Leszek Balcerowicz

Remarks on Barry Eichengreen and Marc Flandreau's 'Central Banks as Architects: The Federal Reserve, the Bank of England, and the Rise of the Dollar as an International Currency, 1914-1939'

Not being an economic historian I can only raise several questions with the respect to some wider implications of this interesting paper and not to the historical facts it discusses.

Architects seem to enjoy a high reputation as witnessed by the fact that to be called 'an architect' (of something) sounds very good, it is flattering metaphor. However, it is only a metaphor. What exactly does it mean that the Federal Reserve was 'the architect' with respect to the dollar as an international currency? A designer, a creator, a facilitator? Would the dollar have remained the domestic currency only if not for some special interventions of the FED?

There are some intriguing passages in the paper regarding this issue:

'We show (….) that not just market forces (the actions of American commercial banks and trust companies) but also public support – the Fed's role as architect – played a role in the dollar's rapid catch up and brief overtaking of sterling as the leading international currency. This occurred before a liquid secondary market of private and institutional investors to which the acceptances originated by US banks and trust companies could be resold was built. The mechanism that enabled to skip this stage was the Fed, which stepped in as secondary market-maker of last resort. Our estimates suggest that the US market in trade acceptances grew significantly faster than it would have in the absence of this official support. There is a message here for governments like China's seeking to promote international use of its currency.
We show (…) that when central banks stepped out of the market for acceptances in the 1930., the market in dollar acceptances collapsed all but completely whereas the market in sterling acceptance did not. Evidently the task of building a new secondary market of individual and institutional investors, analogous to what London had already done in the 19th century, was more difficult than supposed. Indeed, the Fed's aggressive intervention as buyer of last resort may have stifled rather than fostering the development of that market

I am not quite sure what is the normative message of the paper on the role of central banks as 'architects' of some financial markets. Should the central banks intervene in order to accelerate the emergence of a certain market or – in a more radical version - to enable the emergence of such a market which otherwise would not have originated at all (a 'big push' theory of central banks as 'architects'), or should central banks refrain from attempts to be 'architects' of certain financial markets as their interventions would 'stifle rather than foster the development of that market.' The authors stress that the network affects giving rise to increasing effects in the financial markets and, thus, strengthening the position of the first mover into certain markets 'have limits'. This may imply that the 'natural' forces of the market are sufficient to ensure the successful entry into the market for international currencies.

This and the stifling effects of FED's interventions as 'an architect' may be taken to suggest that such interventions are not recommended. However, the authors are not clear on this point. And it is a part of a more general and important problem: what is the rationale for the public bodies to initiate (or sustain) the private markets (except for the market in the public debt). Unless we believe in the free lunch we must consider the costs and compare them with potential effects of such interventions. The costs would include some resource costs, the opportunity costs and the crowding out of the private transactions via reduced incentives and reduced expertise with regard to private participants.

The authors not only discuss the emergence of the dollar as an international currency but also try to draw some conclusions from that with the respect to how quickly we should expect China's currency to gain a consequential influential role. They write:

'As we show, the United States went from a position where the dollar had no place as an international currency and where New York was a negligible source of finance for international trade to one where the dollar was at least sterling's coequal and New York rivaled London as a source of trade in as few as ten years. This is not to predict that the renminbi will necessarily rival the dollar and the euro in 2020. But it does suggest that, if network effects are less powerful than commonly asserted, the renminbi's emergence may be quicker than widely presumed.'

One is tempted to ask: what is 'widely presumed' on the rise of renminbis as an international currency and what is the authors' educated guess on the dynamics of that process. In thinking about the second question one should consider, I think, at least two issues.

First, as the authors rightly stress, a country with an international currency must play an important role in international trade. China's accelerated economic growth since the late 1970. has been accompanied by an even faster expansion of its foreign trade. As a result China's economy has an amazingly high a foreign trade/GDP ratio for such a large country; this ratio is much higher than the one for India. Therefore the China's foreign trade GDP ratio in the future is not likely to grow, it will rather decline as China's gradually moves away from export-oriented growth to the one more geared to its domestic market. The implication is that China's foreign trade is likely to grow more slowly than in the past and will grow not faster than its GDP which, in turn, will slow down in the larger ran.

Second, I wonder whether the role of international currency is not only related to a country's economic potential and its role in international trade but also to some characteristics of its political regime, or - to be more specific – to the possession of some minimal features of the rule of law or a limited government. If this is the case, then in thinking about the renminbi's international role one should not only look to the China's economic evolution but the political evolution, too.

Finally, the authors have raised a host of important questions regarding present situation:

'Finally there is concern that central banks' extraordinary actions in 2007-9, taken to provide liquidity to distressed financial markets by purchasing commercial paper, mortgage-backed securities and other financial assets, created a reservoir of inflationary pressure that will burst when bank lending picks up (in clear, central banks' market-making and market-supporting actions would have created a conflict with their price stability mandate). There are fears that central bank action created a new credit babble destined to burst, and that their interventions merely disguise problems that will become acute once they exit. There is concern about crowding out: central banks' readiness to step in as market makers of last resort may have discouraged other buyers from reentering the market. There is concern that the indiscriminate purchase of securities by central banks will encourage the renewed issuance of financial instruments of dubious quality, setting the stage for another round of financial excesses and problems. We note that the same criticisms were levied against central

banks' market-making activities in the 1920s. While we do not have definite answers to all questions, we offer some food for thought.'

I must confess that the authors have raised my appetite enormously, but I wish they gave me more food. They should link more strongly their story of the emergence of the dollar as an international currency to the important contemporary problems they mention.