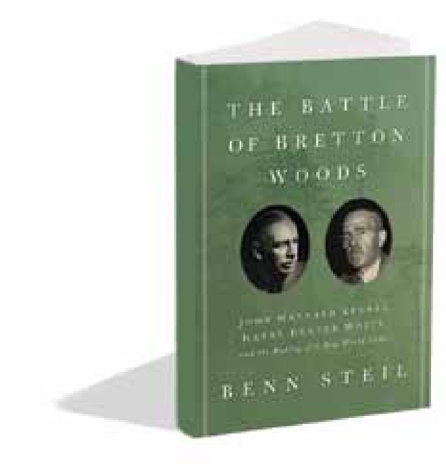
Whitewashing History



Benn Steil

The Battle of Bretton Woods

John Maynard Keynes, Harry Dexter White, and the Making of a New World Order

Princeton University Press, Princeton, New Jersey, 2013, 472 pp., $29.95 (cloth).

The landmark conference of 1944 at Bretton Woods, New Hampshire, in the United States, made the name of the resort town synonymous with institutions of international monetary cooperation. But even the principal authors of the Bretton Woods Agreements, which established the International Monetary Fund and the International Bank for Reconstruction and Development, did not regard them as a success.

The British negotiator and renowned economist John Maynard Keynes expressed dismay that Bretton Woods failed to create an IMF that could act like the "super-central bank" he envisioned. Instead, the IMF spent its first decades as a more modest agency, as conceived by U.S. Treasury official Harry Dexter White. In 1970, Edward Bernstein, a U.S. Treasury spokesman at Bretton Woods, reflected that "the international monetary system has not functioned as well as it should."

Clearly, a history of Bretton Woods should take account of such skepticism about the system and its effects. But Benn Steil (senior fellow and director of International Economics at the Council on Foreign Relations) advances a more radical interpretation. Dwelling on White's role as an alleged secret agent who not only communicated with the Soviets about American postwar policy, but also—as Steil tells it—worked on behalf of the Soviet Union to involve the United States in World War II, the author describes White as the architect of a Bretton Woods system guaranteed to produce, in his words, an "economic apocalypse."

There is enough reliable evidence from Soviet archives to suggest that White clandestinely gave information to Soviet intelligence, though it is impossible to know how much, or whether the Soviet Union put it to substantial use. Even most historians sympathetic to White acknowledge that he engaged in espionage. But Steil goes much further, suggesting that White, acting in the Soviets' interest, substantially wrote U.S. diplomatic notes in November 1941—notes that proposed terms so patently unacceptable that the Japanese had to break off negotiations and attack Pearl Harbor, bringing the United States into the war.

It is a dubious claim for many reasons. Neither White nor the Treasury was at the center of U.S.-Japanese negotiations. At the time of the supposedly critical note, the Japanese task force bound for Pearl Harbor was already at sea. The 2002 history Steil uses to support the case relies, itself, on documentation that historians John Earl Haynes and Harvey Klehr have determined to be fake.

White's espionage isn't the only area in which Steil makes far-reaching claims based on inadequate evidence. When discussing monetary policy, Steil writes favorably of "the pre-1914 gold standard, with its automatic mechanisms for regulating the price of credit and the cross-border flows of gold." This description, while consistent with economic models of how a gold standard could work, does not reflect historical scholarship on how it actually did work.

Even under the gold standard, paper was the principal circulating medium. Note-issuing central banks did not adjust the amount of circulating currency in a mechanical response to the flow of trade, automatically following rules. Rather, monetary authorities set interest rates—and therefore the amount of money in circulation—at a level they thought would generate a profit, at which their government could comfortably borrow, and that would allow them to keep enough gold on hand to ensure a credible commitment to convert paper into specie as necessary.

What Bretton Woods brought was not a perfect system, but a convention of international discussion.

Which is to say, the gold standard, like Bretton Woods, depended on policymakers' good judgment. Steil writes as if, in moving from the gold standard to Bretton Woods and onward into the modern era of floating exchange rates, the world moved from an era of automatic rules to one of discretionary policymaking, vulnerable to political influence. In fact all monetary systems respond to political influence; the differences among them come from political context, not from the institutions or the systems themselves. Bretton Woods and the modern system of floating exchange rates simply respond to more democratic influences than did the institutions of the gold standard era.

If, instead of saying Bretton Woods guaranteed an economic apocalypse, Steil had said that as implemented, the system could not continue forever, he would not have been wrong, and the book would have been better. The original system required that the United States—by the Marshall Plan, and by the North Atlantic Treaty

Organization—put dollars in the hands of the worlds' citizens and also maintain notional convertibility to gold at $35 an ounce, which it could not do forever. But this inevitable outcome was a sign of the system's success, not its failure: it aimed, after all, not only at currency convertibility but also at reconstruction and development. Once the world rebuilt and grew richer, the need for dollar centrality ended. What had been a U.S.-centric system became a multilateral system. With the creation of Special Drawing Rights—a genuine reserve asset—the IMF began to resemble Keynes's super-central bank. Even though the original Bretton Woods system ended in 1971, its goal of international monetary management in the interest of mutual prosperity remained, albeit more often in words than in practice.

In a comparative analysis of international economic performance under various monetary systems, the economic historian Michael Bordo found that Bretton Woods did better than others, including the gold standard. Under Bretton Woods, economies enjoyed stable, low inflation and high growth. Bordo remarks that the modern floating exchange rate system also does pretty well, while allowing even greater domestic policy discretion than Bretton Woods. What Bretton Woods brought was not a perfect system, but a convention of international discussion and occasional coordination. Surely this legacy should provide a starting point for pondering where the world's moneys, and the post–Bretton Woods IMF, might go in the future.

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Banks Stripped Bare

Anat Admati and Martin Hellwig

The Bankers' New Clothes

What's Wrong with Banking and What to Do about It

Princeton University Press, Princeton, New Jersey, 2013, 392 pp., $29.95 (cloth).

Financial regulation has become a hot topic in the wake of the recent crisis; many complex proposals have ensued, and a dizzying array of new acronyms and agencies has emerged. But in their new book, Admati and Hellwig make a forceful case for a classic and simple solution to excessive, unregulated lending: higher capital ratios for banks.

By "higher," Admati and Hellwig mean capital ratios of 20 to 30 percent, more than double—depending on how you count—the proposed levels in the recent Basel III agreement. Their arguments are an important contribution to the debate on capital regulation—with one important caveat, which I will get to.

The baseline argument for higher capital ratios—or the ratio of a bank's capital to its risk—is compelling: if bank failures impose externalities on the rest of us, we should look for ways to make those failures less likely and less costly. Higher capital ratios—sometimes also described as "lower leverage"—are a logical way to make banks safer. An analogy here would be highway speed limits, which can be justified because of the serious risk of injury to pedestrians and other drivers as a result of driver error at high speeds.

The authors take this reasoning further, arguing persuasively that government actions have exacerbated the problem of excessive bank risk in several ways. First, by providing a tax advantage for debt over equity, governments encourage higher leverage among banks. Second, by bailing out the creditors of failing banks, governments lower banks' ex ante costs of debt—compared with in a free market—and, finally, by reducing the ex post cost of bank failure for managers and bondholders, government policy encourages risk taking.

These arguments suggest that higher capital ratios would yield benefits, since better capitalized banks would have a lower probability of failure, with fewer externalities on the rest of us. But what of the costs? In our highway analogy, we could probably reduce the externalities of bad driving if we lowered the speed limit to a few miles per hour. But the cost would be that it would be impossible to get anywhere in a reasonable amount of time. The standard industry arguments against capital requirements usually have this kind of safety versus growth flavor. The main contribution of this book is to convincingly debunk these standard arguments.

One argument against increasing bank capital is that extra capital ceases to be available for investment, leading to lower growth. The authors are absolutely correct that this argument—which is remarkably common among people who really should know better—is based on a confusion between "capital" and "reserves." For banks, capital is simply the equity component on the right-hand side of the balance sheet and, in principle, should have absolutely nothing to do with how assets are invested on the left-hand side of the balance sheet. Reserves, on the other hand, represent cash that must sit idle. Capital and reserves are different and should not be conflated in this debate.

A second objection to costly bank capital argues that given the market's requirement for a higher return on equity than on debt, forcing banks to hold more equity will raise the overall cost of capital for banks, with that cost passed on to the whole economy. This reasoning is clearly inconsistent with the Modigliani-Miller theorem, which postulates that all else being equal, the value of an enterprise is unrelated to how it is financed. The authors do a good job of explaining the ideas behind this theorem to their intended (lay) audience, a task that is much harder than it seems. I have many failed attempts to my name—and am planning to use some of the book's explanations on my next try.

My only criticism of the book is that it focuses too narrowly on "traditional" banks, where our regulatory apparatus is well developed. Regulators can already enforce (or at least try to enforce) capital standards on banks. But the recent crisis began and accelerated in the so-called shadow banking sector, the much more lightly regulated world of securitization, repurchase agreements, and other short-term money markets. Indeed, if we were to increase capital requirements for traditional banks without doing anything about shadow banking, it could easily make the overall financial system less stable as more of the system moves into the shadows. Even small deviations from the Modigliani-Miller theorem—which certainly exist in practice—can induce significant regulatory arbitrage away from traditional banking. (Indeed, it is such regulatory arbitrage on the margin that is often blamed for the growth of shadow banking before the crisis.)

The authors do address this concern toward the end of the book, but they are too dismissive of the scale of the problem. If we lived in a world where all savings were forced into traditional banks, then we could focus exclusively on the safety of those banks. But in a world with multiple parallel highways, a speed limit on just one may only make the others more crowded in a crash.

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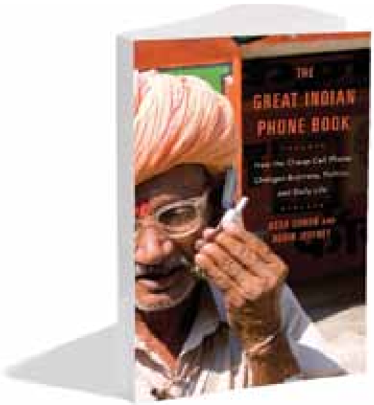
Ringing in the Changes



Robin Jeffrey and Assa Doron

The Great Indian Phone Book
Harvard University Press, Cambridge, Massachusetts, 2013, 336 pp., $29.95 (cloth).

The International Finance Corporation, part of the World Bank Group, has pronounced the mobile phone network "the biggest machine the world has ever seen," and in this book a historian and an anthropologist illustrate the titanic impact of the telecommunications industry on the largest democracy in the world.

This is an important book that can usefully be read by students, social scientists, and business managers—indeed, by anyone interested in change and its effects on developing and complex societies.

The authors demonstrate the futility of attempts by bureaucrats and political leaders to resist, impede, or control the change wrought by this telecommunications juggernaut.

This is well illustrated by Indian, U.S., and European authorities' attempts to auction the spectrum for 3G technologies for huge sums—a mistake that could impede and delay the introduction of, and investment in 4G and LTE, the next generation of wireless technology. Some argue that government has a duty to maximize revenues from these kinds of services. But if, in an attempt to maximize revenues in the short term, governments reduce operators' capacity to make speedy and timely capital investments in new technology, this will ultimately be to the detriment of their societies. Capital for investment is scarce, and extracting extravagant sums from operators impedes, delays, and ultimately raises the cost for consumers. An idea whose time has come cannot be resisted, and should not be delayed.

Jeffrey and Doron decided to focus on India—where there has been more dramatic growth in the spread of mobile phones than in any other region in the world—because its diversity and complexity make for a more satisfying and rewarding study. But the lessons from India are not restricted to this vast subcontinent. Some of the problems and challenges faced by a variety of operators in differing regional markets within India also confronted my own company, Digicel, in the very different markets of the Caribbean and South Pacific—places like Haiti and Papua New Guinea.

Papua New Guinea is a large market with amazing diversity—over 800 distinct dialects—villages only hundreds of yards apart, with large swathes of the population unable to understand one another. It has an inhospitable terrain with poor or nonexistent roads, presenting challenging conditions for tower construction. And in Papua New Guinea—as in India's Bharti Airtel, described in the book—we too, needed to get our marketing messages right and develop prepaid plans and appropriate distribution models for mobile phones and sim cards.

Like the successful operators in India, we did not confine our efforts to the more prosperous groups and areas in the countries in which we operate. Working closely with governments, we have swiftly penetrated even the most difficult parts of those countries—the Blue Mountains in Jamaica, the Highlands in Papua New

Guinea, and remote farming districts and deprived areas in Haiti.

And, as the authors point out, cheap mobile phones have given poor people an instrument that has vastly improved their quality of life and opportunities. But these improvements were unlikely to have happened so quickly, dramatically, and efficiently without the entrepreneurial zeal of the operating companies in India. Their marketing skills and technical abilities were released into a population that previously had no outlet for its latent abilities.

The operators identified telecommunications as the technology for the masses. By 2007 the Indian mobile phone industry employed 2.5 million people in the telecom services sector, and this number does not include the most entrepreneurial and innovative: those engaged in repairs and second-hand sales.

Advertising and marketing companies prospered, as did software developers, and a new world opened up for people who never had such opportunities, in areas such as radio plan design and building towers.

The last part of the book, covering consumption of telecommunications services, confirms our own experiences. We discovered that the fishermen in Samoa responded in similar fashion to their counterparts in Kerala, India, providing information to fellow workers at sea about the best ports to land their catches, information on weather conditions, calls for help in the event of an emergency, and the sharing of information on the best fishing grounds at any particular time. Small-scale producers, whether in India, Jamaica, or Haiti, have been empowered through their access to mobile phones, which has strengthened their contacts with markets and market prices.

The chapter on the impact of women's access to cheap mobile services is optimistic about the prospects for females in a country where the rate of change has, for cultural reasons, been slow. They describe the unique potency of a cheap mobile phone that puts an immensely disruptive device within reach of the poor. As the authors say, the trends are "unpredictable but worth watching and studying."

The authors add that each of the eight chapters in their tome is worth a book in itself. And they are right. In their stated aim of writing a book comprising "sound scholarship, engaging reading and intolerant of jargon" they have succeeded admirably.

Cheap mobile phones have given poor people an instrument that has vastly improved their quality of life and opportunities.

Denis O'Brien
Chairman, Digicel Group, and Chairman and Cofounder of Frontline, the International Foundation for the Protection of Human Rights Defenders