



## TEACHING NOTE

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# US Financial Crisis: Is It the Moment for Bretton Woods II?

### Prerequisite Conceptual Understanding

- Appreciation/Revaluation and Depreciation/Devaluation of Currency
- Gold Standard
- Effects of Foreign Exchange Rate on Exports and Imports

### Synopsis of the Case Study

This case study is intended to facilitate the understanding of students who pursue courses covering macroeconomic problems. With the US financial crisis (2008) as the milieu, the case traces the root of the crisis to the ultra-low interest rate regime made possible by the huge purchases of the US treasury bills by the emerging trade surplus countries, which owe their status to the post-Bretton Woods informal foreign exchange system. The case then proceeds to plug in the deregulatory ambience born out of the debris of the Glass-Steagall Act's partial dismantling in 1999 and unravels how greed powered with financial reengineering led to listless lending. In the process, the debate is set for both the revival of the Bretton Woods and the format thereof. As the case runs its course, it tries to capture various concepts such as – gold standard, fixed foreign exchange rates, floating foreign exchange rates, international liquidity, pegged adjustable exchange rate regime or par value system, disequilibrium in the balance of payments, gold convertibility, Triffin's dilemma, Special Drawing Right (SDR), Post-Bretton Woods Informal System, trade deficits, budget deficits, currency Mortgage-Backed Securities (MBS), 'originate and distribute' lending model, subprime mortgages, Collateral Debt Obligation (CDO) and Credit Default Swap (CDS), Glass-Steagall Act, housing bubble, toxic assets, credit crunch, financial crisis, trade and financial linkages, financial innovations, Bretton Woods II and so on. The case, imbued with requisite rigour, is a powerful classroom aid towards the attainment of the following pedagogical objectives.

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This teaching note was written by Akshaya Kumar Jena under the direction of Saradhi Kumar Gonela. Revised (September 2009) by Hepsi Swarna, IBSCDC. It is only an illustrative orchestration of the case study 'US Financial Crisis: Is It the Moment for Bretton Woods II?'. It is never meant to limit the learning outcomes.

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## Pedagogical Objectives

- To understand the reasons for the origin of the Bretton Woods System and other international institutions like IMF and World Bank
- To analyse the factors leading to the demise of the Bretton Woods System
- To understand the connection between the post-Bretton Woods Informal System and the US Housing Boom
- To debate over the revival of the Bretton Woods System.

## Assignment Questions

- I. What are the reasons for the formulation of the Bretton Woods System? And how did it lead to the creation of the IMF and the World Bank?
- II. What are the factors that led to the demise of the Bretton Woods System?
- III. What is the connection between the post-Bretton Woods Informal System and the US Housing Boom?
- IV. Should Bretton Woods System be revived?

## Teaching Plan

The Teaching Note and Structured Assignment of the case study follow a specific Teaching Plan [**Annexure (TN)-I**].

## Case Analysis

### I. What are the reasons for the formulation of the Bretton Woods System? And how did it lead to the creation of the IMF and the World Bank?

Bretton Woods system was a modification of the gold standard that prevailed globally in the first half of the 19<sup>th</sup> century. Keynes called Bretton Woods the ‘exact opposite of gold standard’. Under the gold standard, each currency was in a fixed proportion to a certain amount of gold, which means that the value of each nation’s currency was set at a fixed exchange rate to gold. Any country, which wanted to purchase goods from a foreign country, had to pay in gold.

The Bretton Woods system was adopted due to massive gold outflows from European countries during the two World Wars, the resulting inflation, and the insufficient production of gold to meet the growing demand from international trade and investment. Maintenance of gold standard was difficult and even disastrous for some countries, and the existence of multiple forex markets made the system inefficient. Pre-War classical gold standard as explained in Annexure I of the case study had many limitations, “...the pre-War classical gold standard, which fixed foreign exchange rates permanently, had the shortcomings of limiting the international liquidity and requiring the trade deficit nations to undergo deflation and contraction.” (**page 2, para 2 of the case study**).

“The origin of Bretton Woods lay in the Great Depression of 1930s that prompted governments across the world to adopt protectionist policies.” (**page 2, para 1 of the case study**). “Hence, between July 1<sup>st</sup> 1944 and July 22<sup>nd</sup> 1944 – in the midst of the war scenario solidarity – 730 representatives from 44 allied

nations converged in the Mount Washington Hotel of Bretton Woods in New Hampshire to formulate a system that could prevent subsequent occurrence of the Depression-like situation. The principal negotiators were the US Treasury Top Staffer Harry Dexter White (White) and the UK Treasury Advisor John Maynard Keynes (Keynes) while the proceedings were chaired by the then US Treasury Secretary Henry Morgenthau.” (page 2, para 1 of the case study). In order to free international trade and finance Post-War reconstruction, the member states agreed to peg their currencies to the dollar. US assured the member countries that its currency was dependable and the dollar was pegged to gold at \$35 per oz. of bullion and “all currencies were anchored to gold. The right to convertibility into gold was granted only to foreign central banks and not to individual dollar holders with the deliberate objective of putting a stop to speculative activities in the currency market.” (page 2, para 2 of the case study).

The circumstances that prevailed following the World War II, dollar gained prominence as most of the international trade was carried out in dollars and most of the times payments were made in dollars. If the countries accumulated more dollars that they could probably use, they could exchange them with the US for gold. Because of the United States’ economic strength and Europe’s economic weakness after World War II, the dollar was used by other governments as a reserve for their currencies. As, during that period, US was the only stable economy, dollar was perceived (read: assumed) to be committed to stability and convertibility. And as it had a fixed gold convertibility, it was supposed to be ‘as good as gold’, and therefore many nations bestowed the reserve asset status to gold just like gold. This practice in course of time resulted in gold becoming the global reserve currency.

Before proceeding further, the meaning of fixed and floating exchange rate systems can be explained. Under fixed exchange rate regime, the exchange rate is fixed (to another currency or a basket of currencies or gold), and the currency is tied to another currency or gold, meaning the value of the currency shall always be in tandem with the currency to which it is tied. Chinese Renminbi is an example of fixed exchange rate regime. On the other hand, in floating exchange rate system, a country’s currency is set by the foreign-exchange market through supply and demand for that particular currency relative to other currencies. Floating exchange rate system is the most common exchange rate regimes in today world. Under Bretton Woods, a balance between fixed and floating exchange rate system was sought to secure the advantages of both the exchange systems without suffering the disadvantages of both. “This resulted in the emergence of ‘a pegged but adjustable’ exchange rate regime known as ‘par value system’ where member countries were obliged to stick to their declared par value. The exchange rate fluctuations were limited to a maximum of 1% above or below the parity. However, the requisite alteration in par value could be resorted to as per agreed procedures in rare occasions in order to correct a fundamental disequilibrium in the balance of payments of a member country.” (page 2, para 2 of the case study).

## International Monetary Fund (IMF) and The World Bank

“The focus of the Bretton Woods conference was centred on two issues – How to establish a stable system of exchange and how to rebuild the war-ravaged economies of Europe. Towards this end, two international organisations were set up. The International Monetary Fund (IMF) was to look after the first issue while the International Bank for Reconstruction and Development (IBRD), popularly known as the World Bank, was to concern itself with the second issue.” (page 2, para 3 of the case study).

The 44 nations under the Bretton Woods System contributed membership fees to fund these two institutions. IMF monitored exchange rates and lent reserves currencies to countries with trade deficits. Since then IMF has played a key role by organising a cooperative response to major international economic crisis and thus had largely succeeded in its envisioned objectives.

The World Bank was designed to provide capital for developing or underdeveloped countries. The Bank gives low interest long term loans to countries for projects which cannot get private-sector financing (almost always autonomous investment). As a result, of the long-term loans by the World Bank, goods and

services flow from developed countries to developing or under developed countries. Once the projects yields profits, borrower nation is left with enough money to pay interest on loans. And at the same time the nation enjoys higher wages and higher standard of living in the country.

Albeit, the Bretton Woods system had achieved its objectives, altering global economic and political affairs, stabilising the war-hit nations, have started exposing the deficiencies in the system. In 1960s, the global economic landscaped has changed so much – relative to that of 1940s – that the Bretton Woods system was deemed irrelevant by its own proponents. The factors leading to the demise of Bretton Woods System can be dealt next.

## II. What are the factors that led to the demise of the Bretton Woods System?

For three decades after the World War II, the world was on a dollar standard and the international trade and finance were carried out in dollars. But during 1960s and 1970s the system began to collapse. The dollar was overvalued, due to which the US' balance of payments position (trade deficits) declined rapidly. The US foreign deficit after 1965 was fuelled also due to increased government spending and the Vietnam War. Under the Bretton Woods system the world relied on the US deficits to avoid liquidity shortage. The trade deficits of US resulted in oversupply of dollars held by foreign banks and business. Economists say the reason behind the demise of Bretton Woods was the oversupply of the dollar to all corners of the globe. While the recipients strengthened their economies, US on the other hand had suffered from economic imbalances that the outflow of dollars had caused.

Countries like Japan and Germany had trade surpluses and dollar reserves started piling up in those countries. Non-reserve central banks of those countries started holding the dollar reserves in the form of US treasury bills. By 1970, the amount of dollar reserves held by the non-reserve central banks increased significantly. This gave rise to the phenomenon called as the Triffin's Dilemma. "The dollar overhang outgrowing its gold stock led to the dilemma Robert Triffin anticipated in 1960 in his great work *Gold and the Dollar Crisis*."(page 3, para 3 of the case study). Dollar overhang occurred when amount of dollars overseas (dollars reserves held by non-reserve central banks) exceeded US reserves of gold, which undermined the dollar convertibility to gold. "Dollar overhang occurred in the system by 1960 and continued to worsen throughout the decade of the 1960s. By 1971 foreign holdings of US dollars stood at \$50 billion while US gold reserves were valued at only \$15 billion."<sup>1</sup> By 1971 due to US' rapidly deteriorating balance of payments position, countries were less willing to hold dollars and started redeeming their dollars for gold, as the case study states: "To preclude lack of confidence in dollar, the US deficits would have to cease. But this would, give rise to the liquidity problem – the problem that the classic gold standard failed to address and the Bretton Woods system was formed to avert. Again to obviate the liquidity problem, US deficits would have to continue. But this would undermine the credibility of dollar. Thus, the post-War international financial system hatched at Bretton Woods was inherently flawed because of this catch-22 situation between the need for the US trade deficits to provide the world with international liquidity in the form of US dollar and the risk of such deficits making the US dollar unattractive to hold."(page 3, para 3 of the case study).

Due to the growing pressure by the trade surplus countries on the US for convertibility of dollar into gold, on August 15<sup>th</sup> 1971 the US president Richard Nixon severed the link between gold and dollar and announced that US will no longer exchange gold for dollars. This led to the demise of the Bretton Woods System and it was the beginning of floating exchange system. By 1976 all the major currencies were floating. "When the dollar went off the gold convertibility and the era of free floating exchange rates followed." (page 4, para 1 of the cases study).

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<sup>1</sup> Suranovic M. Steven, "The Breakup of Bretton-Woods", <http://internationalecon.com/Finance/Fch100/F100-1.php>

### III. What is the connection between the post-Bretton Woods Informal System and the US Housing Boom?

Even after the collapse of Bretton Woods system the US financial supremacy remained the same. All the countries still considered the dollar to be safe. “The guarantee of the US government was seen to be far more credible than that of any other country in the world. Therefore, it is an exaggeration to state that the whole of Bretton Wood system has broken down. What broke down was the convertibility of dollar into gold and the concomitant pegged exchange rate regimes. But the US financial hegemony remained unaffected. This encouraged the US to indulge in substantial trade deficits through its budget deficits since its domestic currency continued to double up as the international currency.” **(page 3, para 3 of the case study)**.

After the demise of Bretton Woods System, an informal arrangement between US and a number of individual countries like Japan, Saudi Arabia and China prevailed. The Bretton Woods gold-dollar fixed exchange rate was replaced by an arrangement where by Asian countries like Japan and China pegged their currencies against the dollar. Japan intentionally undervalued its currency (Yen) to reap the benefits of trade surplus with US. Instead of using the dollars to invest in the Japanese economy or exchange for Yen, Japan recycled them back into the US economy by purchasing US treasury bills. This helped US to finance its huge trade deficits and thus it was in favour of this informal arrangement. “Japan kept its yen intentionally undervalued compared to dollar to perpetuate its trade surplus and dollar accumulation to carry on its export-led growth. US did not retaliate since Japan did not use the dollars in exchange for the yen but recycled them back in the US by purchasing US treasury bills and other dollar-denominated assets amounting to hundreds of billions of dollars.” **(page 4, para 1 of the case study)**. Even China followed Japan’s strategy and by September 30<sup>th</sup> 2008 foreign holdings of US treasury bills stood at \$2,846.4 billion. **Exhibit III of the case study** shows that the major foreign holders of US treasury securities such as China, Japan, UK, Oil exporters and Brazil held around \$1,800 billion worth US treasury securities.

Such huge inflows of capital in US from abroad kept the US interest rates low. “The US was thus freed from the necessity of keeping yield rates on treasury securities high to attract the treasury bill buyers.” **(page 6, para 1 of the case study)**. And the low interest rates have fuelled the US housing bubble. In 2001, when US underwent a mild recession, as the foreign countries were willing to buy the treasury debt, Bush government was able to implement an expansionary fiscal policy (increasing in spending and tax cuts). Otherwise, the recession would have been much severe. The foreigners were willing to buy the Treasury bills even as Federal Reserve lowered interest rates to 1% in 2003. “... the US could afford to bring down the Federal Reserve rate, for instance, from 6% at the outset of the year 2001 to a mere 1% in 2003 after a succession of 11 cuts.” **(page 6, para 1 of the case study)**. **Exhibit VI of the case study** shows that the US interest rates fell, due to net foreign purchase of US treasury securities.

Such low interest rates along with subprime lending encouraged US consumers to buy houses. The increase in the demand for houses escalated the prices, fuelling the US housing bubble and helped speculative investments on housing assets. “The successive interest rate cuts enabled by net foreign purchase of the US securities ... made mortgage loans attractive, fuelled demand for houses and led to increases in their prices resulting in the housing boom.” **(page 6, para 1 of the case study)**.

After explaining the connection between post-Bretton Woods informal system and the US housing boom, the faculty can discuss whether Bretton Woods System should be revived or not, following the 2008 US financial crisis. At the surface, the 2008 US financial crisis is akin to the 1930s Great Depression in its magnanimity and thus would be merited for another Bretton Woods system, but a deep debate might prove otherwise.

#### IV. Should Bretton Woods System be revived?

After the World War II 44 nations gathered to come up with a system which would prevent depression like situation, and Bretton Woods system was the outcome of that gathering. In the same way, when the US originated financial crisis spread to the various parts of the world, some economists opined that it is time when the financial authorities world over gather together and fight the global crisis by reviving the Bretton Woods system. The post-Bretton Woods informal system contributed to the US financial crisis by lowering the interest rates, which in turn fuelled the housing boom. “the post-Bretton Woods informal system – from behind the layers of proximate causes – is alleged to have contributed to the US financial crisis (2008), which quickly morphed into a global crisis owing to both trade and financial linkages in the current era of rapid globalisation.” (page 9, para 1 of the case study). Thus, Bretton Woods system needs to be revived “to prevent the repeat of a financial crisis having international ramifications.” (page 9, para1 of the case study).

However, the critics claim that the financial crisis was not due to foreign exchange regime prevailing under informal post-Bretton Woods system but due to lack of regulation in the financial sector. “It is rather the lack of transparent rules and regulatory laxity combined with greed of financial institutions and political push for subprime loans that contributed to the housing muddle through excessive lending and the consequent financial mess. Hence, what is required is not the revival of the Bretton Woods system but the addressing of domestic regulatory deficiencies.” (page 10, para 1 of the case study). Thus the critics are of the opinion that what is required at the moment is not Bretton Woods II but reformation of the global financial system and plugging the loopholes in financial regulatory systems. Regulatory reforms have to be taken at the national level, respecting sovereignty of individual countries. In this context a Bretton Woods like framework may not be suitable.

#### The Big Picture

Is the time ripe for Bretton Woods II to address and prevent any financial crisis of global proportions?

#### Final Thoughts

The discussion in the class can be wound up with the conclusion that international financial regulation with benign – and not constricting – safeguards is the need of the hour, given the far-reaching ramifications of globalisation; and the national regulatory regimes must be aligned to the international regulatory scheme.

#### Additional Readings

- Marquand Robert, “History Lessons for Financial Crisis: Act Fast, Act Globally”, <http://www.csmonitor.com/2008/1016/p01s02-wogn.html>, October 16<sup>th</sup> 2008
- Sachs Jeffrey, “Amid the rubble of global finance, a blueprint for Bretton Woods II”, <http://www.guardian.co.uk/commentisfree/2008/oct/21/globaleconomy-g8>, October 21<sup>st</sup> 2008

<b>Annexure (TN)-I Teaching Plan</b>				
<b>Sl. No.</b>	<b>Analysis Section</b>	<b>Expected Learning Objectives</b>	<b>Forward Linkage</b>	<b>Ideal Duration (mins)</b>
1	Reasons for the Origin of the Bretton Woods System	<ul style="list-style-type: none"> <li>• Merits and demerits of both fully flexible and fully fixed exchange rates</li> <li>• The gold convertibility of dollar and par value system.</li> </ul>	Provides the back drop to analyse the factors leading to the Demise of the Bretton Woods System	20
2	Factors Leading to the Demise of the Bretton Woods System	<ul style="list-style-type: none"> <li>• The 'exorbitant privilege' of the US transforming its trade deficit into budget deficit</li> <li>• Triffin's dilemma anticipating the collapse of the Bretton Woods System</li> <li>• The inability of Special Drawing Right (SDR) to stem the pressure on gold convertibility of dollar.</li> </ul>	Provides the curiosity to explore any plausible link between the post-Bretton Woods Informal System and the US Housing Boom	25
3	Connection Between the Post-Bretton Woods Informal System and US Housing Boom	<ul style="list-style-type: none"> <li>• The reason for dollar's hegemony and the sustainability of Post-Bretton Woods informal System</li> <li>• The impact of the huge foreign purchase of the US securities on the US interest.</li> </ul>	Provides the of mechanism to probe into the process the US Housing Boom	25
4	Debate Over the Revival of the Bretton Woods System.	<ul style="list-style-type: none"> <li>• The link between the Post-Bretton Woods Informal System and the US financial crisis</li> <li>• Merits and demerits of regulation and deregulation</li> <li>• The arguments over necessity as well as format of the Bretton Woods System II.</li> </ul>		20
Prepared by the author				