From Bretton Woods to the Euro: How Policy Maker Overreach Fosters Repeated Economic Crises*

Preliminary
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ABSTRACT

This paper considers the relevance of the Bretton Woods system for the prospects of reforms in the international financial system and the ongoing euro area crisis. After exploring the challenges for reforms going forward and what resonates, and what does not, from the BW regime, I examine some of the key lessons from that era. Policy makers tried to promise too much and they did not give sufficient thought to how the arrangement devised in the 1940s would actually function. They failed to instill the logic of collective action among its members. In particular, BW failed because the agreement paid virtually no attention to governance issues. Finally, in terms of the present day situation in the euro area, the problems are not purely of the economic type. The successful development of an international regime will require a political-economy approach.

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1. Introduction

The Bretton Woods (hereafter BW) system ended almost 40 years ago. Enough time has elapsed that we should have a clear-eyed view of its contribution to the evolution of the international financial system and its place in the history of exchange rate regimes. Indeed, the policy strategy that underpins the BW system continues to fascinate policy makers to this day, even though economists’ opinions on the performance of the BW have been decidedly more mixed. Former British Prime Minister Gordon Brown, at the height of the financial crisis that raged throughout the world in 2008, went so far as to issue a call for governments to revive the BW aims (Reuters 2008). In doing so, the then Prime Minister was echoing the desire of other political figures to remake the world’s international monetary order as well as seeking to recreate a new world economic order based on what they believed to have been a tried and successful strategy. A key attraction of the BW ideal was the belief that it represented the high watermark of international cooperation in coordinating responses to economic crises.

A little over three years since the Lehman Bros. bankruptcy one sees far fewer calls for a ‘new’ BW as the urgency that accompanied the need to react in some way to the global financial and economic crisis was overshadowed by other concerns of a more domestic nature. Indeed, and in spite of the ongoing travails of the eurozone, there is little desire among policy makers to return to the fixed exchange rate system that predates the creation of the euro currency. Instead, cooperation or coordination is sought elsewhere. Nevertheless, some of the conditions that led the original creators of the post-World War II international monetary system to recommend a system of pegged exchange rates with limited flexibility, more circumscribed
capital mobility, together with a form of peer review of members’ economic policies, persist today. Witness the emphasis euro area heads of government and the EU have placed on fiscal rules that enshrine a form of peer review, if not complete supervision (e.g., see EU Commission 2011). Still, concerns over the role of floating exchange rates continue to pre-occupy academics and policy makers. Whereas in 1984, the U.S. General Accounting Office convened experts to debate the merits of floating exchange rate (GAO 1984), concluding that floating exchange rates are neither good nor bad, and cannot fully insulate an economy against external shocks, small open economies such as Canada, have long advocated the merits of this system, however imperfect it is, simply because the alternative seems worse (e.g., Murray, Schembri, and St-Amant 2003). Indeed, evidence of the insulating properties of the exchange rate during the Great Depression era also underscores the merits of this kind of strategy (e.g., Choudhri and Kochin 1980). We have since learned that a floating exchange rate does not represent a coherent policy strategy unless the anchor of policy is clearly defined (e.g., see Rose 2010 for the latest re-statement of view). Even Canadian policy makers have raised the possibility that floating exchange rates have not lived up entirely to their billing.

Fortunately, while we do not have to cope with the massive devastation occasioned by World War II, there is a return, or perhaps the threat of a return, to ‘beggar thy neighbor’ types of policies. In the present era this translates to resisting exchange rate appreciation, the

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1 As this is written one wonders why EU heads of government think that a Stability and Growth Pact on ‘steroids’ will overcome scepticism and the failure to adhere to the original SGP (see Schuknecht et.al. 2011).

2 For example, contrast Murray’s (2011) comment: “...flexible exchange rates, which have a great deal to recommend them, have failed to live up to their initial optimistic billing. (Canada's positive experience with a flexible exchange rate through the 1950s and early 1960s might have contributed to this overly sanguine assessment.) Their stabilizing properties were shown to be more limited...” with Murray, Schembri and St. Amant (2003), “...flexible exchange rates facilitate adjustment to shocks in the underlying fundamentals.”
imposition of taxes or fees to limit capital mobility, differential rules and oversight of financial sectors, and the ever looming threat of trade protectionism. This is precisely what contributed to the economic misery of the late 1920s and 1930s.

Given all this, why do we continue to be fascinated by the BW era? After all, the agreement ratified by 1946 did not actually fully come into being until the main participants were able to offer convertible currencies and this did not effectively take place until the late 1950s. Moreover, if we date the end of the BW era with President Nixon’s decision in 1971 to sever the link between the price of gold and the U.S. dollar (set at $35/oz.), this international arrangement lasted only a dozen years or so. Consider the next big experiment in coordinated policy making, namely the creation of the euro zone. Although European Monetary Union was introduced in stages, beginning with the 1991 Maastricht Treaty and ending with the introduction of the euro in 2001, it is showing signs of severe stress as this is written, again a mere dozen years after the common currency began circulating among select member states of the EU. What are the common features, if any, between such regimes and what role might have been played by flaws in the design of such regimes?

The rest of the paper is organized as follows. The next section considers what economic constraints were implicit or explicit in the BW system and how the system was set up for failure because it paid virtually no attention to governance issues. The paper then considers what aspects of the BW continue to have resonance today and what do not before asking: where do we go from here? The paper concludes with some of the lessons for BW that policy makers
need to consider if an organization such as the G20 is to successfully create the conditions for a transition to a new international regime.

2. The Ingredients of a Lasting Policy Framework

There are other monetary standards (e.g., gold, inflation targeting) that have easily outlasted the BW agreement. Indeed, it was known almost from the start that the original articles of agreement contained a fatal flaw, since called Triffin’s paradox. At the risk of oversimplification the paradox emerged from the fact that as there effectively remained only a single world reserve currency, the U.S. dollar, a worldwide shortage of U.S. dollars could only be averted, and worldwide trade and economic growth sustained, if the U.S. permanently ran a balance of payments deficit. While this is technically feasible there is the question whether, and at what level, such a deficit would become unsustainable. Perhaps Gordon Brown, and others, saw BW as a regime that delivered low and stable inflation combined with sustained economic growth while international trade rose substantially. Perhaps supporters of the BW arrangement felt that an agreement among a large number of nations is a signal achievement worth replicating.

No doubt someday a policy maker may also look back at the era of the ‘Great Moderation’, in the same manner. The term was used famously by Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System, to describe the period from approximately the mid 1980s to the middle of 2007 when inflation was also low, economic growth stable with relatively few large shocks hitting the world economy. Even so, one needs to regard with a

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3 Quantities of gold could not be combined with U.S. dollars in sufficient quantities to offset a potential shortage of the U.S. currency.
considerable amount of skepticism previously advertized assessments of relative macroeconomic performance across different policy regimes. Consider Figures 1 and 2 which plot inflation and real GDP growth during the Bretton Woods and the recent decade culminating with the end of the Great Moderation. The chosen countries are somewhat arbitrary but they are meant to highlight overall economic performance in different eras. Figure 1 illustrated the Canadian and German experiences. Both are open economies, the latter a large one, the former the archetypical small open economy. By today’s standard of low and stable inflation (i.e., the 1-3% range adopted by many central banks) both economies perform well until perhaps the arrival of the first of two oil price shocks in the 1970s. Real GDP growth is seemingly volatile but mean growth rates are 5.18% for Canada and 4.21% for Germany for the 1960-1972 period. Turning to the period since 1998, real GDP growth, now shown for Canada, Japan, and China, appear more stable but divergences across the three countries are striking. Canada is included for continuity with the Bretton Woods era while China and Japan are the poster children for fast growing emerging market economies and mature economies stuck in a long slump. Yet, the apparent Great Moderation is an illusion. The standard deviation of growth rates between the two samples is, in fact, not statistically different, even for China.\(^4\)

When we turn to inflation the comparisons highlight the differences in policy regimes with Canada having adopted an inflation target while the other two economies shown did not. Inflation targeting did not bring with it a Great Moderation in overall economic performance

\(^4\) Mean economic growth rates, with standard deviations in parenthesis, are as follows for the BW and PBW periods considered: BW, 5.18% (1.80) for Canada, 4.21% (2.42) for Germany; PBW, 2.37% (2.17) for Canada, 0.63% (1.80) for Japan, and 8.90% (2.63) for China.
but succeeded in anchoring inflation. Since the exchange rate regimes also differ widely across the economies considered it is also unclear how, say, a floating regime versus one that permits considerably less flexibility, can explain these outcomes. Obviously, one explanation is that the economies examined are in various stages of their long-run cycles. However, one cannot exclude the possibility that design of institutions and economic governance more generally, are also elements in the mix.

Therefore, as in the BW system, what matters as much is not just what the era delivered in terms of economic performance, but the build-up of imbalances and other inconsistencies that led to their ending. In other words, an era should be judged not only by what was accomplished during its existence but by the economic aftermath of the end of the particular era in question. These considerations may well also influence the duration of particular regimes. In this connection it is, therefore instructive to consider examples of the imbalances created by regimes that appear to function well at some level for some time, but hide pressures that build up elsewhere, here in the current account, as shown in Figure 3, or in financial terms, as shown in Figure 4 where the foreign exchange reserves accumulation of select Asia-Pacific economies are plotted.

Dwelling on some of the positive aspects of the BW accord that continue to resonate today is worthwhile, if only in light of the G20’s repeated desire, mostly on paper, to deal with the ‘imbalances’ that plague the world’s economy and the diminished interest in reaching actual

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5 This may perhaps be explained by the ‘anchoring’ phenomenon (Kahneman 2011, p. 119) wherein “…people consider a particular value for an unknown quantity before estimating that quantity…estimates stay close to the number that people considered…”. In the case of the inflation target that is considered credible, individuals will expect 2% - the mid-point of the 1-3% inflation target range – and the monetary authority will endeavour to deliver this value.
cooperative solutions. They are (not in order of importance): first a recognition that economic shocks are transmitted across borders and that cooperative solutions are desirable. Second, the importance of defining rules of conduct to constrain the likelihood that bad policies will be practiced while allowing sufficient flexibility to deal with cases where ‘bad luck’ requires some adjustment and cost sharing among members. Third, that the whole (i.e., a concern for global considerations) can be greater than the sum of its parts (i.e., purely sovereign concerns).

Given the potential benefits of accords of the BW type the implications going forward of attempts to design and operate an international financial infrastructure are as follows: that externally imposed constraints are either superior to discipline in policies that originate domestically or, rather, that external discipline can usefully supplement purely domestically oriented policy; that, so long as there is sufficient transparency and an enforceable measure of accountability, there is the possibility of building trust in an institution or an arrangement and sustain it over time even when there are occasional setbacks in the form of a temporary loss of credibility. Finally, any successor to the current regime, whether of the BW or some other variety, must be flexible enough to recognize that there is a trade-off between the principle of national sovereignty and the need to recognize that in a global environment there are interdependencies and externalities from individual country decisions.

While the foregoing prescriptions can be applied to a wide variety of circumstances, in what follows, an ongoing concern is the future of the eurozone. Even Jacques Delors, whose name is inextricably linked to the EMU project, has admitted that the eventual member states of the

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6 As opposed to a coordinated solution. Some of the blame for the failure of BW may be laid at the hands of policy makers who confused the two types of solutions.

7 In other words, trust is a ‘stock’ that needs building while credibility is a flow that changes over time.
euro area did not take seriously enough the necessary condition for EMU to be a success, that is, the requirement that member states cooperate (Moore 2011). Instead, imbalances, hidden from view at least to some, continued to build until the entire project was threatened for the simple reason that there was insufficient surveillance combined with a failure of will to consider some of the challenges associated with a single currency. This outcome is the natural conclusion of attempts by policy makers to ‘overreach’ in terms of promises made about the stability and durability of policy regimes.

3. **Looking Back at the Bretton Woods System: Challenges and Constraints**

The appeal of arrangements that tie the hands of its participants is universal either because individual members cannot be trusted to deliver policies that evince a concern for the collective or because a desire for ‘fairness’ or balance in international arrangements is deemed to be a desirable objective. The European exchange rate mechanism followed by the launch of the euro, are examples of cooperative arrangements that eventually necessitated a form of coordination. It is important at this stage to make the distinction between cooperative and coordinated actions. These two policy strategies imply different constraints on the available menu of policies even though it is not always straightforward to separate or identify one kind of approach from the other. At the outset it must be emphasized, of course, that a BW style arrangement contains elements of both cooperation and coordination which likely also contributes to its appeal for many policy makers.

As shown by Obstfeld and Rogoff (2002) a cooperative like solution is possible even if individual countries pursue independent rules like behavior in the conduct of policy. In other
words, one can end up with a solution that is desirable from a global perspective even if sovereignty over the choice of domestic policies is retained. As Murray (2011) points out, the 1980s saw important contributions in economics which, on balance, suggested that cooperative solutions yield small welfare gains. Cooperation on the maintenance of exchange rate regimes is the one economist had foremost in mind. Of course, models such as Obstfeld and Rogoff (2002) are highly stylized but they do draw attention to the role played by distortions, here distortions in capital markets, as factors that make the idealized cooperative solution exceedingly difficult to obtain in practice. In particular, these models did not consider what might happen if the transmission of economic shocks changes over time. Figures 5 and 6 illustrate by plotting the dynamic conditional correlations in real GDP growth between the USA or China and other regions of the world. Note the dramatic rise in correlations on a global scale from insignificance as recently as the year 2000 to very high levels on the even of the global financial crisis. Rather strikingly, a similar phenomenon is apparent from financial markets, here illustrated by the dynamic conditional correlations in stock returns between the USA and select Asia-Pacific nations.

The recent crisis also highlights, however, that economies, in spite of the so-called globalization of trade and finance, can easily decouple. While it is not clear, a priori, how globalization leads to coupling or decoupling in business cycles or financial cycles the results shown here ought to provide additional incentives to reach cooperative solutions on monetary and fiscal strategies. Yet, there is evidence, based on recent G20 or G8 meetings, that politicians resist these pressures and are happy to ‘muddle’ through until sufficiently pushed to adopt the correct strategy. Nevertheless, predictions from models referred to above also have
implications for an alternative strategy, such as limitations on exchange rate movements, or global goals as in the recent U.S. proposal to set specific limits on current account imbalances, as these require setting external constraints, making mutually consistent decisions difficult to attain. This can only be accomplished if, say, a supra-national authority is in place and has the tools, and the ability to enforce the necessary steps required to ensure that consistency is maintained. The foregoing distinctions are important both because there have been hints from policy makers in some emerging markets (e.g., see Reuters 2010) that coordination is a desirable objective while the problem of imperfections and distortions in domestic capital markets remains one of the most salient differences between emerging market economies (EMEs) and advanced economies (AEs).

The continued debate over the consequences of alternative exchange rate regimes is also a manifestation of the recognition that international considerations cannot be blithely ignored or assumed away behind a floating exchange rate regime (e.g., see Klein and Shambaugh 2010, Rose 2010). Given this backdrop one would have imagined that BW, born out of the ashes of World War II and the debilitating experience of the Great Depression, would have had a longer and more successful life. Yet, the exchange arrangement inspired in part by Keynes but ultimately fashioned by the U.S. (e.g., see Boughton 2002, Bordo and Eichengreen 1993), eventually met a series of challenges it could not survive. In no particular order of importance are: the reaction to the two oil price shocks of the 1970s (e.g., also see Figure 1) which inspired countries to adopt different responses that ultimately proved inconsistent with the BW ideal of
stable exchange rates (e.g., see Rogoff 1985, Fischer 1990);⁸ the emergence of central bank independence and, with it, the desire to emasculate international considerations in favour of domestic objectives for monetary policy embodied in the trade-off between inflation and economic growth; the realization that floating regimes, or at least regimes with some exchange rate flexibility, combined with a suitable anchoring of domestic inflation, may yield desirable economic outcomes as reflected in the Great Moderation previously referred to.

One would be remiss if attempts to revive the BW style system in the form of the Plaza and Louvre Accords of 1985-1987 (e.g., see Poole 1992, and references therein) were not mentioned. After all, it can be argued, at least in the case of Japan, that these agreements, by perhaps artificially appreciating the yen against the U.S. dollar set the stage for its now almost two ‘lost’ decades long deflation and low economic growth (e.g., Hamada and Okada 2009). In the meantime, Germany was increasingly becoming pre-occupied by the drive towards closer European economic (and political) integration while the approaching fall of the Berlin Wall would further lead Germany to turn inward as it sought to cope with these shocks. No doubt these attempts at exchange rate manipulation are also on the minds of Chinese and other policy makers going forward as the global economy seeks to recapture some semblance of balance, yet to be precisely defined by the political authorities. It seems doubtful that a current-day James Baker, Secretary of the Treasury at the time of the Plaza and Louvre Accords, could command the kind of moral suasion that could an exchange rate realignment of the kind

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⁸ Escaping from a system that does not meet the needs of most of its members is nothing new. Since it is currently fashionable to refer to policies around the time of the Great Depression it is worth noting that, just as was true at the end of the BW era, so did the competitive devaluations during the gold standard end up loosening monetary policy sufficiently as to help lift the world out of its great slump. See Eichengreen (1992).
engineered almost 25 years ago as we today live in a more multi-polar world economically than it was during the 1980s.

In light of the criticisms leveled at U.S. economic policies from all quarters it is useful to further consider the backdrop for the creation of BW in the first place. As noted above, prior to World War II, the impact of competitive devaluations was still fresh in the minds of many policy makers who concluded that the Gold standard was too rigid a system for a world economy that required liquidity to meet the expected growth in international trade.\(^9\) Perhaps most importantly, the major players at BW felt, at least initially,\(^{10}\) that a coordinated response was required to prevent threats to the world economy from individual countries, especially large ones, that ignored the potential negative externalities from the single-minded pursuit of policies only meant to meet purely domestic objectives. To meet this objective required an international agency that would have oversight functions and, ideally, the power to impose sanctions on misbehaving members. The latter proved to be an impossible objective to meet and the newly created International Monetary Fund (IMF) could only resort to moral suasion, both in private and in public, to keep members in line.

To understand what it is about BW that continues to resonate with policy makers today, and what does not, it is helpful to briefly summarize its principal features.\(^{11}\) The following represent the core of the agreement reached at BW. First, currencies had to declare a par value

\(^9\) The seminal work deconstructing the Gold standard is Eichengreen (1992a).
\(^{10}\) While Keynes and White, two of the central characters in the BW story, may have preferred some form of coordinated action to prevent a recurrence of another Great Depression, American politicians, also present at Bretton Woods, eventually had ideas of their own and these evinced little concern for the opinions of others at the negotiating table. See Bordo and Eichengreen (1993).
in terms of gold and the U.S. dollar. The relationship between the latter two was fixed at $35/oz. The U.S. dollar, by default, would represent the nominal anchor of policy. Currencies could fluctuate in a zone 1% around the announced par value. Changes (i.e., revaluation or devaluation) were permitted only in the event of a fundamental disequilibrium in the balance of payments and following consultation with the IMF. While such moves could not be prevented different thresholds would be applied depending on the severity of the problem and sanctions (e.g., expulsion from the IMF) were to be the last resort.¹² A system-wide redefinition of par values would require majority approval as well as the support of ‘large’ members.¹³ Convertibility on current account transactions was necessary but controls on the flow of capital were permitted. Membership in the Fund implied access to the liquidity available from the contributions made by its members. Finally, to alleviate the possibility of a shortage of the reserve currency, a scarce currency clause was included which permitted a trigger to set in motion a form of rationing. The clause has never been invoked. In spite of the built-in flexibility of the system, and attempts to anticipate various eventualities that might place strains on the system, “[T]he architects never spelled out how the system was supposed to work.” (Bordon 1993, pg. 28). Implicitly, however, the system involved a peg to the U.S. dollar, an expectation and that the 1% tolerance band would be maintained via foreign exchange intervention, and an appropriate mix of domestically determined fiscal and monetary policies. The fact that the architects of international standards and arrangements are unable to communicate or even lay

¹² Hence, a 10% change in the par value of a currency could not be prevented if a member so wished, while changes in parity that exceeded this threshold would be delayed by up to 72 hours while the IMF debated their advisability.

¹³ That is, members whose quota (i.e., contribution to the creation of the Fund) exceeded 10% of the total. Not surprisingly, economic size when the IMF was created dictated influence within the organization and the financial contribution required to operate the Fund.
out in some detail how the system works is precisely the same problem that would impact of the eurozone in relation to its creation based on the Maastricht Treaty. The Treaty was failr clear about how to get to EMU but not so careful about how it would work, let alone survive the test of time.

History would not be terribly kind to the BW system. The BW arrangement took over a decade to effectively come into force. In the intervening period there were several notable devaluations from parity, the departure from the agreement by Canada (as well as Belgium for a briefer period), while the Marshall Plan and an early manifestation of the drive toward greater European integration in the form of the European Payments Union. More shocks would follow during the 1960s as growing imbalances in the world economy slowly but surely threatened the survival of the BW system. All of these events have been ably documented in a variety of places, including Bordo and Eichengreen (1993), and James (1996).


The creators of the BW system did not give much thought to economic governance issues as they are understood today. Essentially, the victorious powers got the international framework they wanted. Indeed, it was largely a uni-polar world with the US seen as largely dictating the shape of the new international monetary system. More to the point, there was little concern about how the system was supposed to function. Eventually, responsibility and accountability shifted back and forth between the U.S. and the major industrial economies, collectively known as the G7, until the global financial crisis of 2008 forced an expansion of consultations to a larger and more diverse set of countries known as the G20. In the meantime varieties of
institutions were created or existing ones were tasked to deal with a variety of issues that arose in the sphere of international economic affairs (e.g., the Financial Stability Board, the BIS, and so on). With an enhanced role for emerging market economies (EMEs), including ones that do not share the same democratic ideals that most of the industrial economies live under, the economic governance problems became more acute.

No amount of effective cooperation is possible unless some of the pressing governance questions get resolved. Drawing upon some of the results mentioned earlier, it may be preferable to invest international organizations with the task of ensuring as much cooperation as possible in normal times while putting into place mechanisms to deal with emergencies in crisis times. The recently created European Financial Stability Facility (EFSF) is one such models though early indications are that it has either not been up to the task or is still too much in its infancy to be judged impartially at this stage. The European Commission (see EU 2011), in an attempt to persuade markets and the public that Europe’s debt crisis can be controlled under existing Treaties, revealed amendments to the 1997 Stability and Growth Pact aiming to increase surveillance measures on Member States that triggered the excessive deficit procedures. These include enhanced budget coordination, the introduction of national fiscal rules supported by oversight from national fiscal councils, and rules about access to financial assistance through the EFSF and the International Monetary Fund (IMF). The amendments failed to persuade markets and policy makers outside the euro area that the governance problems were resolved and, as this is written, France and Germany were planning to take the additional step of proposing Treaty changes to enshrine a form of budget discipline among the Member States.
The ‘exorbitant privilege that the U.S. dollar continues to enjoy is also a fact that marks the BW era and continues to pre-occupy policy makers today. Neither the euro nor the Chinese renminbi are likely to displace the dollar anytime soon, in spite of a yearning by some to supplement it with an alternative. The central place of the U.S. currency is both a threat and an opportunity going forward. It is a threat because U.S. economic policies are entirely focused on domestic considerations. However, there is also an opportunity since, under the present circumstances, the emergence of China, India, and Brazil, most notably, should create the incentives where the major economic powers, including the U.S., can find cooperative solutions that retain a sufficient amount of national autonomy. Of course, such incentives must also confront a reluctant U.S. Congress – regardless of the party in power – to take account of any international implications of its legislation. Overcoming this problem requires recognition that, with power, there is responsibility. Perhaps persuading U.S. politicians that one way to prevent the perception, in some quarters, of America’s waning importance or influence is to highlight how cooperation can actually reverse such views. Note that the currency from the world’s largest economic block, namely the euro area, does not even enter into the picture until national governments effectively deal with the sovereign risks of its members.

Finally, just as imbalances built-up over time under the BW system so do imbalances, arguably perhaps of a different kind, continue to threaten the world economy today (also, see Figure 3). Back in 1945, when the BW system was being created the focus was on ensuring that the arrangement provided the requisite incentives, via the nominal exchange rate anchor, to ensure that domestic fiscal and monetary policies would be suitably set to help ensure the survival of the policy framework. Unfortunately, as previously discussed, how the regime was
supposed to function was never fully explained. Today, the concerns are similar but to these must be added macro-prudential concerns that became central in the aftermath of the global financial crisis of 2007-9. While policy makers are now in a much better position to spell out how monetary policy functions both in normal and in crisis times, a great deal of uncertainty surrounds the role of fiscal policy and we know even less about which macro-prudential tools to use and their effectiveness.\[14\]

In spite of the fact that several elements of the BW system continue to have resonance today there are likely many more considerations in today’s environment that do not resonate with the conditions that policy makers faced back in 1944. In retrospect it is clear that whereas a series of aggregate supply shocks, namely the oil prices shocks of 1973-74 and 1978-79, contributed to preventing a revival of a BW style arrangement, at the root of the continued sluggish recovery from the latest global economic crisis is a large aggregate demand shock. Regardless of one’s view the state of macroeconomics today all fiscal and monetary authorities are well aware that the policy response to these two types of shocks cannot be the same.\[15\]

Arguably, one of the most important differences between then and now is the degree to which capital is mobile. Moreover, despite attempts to curtail the flow of ‘hot money’ especially, there are very few voices calling for a return to the restrictions on capital flows that marked much of the BW period. In part this is because these capital flows are seen a vital for emerging markets’ development although a case can be made that the ease of capital mobility

\[14\] A major difficulty in the present circumstances is that macro-prudential tools currently being discussed may or may not be sufficiently orthogonal to existing monetary policy tools (viz., manipulating a policy rate or direct asset purchases by central banks).

\[15\] One parallel between the 1960s and the events of 2007-9 not frequently discussed is that, in both cases, the largest economic power, the United States, was fighting a war that was potentially financially debilitating.
may have slowed the pace of financial maturity that must surely accompany the rapid economic growth and catching up phase of EMEs development. Nevertheless, unlike the BW era, policy makers are today not simply concerned about current account imbalances but the associated financial imbalances. More tellingly, since many of these imbalances are built-up as a result of a domestically driven economic agenda, the resulting spillovers we now understand can threaten the global economy.

Next, in spite of the shift towards more flexible exchange rate regimes over the past two decades, the impact of the global rise in the trade of goods, services, and capital has actually made business cycles more not less coincident, as discussed earlier (see Figure 5). For a brief moment around 2008-9 some analysts were announcing the decoupling of business cycles particularly between Asia and the rest of the world. This quickly proved to be an illusion (e.g., see Eichengreen and Park 2008).

At the heart of the BW standard is the anchoring of expectations to a form of exchange rate stability. Yet, despite complaints about exchange rate volatility there is simply no convincing evidence that exchange rate flexibility creates additional economic costs. Perhaps more importantly, central banks, governments, and likely the public, have learned that price stability, typically defined as the goal of low and stable inflation perhaps with a numerically specified tolerance range, is both a more practical and feasible task for the monetary authorities to be held to account. Indeed, such a system has the virtue of being relatively transparent, seems to be a goal that can be easily communicated to the public, yet permits the flexibility that is essential in all standards where some cooperation across countries is required.
As World War II ended there may have been a large number of Allied countries that were victors but, for all practical purposes, only a single power would dominate both politically and certainly economically for decades to come, namely the United States. As the first decade of the 2000s ends it can no longer be said that, in economic terms, we live in a uni-polar world. Indeed, there seems to be a perceptible shift towards a type of bi-polar world with the U.S. and some emerging markets (viz., the BRIC countries consisting of Brazil, Russia, India, and China) vying for economic influence with the euro area, in principle also a large competitor, seemingly hobbled by a serious internal failure of coordination, if not cooperation. Therefore, the relative size of the ‘core’ versus the ‘periphery’ in international affairs has changed rather substantially since 1945. As a result of the shift in economic power there are expectations that any international economic agreement involving a mixture of cooperative and cooperative elements require some symmetry even if the BW standard was firmly built on an asymmetric relationship between the U.S. and the rest of the world. In addition to such expectations it is highly unlikely that the public and those responsible for fiscal, monetary and financial stability at the domestic level will believe in the success of grand attempts at fashioning a new international standard for economic cooperation. It is almost as if the public signal, that is, from the politicians who sign on to re-designing international agreements, is drowned out by the signal emanating from domestic policy makers who warn about the severe limitations and risks associated with major reforms of this kind.

5. Lessons Learned From Bretton Woods
History tends to favour incremental agreements at reforming institutions and policies that include an international dimension. If this is the case then BW represents an aberration unlikely to the repeated. Indeed, the mere fact that, in spite of the global financial system’s ‘near death’ experience in 2008, politicians have scaled back their ambitions to create a new BW type arrangement captures the inherent reticence of politicians to give up more sovereignty than is absolutely essential. More worryingly, there is a sense in which the demands by the U.S. to ask others to do at least part of the ‘re-balancing’ believed necessary to restore sustained economic growth is meeting resistance from the block of Emerging Market Economies (EMEs) that continue to see the need for trade and competitive exchange rates as the surest path to creating economies that will eventually be mature enough to be driven by domestic aggregate demand. The resulting stalemate also does not augur well for chances of reaching even some cooperative solutions to the imbalances that plague the world’s economy. Part of the difficulty is that economic solutions which may seem sound on purely economic principles may conflict with political constraints within the EME block of countries. Whereas BW was primarily an economic agreement with little concern for political implications, any new international standard must view the problem from the standpoint of political economy. The political economy dimension is surely complicated by the fact that not all the major participants play by democratic accountability rules. How this is overcome remains entirely unclear.

As argued in the previous section the BW system involved largely technical issues. However, in view of the participants in the original conference, one could not entirely escape the political aspects of any international agreement. The creators the BW system did not think through how the regime would actually function. Perhaps, as Meltzer (2003) points out, it is because “Central
bankers had a modest role” (op.cit., pg. 620) to play in setting out the mechanisms that needed to be in place for the smooth functioning of a pegged exchange rate system. There is another lesson to be learned from the more recent history of central banking, namely the joint responsibility doctrine. This doctrine holds that decisions about the objectives of policy are to be made by governments as they are, ordinarily, held accountable for their actions. Once the objectives are set, central banks are left to meet those objectives with a large dose of autonomy. This is what Debelle and Fischer (1994) referred to as instrument independence but not goal independence. The same principles should be applied to any future attempt at creating a new international financial infrastructure.

Next, in retrospect, BW asked too much and promised too much. It is always tempting to think that the right dose of flexibility, combined with necessary rules to limit the scope of individual action, can be achieved. Clearly, this proved illusory in the BW case almost right from the start and, although we know considerably more about how economies function today, finding the right balance is likely once again to evade policy makers unless they wish to negotiate an agreement that is far more complex than is desirable. Alternatively, it is likely preferable to set broad limits to what countries can do to satisfy purely domestic considerations, provide the necessary tools and resources to international organizations to provide an independent assessment of member countries’ policy stances – this will of course require a commitment to transparency that is somehow enforceable – while devoting far more attention to managing crises when these do happen. As Reinhart and Rogoff (2009) make clear “This Time Is Different” means that crises do take place on a regular basis, are unlikely ever to be avoided, while policy makers harbor the illusion that reforms can always prevent the next
one. If is it impractical to devise a full-proof way to prevent all occurrences of crises then at least the international community should have some mechanism in place to deal with the ‘unexpected’ when it happens instead of reacting often in an *ad hoc* manner as happened after the crisis that began in 2007 erupted. This can only be accomplished by instilling in policy makers the logic of collective action.16

Finally, BW teaches us that international standards based on faulty or incomplete thinking about the consequences or how the system ought to operate suggests at the very least the absence of a benchmark against which one can evaluate the success of a particular regime. Just as importantly, grand strategies like BW give a false sense that we know far more about how economies function and how they are likely to react to shocks that emanate from different sources. The last financial crises revealed, contrary to the notion that most economists used to subscribe to, namely that price stability and financial stability go hand in hand, that the two can be quite separate phenomena and dealing with the consequences of the failure of the latter objective requires a fundamental rethinking of the implications of worrying only about the sufficiency of the former. Instead of reaching for the moon policy makers should acknowledge their past mistakes – central banks, in particular, have stubbornly resisted acknowledging their complicity with the events that led up to the crisis of 2007-9 – and aim for a level of commitment that seems feasible and likely to elicit public support. Grand designs and the reshaping of an entire infrastructure requires more time than the typical political cycle permits and, surely, not everything about the existing regime is broken.

16 In this connection policy makers might greatly benefit from consulting Mancur Olson’s (1965) seminal work on the behaviour and management of groups.
6. Conclusions

The foregoing general overview of the roots of failure of certain regimes to last or provide the kind of economic stability so desired by policy makers and the public lead to the following broad conclusions. First, grand designs, such as the BW system, or the euro project, promise too much, while understating the hidden and not so hidden risks that can threaten their survival at any time. As a result, time and time again, politicians overreach and agree to rules or create institutional arrangements that are inherently flawed. Since the planning horizon of politicians is shorter than that of central bankers, and the incentives to reconsider Treaties that are difficult to change and are fraught with complexities that are time consuming to negotiate, with political and economic benefits that likely bear fruit well after some future election, there are insufficient incentives to implement economic governance standards that are resistant to economic crises. Unless politicians are willing to cede national sovereignty to supra-national agencies, which may well dilute democratic accountability, or create rules that are so inflexible that they are unable to cope with the need for alternative decision-making principles during crises, there is little reason to hope that any reforms to euro area governance currently being contemplated will resolve problems once and for all. Ideally, just as the notion of a directive – the device wherein the central bank can only be overruled under certain pre-specified conditions with responsibility for such a decision resting entirely with government - has proved to be an essential ingredient in central banks’ ability to maintain their independence while supporting the notion of democratic accountability, it is possible that a similar directive that threatens the ability of a sitting government to manage a crisis once credibility and trust have evaporated, might represent an improvement. In the European context, this might mean...
temporarily ceding control over the government budget and fresh elections, before control over fiscal representatives is eventually restored. No doubt there exist many challenges with such a proposal, such as who would issue the directive and how long it might remain in place, but these are beyond the scope of this paper.
References


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Figure 1 Economic Performance During the Bretton Woods Era

Consumer Price Inflation

Real GDP Growth

Note: Inflation is the annualized rate of change in inflation; real GDP growth is the annualized rate of change in real GDP. Data are quarterly and are from the IMF’s International Financial Statistics CD-ROM.
Figure 2 Economic Performance in Select Countries, 1998-2009

Consumer Price Inflation

Real GDP Growth

Note: Sources and calculations are the same as for Figure 1.
Note:
Figure 4 Foreign Exchange Reserves in Select Asian Economies

Note: The data are foreign exchange reserves to GDP ratios for the countries shown and are from Filardo and Siklos (2011).
Figure 5 Dynamic Conditional Correlations in real GDP Growth: Select Regions of the World vs USA and China

Note: USA is the United States, ASEAN are the Asian Economic Nations, CEE are the central European countries, EU is the European Union, JAP is Japan, LA are the Latin American countries, NIC are the newly industrialized countries, ME are the middle eastern countries. Source of data the same as in Figure 1. Countries in each region follow IMF definitions.
Figure 6 Dynamic Conditional Correlations in Stock Returns: Select Regions vs China and the USA

Note: From Burdekin and Siklos (2011). SP denotes the US S&P 500 and all other terms are as defined under Figure 3. The DCC model is estimated using the returns for the Shanghai, S&P 500 (lagged one day), JCI, KLCI, PCOMP, SET, and TWSE indexes. R refers to equity returns (100 times the log level of an index). The key to the indexes (from top to bottom) is: SH (Shanghai), KL (Malaysia), NI (Nikkei), PC (Philippines), SE (Thailand), TW (Taiwan), JC (Indonesia). The model consists of the vector of returns for: Shanghai, Nikkei, JCI, KLCI, PCOMP, SET, and TWSE.