more interested in increasing their income and wealth levels as rapidly as possible. Here the goal is more appropriately the highest achievable rate of growth of per capita incomes. But, not only is there a difference in growth policies, there are substantial natural differences in potential growth rates. Not only do developed countries operate policies to keep growth below potential, the potential growth rates are themselves lower than in developing countries. These differences

complement the differences in employment policies observed in the Bretton Woods discussions.

Now, there is no reason why these diverse objectives should not be compatible, indeed theory argues that the free flow of capital around the globe in search of the most remunerative uses should maximise global growth (although it says little about how these benefits are distributed across countries). However, the recent experience of increasingly frequent and intense financial crises suggests that this is not the case.

Further, the experience of the response to the recent financial crises suggests that protecting the interests of those seeking to preserve their capital and to maximise their rates of return on the investment of capital has tended to dominate the objectives of those countries seeking to maximise growth of per capita incomes. The provision of emergency funding in support of exchange rate convertibility and stability has served primarily to provide the means of repaying international creditors without loss and has clearly been at the expense of the borrowing countries seeking higher income levels. The introduction of austerity policies in the name of reducing the inflationary potential of the bailout of failed domestic banking systems, but which simply curtail growth in order to provide balance of payments surpluses capable of generating foreign exchange to repay foreign creditors is an even more direct example of sacrificing income growth in developing countries for the preservation of capital values in developed countries.

It was to be the role of the new international monetary system created at Bretton Woods to provide the means of making domestic full employment policies compatible with fixed exchange rates. In the post-Bretton Woods world the developing countries, with high potential growth rates relative to the developed countries with lower potential growth rates, have both the tendency and the necessity of running balance of payments deficits. This tendency is linked to the generally accepted existence of a resource gap or savings gap that has to be filled by imports of instrumental goods and can only be paid for by borrowing from foreign suppliers, i.e. financed with foreign capital inflows. This is buttressed by the idea that developing countries with high growth potential also have high relative real rates of return on investment and thus are ideal investment targets for developed countries with excess savings and few attractive domestic outlets for investment. But, the larger the differential in relative growth rates and the larger the resource gaps, the larger the required capital inflows and associated balance of payments deficits. But, the larger the deficit, the higher the likelihood of an exchange rate adjustment or depreciation, creating higher volatility in returns and greater risks to developed country investors, leading to reductions in capital inflows and demands for higher risk-adjusted rates of return. Thus, the more successful the system is in allowing developing countries to achieve their potential growth rates, the less willing will developed country investors be to lend to them to permit it.

Thus, the Triffin paradox of the 21<sup>st</sup> century implies that the more successful developing

countries are in achieving their potential growth rates by borrowing in international capital markets to fill their resources gaps, the larger will be their foreign imbalances and the less likely they will be to retain the capital inflows required to support the growth rate. Just as large US deficits increased the risk of holding dollars, larger developing country deficits increases the risk of investing in them. In the case of the dollar, dollar balances were held because central banks had to support their Bretton Woods parity and the dollar retained international value that was in excess of its gold backing. In the case of developing countries, exchange rates are held up by the force of capital flows themselves, which in most cases exceed the funds needed to meet balance of payments shortfalls and produce a continuous upward pressure on the currency. Also, because of their higher potential growth rates, most developing countries monetary policies produce interest rates that are higher than those abroad, providing an additional attraction for foreign investors. This produces a condition for foreign investors that is much like the "catch 22" faced by central banks under Bretton Woods. As the balance of payments deteriorates the risk-adjusted rate of return on investment declines, but withdrawing capital will inevitable produce exchange rate instability that erodes or eliminates the nominal excess returns expected to be earned in developing countries. Eventually, the balance tips towards increased risk and the result is that the dilemma is resolved by an exchange rate crisis that requires an adjustment policy that generates a decline in income growth and employment, in many cases wiping out the accumulated benefits of the period of high growth.

Thus, the same asymmetric adjustment that made deficit countries adjust their policies to those of surplus countries also forces developing countries adjust their policies to make them compatible with the policy objectives of the developed countries. But, in difference from the Bretton Woods regime, it is now the reversal of international capital flows that produces the adjustment. A country that grows too rapidly, and produces an large balance of payments deficit that threatens exchange rate stability and thus its excess rate of return finds that foreign capital reverses and a financial crisis forces adjustment. It is somewhat ironical that when these crises occur, or appears to be impending, it is the IMF that enforces adjustment in the form of stabilisation policies and letters of intent that reduce income growth and employment, without any recognition that the difficulties faced by developing countries might be at least in part caused by the slow growth and insufficient imports of the developed countries. Thus, the current system suffers from the same defects as that prior to Bretton Woods, a tendency to converge towards the (lower) growth rate of the developed countries and the tendency to accept their policy objectives of financial asset and goods prices stability and efficiency to preserve capital and maximise rates of return.