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PAPER

HOW TO IMAGINE A SCENARIO FOR A RENEWED BRETTON WOODS AGREEMENT

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How to imagine a scenario for a renewed Bretton Woods agreement¹

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With World War II still blazing, the Western Allies, and in particular United States and Great Britain, started to consider a way to re-establish the Wilsonian order as a mean to foster post-War reconstruction and integrate democratic economic systems. As the only great power to have avoided the destruction of the war, the United States quickly became the promoter of this new order, and, still during wartime, in 1944, a conference held at the Mount Washington Hotel in Bretton Woods, New Hampshire, United States, paved the way for a new world economic order in the aftermath of WWII.

The conference laid out the architecture of the monetary system to be put in place, only inspired by the pre-war scheme, eventually preserving its basic principles, whilst innovating the institutional design. Given the new balance of powers amongst allies, and the growing role for the United States, British economist John Maynard Keynes' views about the establishment of a new global reserve currency (the "Bancor" – which was supposed to be completely disentangled by any national denomination) were not retained. Rather, Harry Dexter White's idea to return to a gold exchange standard based on a central role for the US dollar as the main international reserve currency prevailed and was adopted. As a result, the new order was centered on the US dollar and a basket of convertible currencies, all pegged to gold reserves (gold exchange standard), and a system of international trade which had a new institution, the International Monetary Fund (IMF), as the guardian of the agreements. Members of the newly established IMF contributed with quotas subscribed by the respective central banks with part of their (convertible) currencies and gold reserves, to form a pool of financial resources that the IMF could lend to countries in need.

The drawback of this system was that there was an inherent asymmetry that actually led to policy disputes. In fact, the United States, which occupied a special position within the system, experienced large current account deficits and needed to depreciate its currency. But, after two decades, the system established at the Bretton Woods conference proved its inability on adjusting economic and commercial imbalances between its member states. Therefore, starting from the beginning of the 1960s, the system started to be theoretically challenged also by non-Keynesian economists.

These and other drawbacks led to the breakup of the Bretton Woods system in 1971. As such, the system had proven his flaws and limits, as by the early Sixties of XX Century, trade imbalances started to cause significant tensions amongst the group of advanced economies, forcing twice (1963, 1968) the realignment of the parities against the US Dollar, and, in the end, given the pressure over the Federal Reserve Bank system to return gold against dollars, after the US de-pegged their currency from such metal, causing the abandoning of the gold convertibility by all participants in 1971-73.

If we look back to 1965, when Jacques Rueff, president De Gaulle's economic adviser, criticized the Bretton Woods international monetary system with the famous allegory of the tailor ("If I had an agreement with my tailor that whatever money I pay him he returns to me the very same day as a loan, I would have no objection at all to ordering more suits from him") the limits of the original agreement become clear. The scheme was sustainable in a war aftermath economy – so during a reconstruction

phase - and helped Western European countries to recover their pre-war production levels by leveraging on the United States as engine for the restart of international trade and demand of European goods. But had proven its limits when European economies were back as fully fledged competitors of the US.

As Rueff outlined the 1944 system hindered commercial disequilibrium adjustments, because the country supplying the currency convertible into gold, the US, could finance its trade deficits without limits. Differing from the gold standard, which Rueff supported, the gold exchange standard allowed the central banks of countries with a current account surplus to increase money supply on the basis of reserves held in gold, dollar and dollar-denominated assets. As a consequence, because countries with a current account surplus that purchased Dollar-denominated assets maintained, as a matter of fact, their own reserves in the US central bank as dollars, the eventual outflow of dollars from the issuing state, to balance its trade deficit, did not actually determine an outflow of gold, nor a decreased capacity of domestic expenditure. In other words, at the end of the 1950s and the beginning of the 1960s, this system enabled the European countries and Japan to reindustrialize themselves by providing “clothes” to the US, which was able to purchase in great amounts, thanking to the continuing credits that the “tailors” of those countries granted them.

Rueff’s analysis on the unsustainability of a system which enabled the US to maintain permanent current account deficits was consistent with the 1960 analysis of Robert Triffin², known as the “dilemma”. The Triffin dilemma is the conflict of economic interests that arises between short-term domestic and long-term international objectives for countries whose currencies serve as global reserve currency. Triffin’s analysis is aligned with Rueff’s analysis in that they observe that the dollars collected by the countries in surplus are used to purchase US debt to hold as a reserve asset alongside gold, and, as a result, there is no mechanism to re-absorb imbalances. The conclusion of the two economists was that, inevitably, the amount of dollars retained by the member countries would increase compared to gold, and, as a result, undermine the confidence on the Dollar’s effective convertibility.

This meant declaring that one of the original goals of the Bretton Woods conference, namely that of returning to a system of fixed exchange rates, was unachievable. Rueff and Triffin shared the diagnosis on the flaws of the Bretton Woods system, but diverged on the therapy. Indeed, while Rueff hoped on returning to a gold standard, Triffin aspired to an international monetary system based on the Keynesian Bancor, in other words, on the institution of a global currency.

On August 13th, 1971, with the American announcement to suspend the convertibility of the dollar into gold, the gold exchange standard scheme adopted since the conference ended, and the debate took a different perspective. With the end of the Bretton Woods regime, also Western European countries were forced to give up the convertibility of their currencies, and exchange rates started to float. In the wake of such change, financial and monetary stability seemed to be suddenly at stake.

² Robert Triffin (1960). *Gold and the Dollar Crisis*, New Haven: Yale University Press.

However, this event did not compromise the role of the Dollar as an international currency with its triple function as a store of value, unit of account and medium of exchange. Despite an international monetary system largely turned anarchic - not guided by clear rules - the Dollar maintained and reinforced under the international monetary system a dominant role, giving the United States the so-called “exorbitant privilege”. The US Dollar remained the main international currency (also because of the US-Saudi Arabia deal which required oil to be traded exclusively in US dollars). This role lasted until current days and has never been really challenged neither by new “strong” currencies (the Euro), nor by the emerging relevance of new powers (China).

One of the notable consequences of the end of the system in place since 1944 was to leave the Europeans in need of a replacement scheme to ensure stability to their currencies. It took two years to the Europeans to elaborate a possible way to anchor their currencies. The Werner plan (1973) seemed a feasible solution, in the wake of oil crisis which accelerated the process and forced Western European states to resolve their differences. It then led to a new system (EMS), established in 1979, which, despite several realignments among strong and weak currencies, seemed to be stable. When, in January 1992, the treaty of Maastricht was signed, the decision to create limits and constraints to public spending, deficits and debts seemed to be the right way for moving towards a new strong currency, one with the potential of challenging the exorbitant privilege of the only true reserve currency, the US dollar³. Nevertheless, as recently claimed by Henry M. Paulson Jr., Secretary of the Treasury during the George Bush administration, “the privilege conferred on the US Dollar as the global reserve currency was hardly preordained”.

The crisis of September 1992 was a major hit for this ambitious project, but it was only a temporary setback⁴. Notwithstanding such events, the path outlined by the Delors plan was kept ongoing, and, in April 1998, all major EU member states took a giant leap towards closer monetary integration. They agreed on the introduction of a new single currency, the Euro, to be then circulated as paper bills as of January 1st, 2002. Initially the new Euro seemed a strong and competitive reserve currency, but never managed to raise at the same level of the US Dollar in terms of weight on international reserves held by central banks (which, even today, are denominated in US Dollar assets for about three quarters). This seems to be linked to the fact that European Union never got credibly on the path for a political project, which would have given the Euro a different weight.

Unfortunately, the attempt, in 2003, to reshape European Union governing rules failed, and, when in 2004, 10 new member states (then followed by other two in 2007) joined the EU, the burdensome decisional architecture showed all its limits, with too many persons sitting at the same table, trying to make decisions under the constant threat of multiple cross-vetoes, only able to make difficult compromises based on very low common denominators.

³ Ben Bernanke and Frederic Mishkin (1992). Central Bank Behavior and the Strategy of Monetary Policy: Observations from Six Industrialized Countries, NBER Working Paper No. 4082.

⁴ Michele Fratianni and Franco Spinelli (1997). A Monetary History of Italy, Cambridge University Press, Cambridge.

Whilst Europe as a political project stalled, so did the convergence of different economies. Only some of them had a single currency. The Euro was born with a flawed architecture. It was, and it is, the common currency for very different economies, with substantive differences in fiscal as well as in macroeconomic performance. Furthermore, the Euro was born with no single Treasury behind it. Instead, it relied and relies only on a Central Bank that has a very narrow target of price stability. The treaty confines the ECB to the role of ensuring the stability of the system rather than an instrument of economic support through monetary policy (like the Fed). Recent developments during the Covid-19 pandemic seems to indicate a shift by this position, but it is not supported by any change in current treaties.

The 1998 decisions left European fiscal policies in the hands of national governments, leaving Brussels with limited say, or, at least, no effective means to enforce rules. But despite these flaws, for a decade markets implicitly accepted the “convergence theory”. Sovereign bond spreads between Eurozone countries were, in fact, quite limited for a decade (1998-2008). The burden of past public debt and inefficiencies could have been a major impediment to launching the Euro, but financial markets simply assumed that European economic growth would facilitate the convergence and the debt burden would prove to be manageable even in higher debt economies. In short, the Euro was a currency launched without an adequate institutional foundation, or, as events a decade later proved, the political commitment to sustain it.

The Lehman crisis (September 2008) was the spark for a debt crisis that rapidly involved banks, non-financial corporations, households and, last, but not least, national governments. Initially, it was primarily the banking sector's stability that was at stake, worldwide and in Europe. Governments reacted by supporting the banking system (with guarantees, capital and debt). In order to avoid a deep recession, most countries supported collapsing demand by expanding public spending. Both actions stretched public finances and increased sovereign deficits and debts. Indeed, rather than act in concert, each Eurozone member supported its ‘own’ banks. This choice was perceived by markets as the end of the European convergence: the risk was shifting from commercial (banks) to sovereigns (states), but in an uneven manner: each one was on its own.

The failure to bring down yields for sovereign bonds substantially as spreads amongst “strong” and weak” states remained significant and the associated drop in the economic activity caused a vicious circle. Austerity deepened the recession. The recession worsened the fiscal situation of many countries with deficits coming down too slowly and the debt to GDP ratio increasing. This context seems now superseded by the current marked trends since the start of 2020 Covid-19 crisis, but it has to be noted that current measures are apparently “temporary” and not linked to a consensus on a long term political plan (rather, eventually, another economic plan, centered on a “recovery fund” to be launched by 2021). But the current Covid-19 crisis changed again the landscape and cast new shadows about the future, whilst it is still unclear the real path that European union will follow in the coming decades and, notably,

if it will be leaning towards a “single market of sovereign states” or, rather, to a possible, at least partial political union. This latter seems not an easy task by today perspective.

In the wake of the 2008 crisis and the current one, a debate about the adequacy of the international monetary system has gained attention, as trade imbalances (particularly amongst China and US) are leading to a permanent tension on the monetary system and eventually putting at stake the credibility of money as we know it.

Already after the accession of China to the WTO in 2001, there has been talks about a “renewed” or “Second” Bretton Woods, with some of the principal Asian currencies, in particular the Chinese Renminbi, in addition to Latin America’s currencies, pegged to the US Dollar alongside with controls on international capital flows between these countries and the United States. But, the story of this “second” Bretton Woods, and the global imbalances associated to it, is instructive. The rapid Chinese economic growth coincided with its accelerated integration in the global economy. Its double-digit growth in trade with foreign countries, compared with the overall growth in global trade, generated increased and persistent trade balance and current account surpluses. In the three years preceding the 2008 financial crisis, the Chinese current account surplus was on average close to the 9 % of its GDP.

Until 2005, by maintaining a fixed exchange rate with the Dollar and controls on financial capital outflows, China had, for many years, avoided adjusting its trade imbalances, also by accumulating official foreign reserves, which in 2011 accounted for 25% of registered central banks’ global foreign reserves. The purchase by China of public debt and other financial assets issued from countries with trade deficits, in particular the US, enabled these countries to maintain high internal liquidity, allowing them to sustain their internal consumption and investment demand. In addition, these purchases allowed China to control its excess liquidity and, as a result, to control its inflation pressures.

The two sides of the Pacific neutralized the classic monetary adjustment mechanism of fixed exchange rates imbalances, namely the adjustment of real exchange rates through shifting domestic prices. The American expansionary monetary policy, that at the turn of the Century had supported the new economy and real estate market speculative bubbles (and had financed the excess domestic demand), has been the reverse of the coin of the Chinese central banks’ policy of exchange control and trade surplus management.

Once again, the story of the Second Bretton Woods is not far from the story of Rueff’s “tailor”. However, even this “second” Bretton Woods, which rather than a formal agreement has been a tacit way of making business in the understanding of benefits for both parties (US and China) couldn’t survive the 2008 financial crisis. Already in 2005, under US pressure, China abandoned pegging its exchange rate to the Dollar and the Renminbi, in just three years (2005-2008), appreciated by about 18%. But, during the 2008 financial crisis, China restored for some years - in a view of financial cooperation - the policy of pegging its currency to the Dollar, only to ultimately abandon it again in the recent years.

The idea that has consolidated in China is that the Dollar standard is not able anymore in assuring monetary stability in the relations between America and Asia and the American financial market will be unable to maintain its dominant position in the future. The increased exchange rate flexibility that China has decided to adopt responds to the goal of orienting production towards its domestic market. This goal is pursued because the foreign market, compared to a production capacity tremendously increased and to an accumulation of private savings with a high inflationist potential, is too fragile.

This means that China, in the medium term, will no longer be interested in financing the American deficit. This change of course, however, will take some time since there is a concern to avoid a rapid depreciation of the Dollar that could in turn devalue China's Dollar-denominated assets. In addition, Asia still lacks a financial market sufficiently sophisticated that can assure proper investment options for its savings.

In fact, neither the 2008 financial crisis, nor more recent events, generated by the US has undermined the central role of the US Dollar, which confirmed its role as a safe asset also, and especially, in circumstances of major international strain.

However, there are at least three factors that reintroduce the debate on the role of the Dollar and on the necessity of a new international agreement that lays the foundations for a new monetary order and shared rules on international trade: a) the first factor is represented by the emerging fragility of economic hyper-globalization and by the research for new rules to govern international trade; then b) technology should be taken into account, as it has radically changed the payment systems (also the transnational ones) and has concretely placed the possibility for a digital currency with an international role, both private or issued by central banks and possibly by multilateral institutions; and, lastly c) the recent changes in the geopolitical and geo-economic framework, which has reintroduced, in this new context, the strategic and political use of the Dollar, defined as "Dollar weaponization".

In September 2018, the governor of the Bank of England Mark Carney, speaking in front of an audience made up of bankers and economists at the Jackson Hole annual meeting in Wyoming, suggested that the world dependence on the US Dollar is not sustainable anymore and invited the IMF to take the lead on designing a new international monetary and financial system based on multiple currencies.

Mark Carney's analysis starts from the finding that it is not true that a flexible exchange rate regime is the solution to enable countries to absorb global shocks and maintain stable production levels and domestic prices through a flexible monetary policy. Particularly when a single currency holds a position of ultimate reserve currency and causes global growth to be strongly affected by the impact of economic events and American monetary policies on the dollar, leaving countries exposed to the volatility of the US currency and to global risks.

Mark Carney's conclusion, as that of other economists, is once more that the dominant role of the Dollar in the monetary system is a source of instability and, as a result, a multipolar system transition is needed. This multipolar system could be based either on several international currencies or a single global

currency, which could take the form of a global electronic currency. But this debate, still active and participated, has not yet brought to any factual conclusion.

In fact, Covid-19 pandemic created unprecedented challenges to the global economy; we are experiencing a deep recession that hit all economies, advanced and emerging as well as developing, and an unprecedented explosion of sovereign and private debts all over the world. Considering the pre-Covid-19 existing three global trends - the retreat from hyper-globalization, the relationship between market and government, with a growing role of the latter, evident also in Europe, and a declining growth rate - the pandemic crisis probably will not be a game changer but rather a game accelerator. A possible outcome is an economic conflict between the West and the new Asian power, with the potential of a trade war between the US and China being only a starting point of a technological competition, which may include not only the configuration of the global value chains, but also geostrategic matters as security, the unity and interconnection of ICT networks and the financial and international payment infrastructures.

For these reasons, attention must be paid in order to avoid that a strong action to contrast the Covid-19 might determine the diffusion of a sentiment indicating the globalized world as the root cause of dangers that can only be challenged by closing down borders. During the 2008 financial crisis, China and the US adopted a cooperative response, with a great fiscal stimulus in China and unconventional monetary policies in the US. In the after Covid-19 world, a “New Bretton Woods” agreement is an alternative to protectionism, nationalism and the disruption of international trade and investment channels that have contributed so far to the growth of global well-being. Only a coordinated effort about a new deal, of the monetary system Worldwide, to rethink a new scheme for the years to come, jointly promoted by all main economies, including the new emerging ones. Possibly, the first step should be a renewed EU-US Transatlantic pact with the US leading the process.