

# Resurrecting Creditor Adjustment

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LONDON – With all the protectionist talk coming from US President Donald Trump’s administration, it is surprising that no one has mentioned, much less sought to invoke, an obvious tool for addressing persistent external imbalances: the 1944 Bretton Woods Agreement’s “scarce-currency clause.”

That clause, contained in Article 7 of the agreement, authorizes countries, “after consultation with the [International Monetary] Fund, temporarily to impose limitations on freedom of exchange operations in the scarce currency”; and it grants those countries “complete jurisdiction in determining the nature of such limitations.” A country’s currency is considered scarce in the foreign-exchange market if it imports more than it exports – which is to say, if it runs a current-account deficit.

The scarce-currency clause has an interesting history. In his original plan for an International Clearing Bank, the British economist John Maynard Keynes proposed an escalating range of sanctions against member states that maintained continuous credit balances (and less onerous sanctions on countries with persistent debt balances). The idea was to pressure countries to reduce their current-account surpluses. Surplus countries would not be prevented from spending their money freely, but they would not be permitted to hoard it.

The United States, which was by far the world’s largest creditor,

understandably refused to go along with Keynes's proposal. As a result, the IMF was left to provide short-term financial help for deficit countries, and otherwise to uphold the orthodox doctrine of debtor adjustment. But, to placate the British, Harry Dexter White, the US Treasury official now remembered as the architect of the Bretton Woods Agreement, inserted Article 7 to allow dollar-deprived member states to restrict their purchases of US goods.

The scarce-currency clause has remained a dead letter ever since. In the early postwar years, the US plugged up European countries' current-account gaps with Marshall Plan funds. By the early 1970s, the US itself was running trade deficits, and the dollar was in oversupply. The US Congress urged the IMF to invoke the scarce-currency clause against "recalcitrant" surplus countries, but its efforts were in vain. As the Princeton University historian Harold James has pointed out, the tables had turned: the US had taken up Keynes's arguments, but creditor European countries, along with Japan, successfully resisted them.

Fast-forward to today. Of the world's four largest economies, only the US suffers persistently weak competitiveness. China, Japan, and Germany, by contrast, are super-competitive. And because China has been willing, for its own reasons, to finance the US deficit, the dollar and the renminbi now seem to be locked into misaligned positions.

To redress this state of affairs, the economist Vladimir Masch suggests that the US should pursue a plan of "compensated free trade" (CFT), which essentially amounts to a unilateral

activation of the scarce-currency clause. The Trump administration would set a ceiling on the US trade deficit each year, and then impose limits on major US trading partners' surpluses. This would largely affect China, Japan, Germany, and Mexico, which contributed \$347 billion, \$69 billion, \$65 billion, and \$64 billion, respectively, to the US's \$737 billion trade deficit in 2016. Without services.

Under Masch's CFT arrangement, it would be up to each surplus country to limit its exports to the US. Countries could exceed their export quotas only if they paid a fine equal to the difference between the value of their actual and allowed exports. And if they tried to export more than allowed without paying the fine, their surplus exports would be blocked.

The problem with this plan is that it puts no pressure on Germany to reduce its surpluses with other eurozone countries. To be sure, after the 2008 global financial crisis, the European Union did establish a Macroeconomic Imbalance Procedure to fine eurozone countries with surpluses exceeding 6% of GDP or deficits exceeding 4% of GDP. But the MIP, even if it is in the spirit of Keynes's proposal for an International Clearing Union, lacks two essential mechanisms.

First, Keynes's plan would have automatically levied sanctions against persistent creditors, whereas the EU's framework has proved incapable of doing so. Germany has run a surplus exceeding 6% of GDP for over a decade with impunity. Although its surplus vis-à-vis the eurozone recently shrank to under 3% of GDP, that is largely a reflection of impoverished Mediterranean countries importing fewer German goods. If

those countries' economies recover and return to anything near full employment, the German surplus will likely rebound.

The MIP's second flaw is that it lacks the omit protections for debtors that are afforded by the scarce-currency clause. Without the ability to devalue their currencies, the only recourse the eurozone's persistent debtors have is to threaten to leave the single currency. But, as the Greek crisis demonstrated, this is not a credible threat. The result is that imbalances between creditors and debtors have been locked into place.

One way to unlock current imbalances would be to adapt the Bretton Woods mechanism. Each eurozone member state would pay into a European Monetary Fund in proportion to its national income and level of trade. And the Fund would have its own scarce-currency clause, allowing for member states to discriminate against imports from creditor countries.

In his wide-ranging speech at the Sorbonne last month, French President Emmanuel Macron called for the creation of a European Monetary Fund, though he did not spell out the details of what he envisions. A mechanism that provides for trade discrimination could potentially violate the EU's free-trade principles. And yet economic integration has always depended on some degree of creditor adjustment. Without it, a free-trade system will eventually break down. Advocates of open borders can pay now, or they will certainly pay later.

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