



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

“Economic health of a country is a proper matter of concern to all its neighbours, near and distant.”¹

– F.D. Roosevelt, Former US President

“It took the world 15 years and a World War to come together to address the weakness in the global system that contributed to the great depression. It is to be hoped that it will not take us that long this time; given the level of global interdependence, the costs would simply be too high.”²

– Joseph E. Stiglitz, Nobel-Winning US Economist

“You never want a serious crisis to go to waste. And what I mean by that is an opportunity to do things you think you could not do before.”³

– Rahm Emanuel, US President-Elect Barack Obama’s New Chief of Staff

To discuss the US financial crisis (2008) that has engulfed the whole world and therefore requires synchronised coordinated global action, the US President George Bush invited the leaders of the G20 – comprising both industrialised and emerging nations – to a meeting in Washington to be held on November 15th 2008. The British Premier Gordon Brown (Brown) and the French President Nicholas Sarkozy (Sarkozy) and many others have seized the opportunity to call for a rerun of Bretton Woods – the Bretton Woods II – to fashion a consensual international financial architecture to prevent any replay of the global financial crisis. It is presumed that at the deep bottom of the US-originated worldwide financial turmoil, there lies the international monetary disorder that has kept on snowballing since August 15th 1971, when the first Bretton Woods system, tied to gold-convertible dollar, was brought to an abrupt close.

¹ Schifferes Steve, “How Bretton Woods reshaped the world”, http://news.bbc.co.uk/mobile/i/bbc_news/business/globalcreditcrunch/772/77251/story7725157.shtml, November 14th 2008

² Stiglitz Joseph E., “The Next Bretton Woods”, *The Economic Times*, November 11th 2008

³ “Rahm Emanuel: Don’t Waste A ‘Serious Crisis’”, <http://allthenewsthatfits.wordpress.com/2008/11/21/rahm-emanuel-dont-waste-a-serious-crisis/>

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The History of First Bretton Woods System: Reasons for the Origin and the End

The origin of Bretton Woods lay in the Great Depression of 1930s that prompted governments across the world to adopt protectionist policies— contrary to the intention of maintaining domestic employment – which led to massive unemployment born out of contraction in international trade. Though World War II brought Great Depression to an end, the underlying causes of the Depression were not extinct. Nor was anyone approving of a tragic war to provide relief from an economic slump. Hence, between July 1st 1944 and July 22nd 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. Keynes wanted avoidance of painful deflationary policies by deficit countries and hence proposed trade surplus countries to lend to trade deficit countries. But White did not want to part with his country's surpluses automatically and coveted control over policies of debtor nations.⁴ A compromise was hammered out which was much closer to White's plan reflecting US' growing dominance and UK's waning influence. However, all agreed on the fundamental disadvantages of the unrestrained flexibility of exchange rates prevalent during the inter-War period that discouraged trade and investment and encouraged speculation in the currency market.

But 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 (Annexure I). So, a fine balance was sought between the two polar alternatives of fixed and floating exchange rates so as to secure the advantages of the both, without suffering the disadvantages of the either. 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. Under the Bretton Woods system, foreign currencies were pegged to the US dollar and the US dollar was pegged to gold at \$35 per oz. It meant as if 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.

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. A third organisation, named International Trade Organisation (ITO), was conceived to encourage free trade; but it came

⁴ Desai Meghnad, "Dealers with Dollars", *The Financial Express*, November 3rd 2008, page 6

out stillborn with US' refusal to ratify it, though tariff reductions were pursued through a watered-down General Agreement on Tariffs and Trade (GATT), which later on eventuated into the World Trade Organisation (WTO).

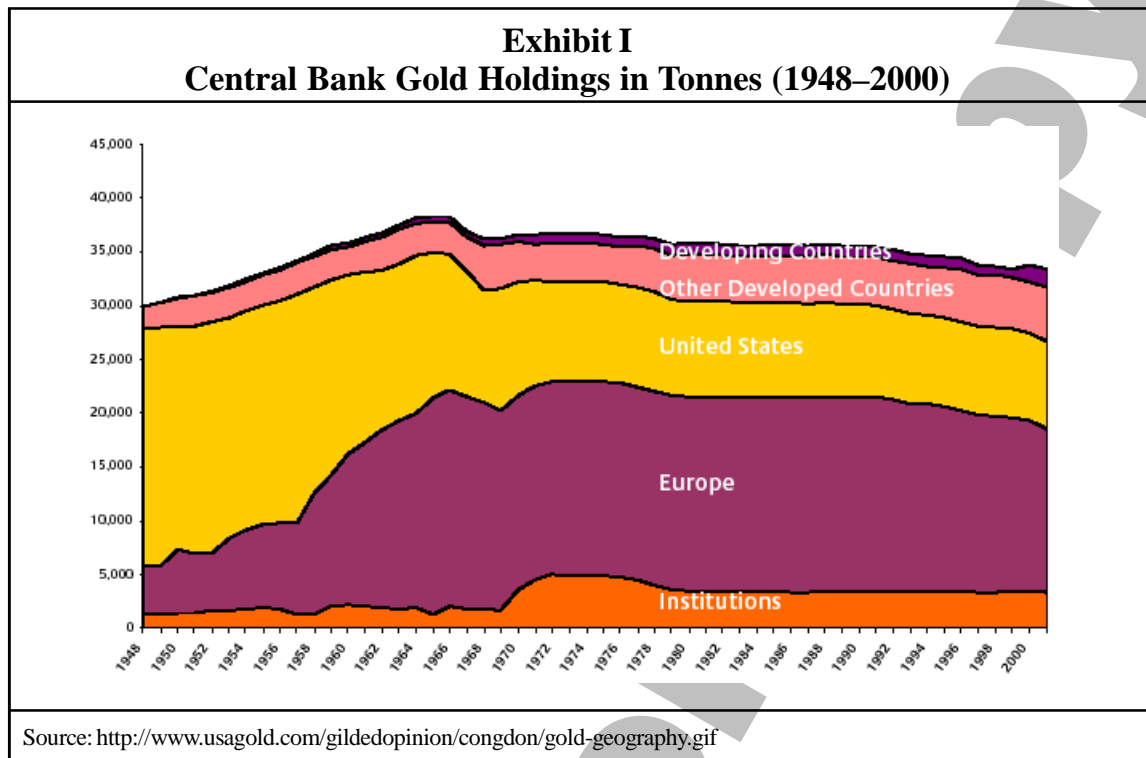
Bretton Woods was, in actuality, more than an attempt to shape the global economic system. Lurked behind the US interest in strengthening the economies of the rest of the world, particularly the West Europe, was the real intent to immunise them from the impending contagion of communism and to contain the sway of Soviet Union. The North Atlantic Treaty Organisation (NATO) was born post-Bretton Woods to hedge against Soviet invasion. Therefore, the US allowed almost tariff-free access to West Europe even though the latter imposed tariffs on their imports. This helped Europe develop economically. But the US also benefitted as well on matters political and military by securing their acquiescence to its decisions. For redevelopment of Western Europe, the US extended loans, most of which later on turned into grants under the Marshall plan. Any country such as Japan, South Korea and Taiwan signing up as its cold war allies also gained from the US trade deficit with them.

The Beginning of the End

The US' 'exorbitant privilege' of resorting to budget deficit to meet its trade deficit became more destabilising when its budget deficit-backed expenditure on social programmes and Vietnam War came up so huge. 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*. 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. The growing pressure on the US for convertibility of dollar into gold by trade surplus countries finally led Richard Nixon, the then President of the US, to unilaterally sever the gold tie to the dollar on August 15th 1971 when its dominant gold position weakened (Exhibit I).

When the supply of two key international reserves – gold stock and the US dollar – proved insufficient to support the ongoing expansion of world trade and financial development, it was decided to create a supplementary international reserve asset called the Special Drawing Right (SDR) under the auspices of the IMF in 1969 to fortify the threatened Bretton Woods fixed exchange rate system. SDRs, the value of which is based on a basket of key international currencies, are allocated to member countries in proportion to their relative size in the world economy. The SDR is not a currency, but “a potential claim on the freely usable currencies of IMF members”.⁵ These currencies in exchange for the SDRs can be realised either through the arrangement of voluntary exchanges between member countries or through the IMF's mediation whereby members with strong external positions are designated to purchase SDRs from members with weak external positions. However, this could not ward off the collapse of the Bretton Woods system that occurred 2 years later.

⁵ “A Factsheet: Special Drawing Rights (SDRs)”, <http://www.imf.org/external/np/exr/facts/sdr.htm>, September 2008

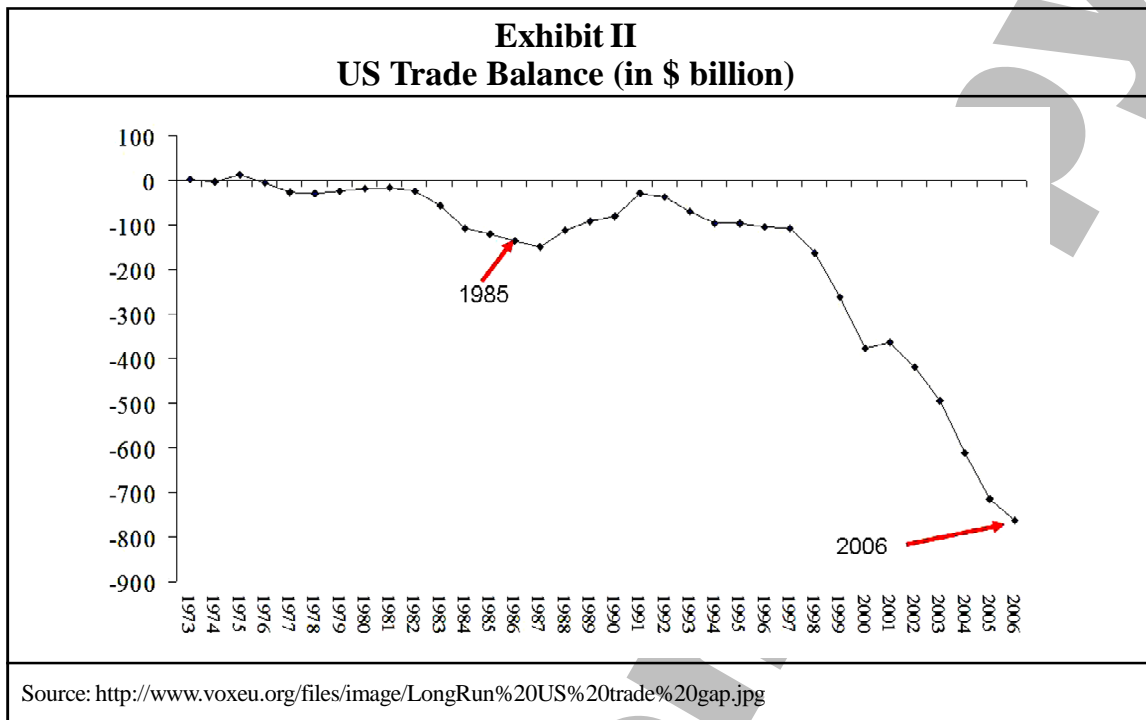


Dollar after the Demise of Bretton Woods

When the dollar went off the gold convertibility and the era of free floating exchange rates followed, the US dollar, far from being relegated to sidelines, actually – and paradoxically – became more desirable. This was because despite all its shortcomings, the US currency was deemed to be the safest one to hold forth. 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.

The Post-Bretton Woods Informal System

After the Bretton Woods breakdown, the informal system that prevailed evolved out of a set of decisions of the individual countries such as US, Japan, Saudi Arabia and later by China. This informal system is sustained by differing but complementary national policies of the key and emerging economies. The US accepted the adverse effects of trade deficits on its employment situation in exchange for its trade deficits being funded by emerging economies. And the emerging economies accepted a lower standard of living in exchange for its export-led growth. For decades, without incurring the need to depreciate its own currency, the US has been running enormous trade deficits (Exhibit II) with the easy recourse to massive budget deficits.



On the other side of the coin, 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. Japan's strategy, followed by China and others, has kept on swelling the foreign holdings of the US treasury securities, which stood at \$2,846.4 billion as on September 30th 2008. The major buyers of the US treasury securities such as China, Japan, UK, Oil Exporters and Brazil held around \$1,800 billion (Exhibit III).

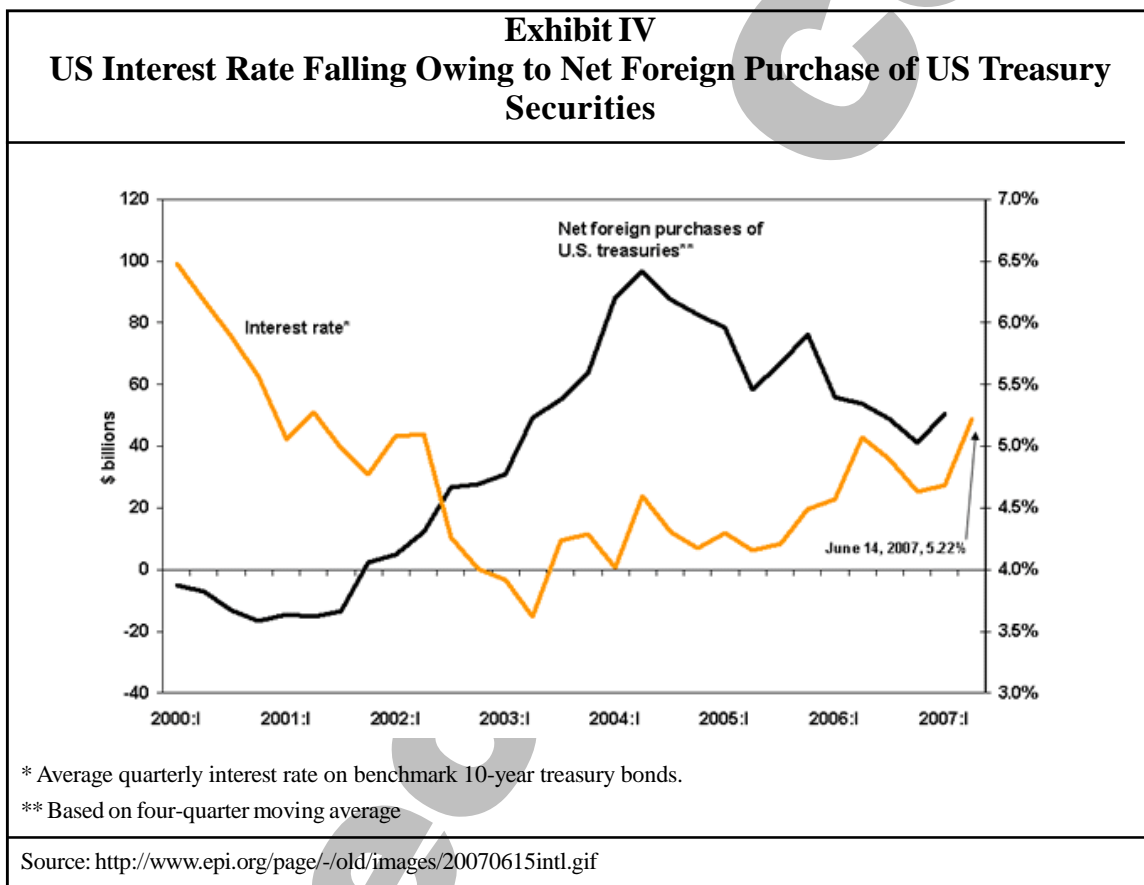
Exhibit III
Major Foreign Holders of the US Treasury Securities (End September 2008) (in \$ billion)

China, Mainland	587.0
Japan	569.8
UK	336.9
Oil Exporters	182.0
Brazil	141.9

Compiled by the author from "Major Foreign Holders Of Treasury Securities", <http://www.treas.gov/tic/mfh.txt>

Impact on the US Interest Rate and the Housing Boom

The US was thus freed from the necessity of keeping yield rates on treasury securities high to attract the treasury bill buyers. The yield rate on a 30-year treasury bond, for example, ruled at a measly 4.2%⁶. As a result, 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.⁷ The successive interest rate cuts enabled by net foreign purchase of the US securities (Exhibit IV) made mortgage loans attractive, fuelled demand for houses and led to increases in their prices resulting in the housing boom.

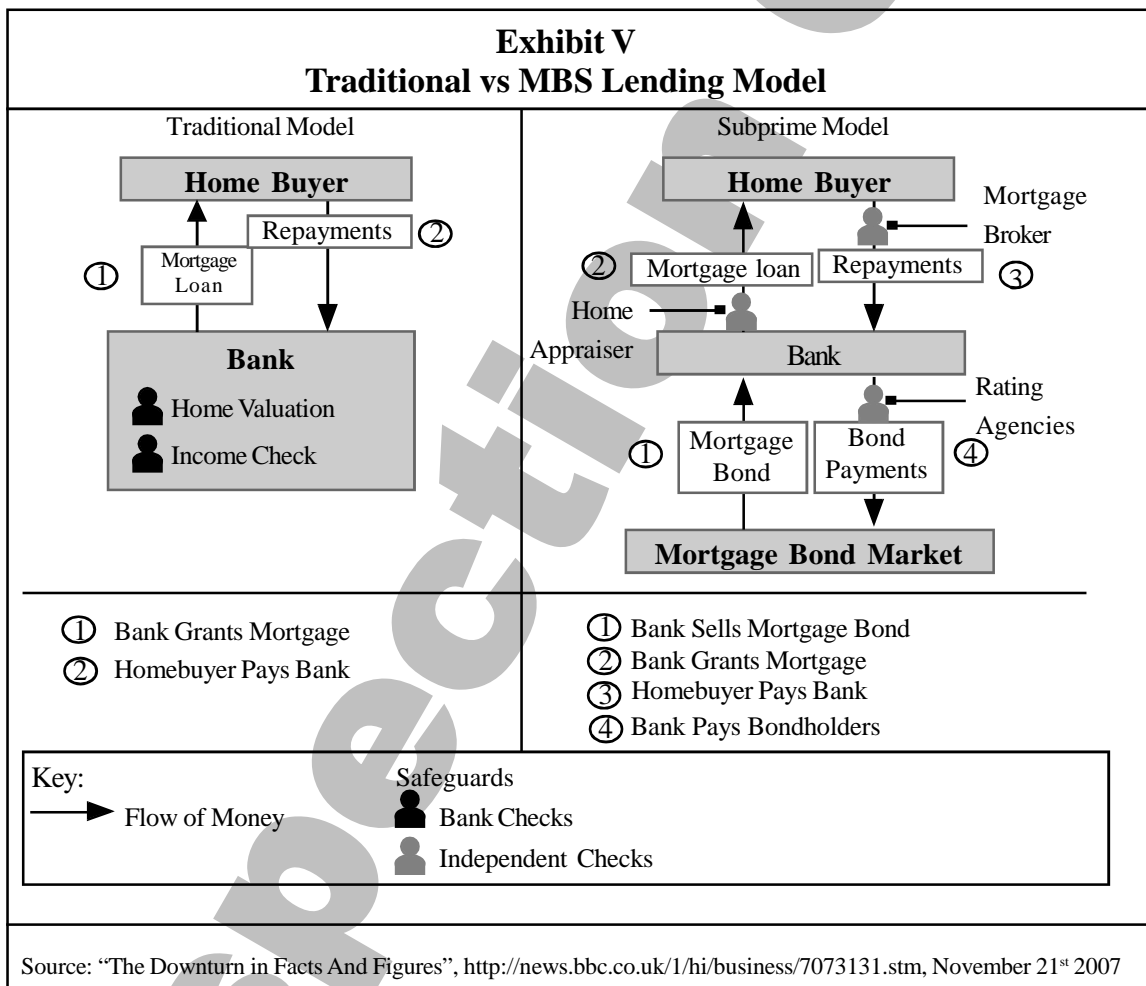


⁶ “A Billion Here, A Trillion There: Calculating the Cost of Wall Street’s Rescue”, <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2084>, October 29th 2008

⁷ “Global Credit Crunch – Towards a Crisis of Globalisation”, <http://www.fifthinternational.org/index.php?id=259,1303,0,0,1,0>, Autumn 2007

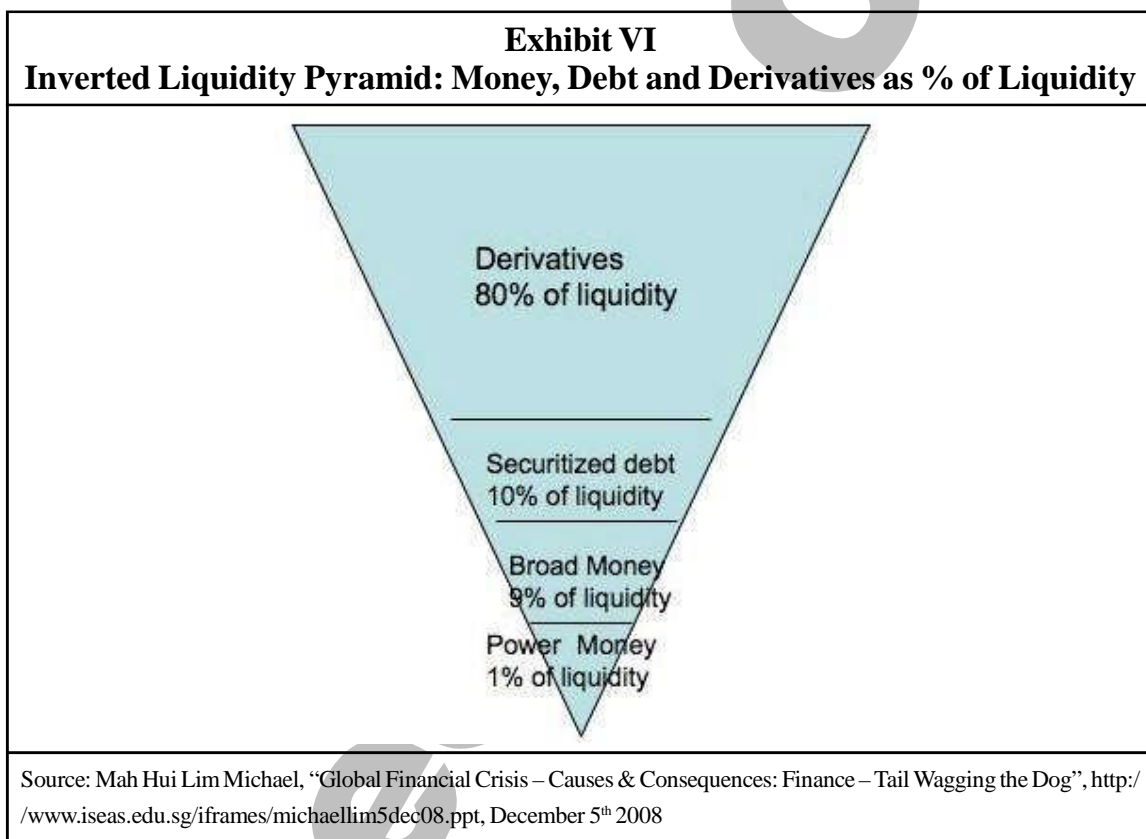
Unfolding of the Global Financial Crisis

The US-originated financial crisis (2008) has been ascribed to the ultra easy credit often with zero down payment in the early 1990s, topped with Clinton administration’s pressure in the late 1990s on the nation’s biggest home mortgage underwriter Fannie Mae to devise a way to grant more loans to “borrowers whose incomes, credit ratings and savings are not good enough to qualify for conventional loans”.⁸ Thus, loans flowed even to the subprime borrowers, who were hardly able to pay these back. The newly devised ‘originate and distribute’ model through securitisation of mortgage assets took away the necessity of exercising due diligence while lending to subprime borrowers. Unlike in the traditional lending model where the safeguards used to be checks by banks themselves, in the Mortgage-Backed Securities (MBS) model, the safeguards were checks by independent agencies that had a vested interest in endorsing more home loans in order to earn more fees (Exhibit V).

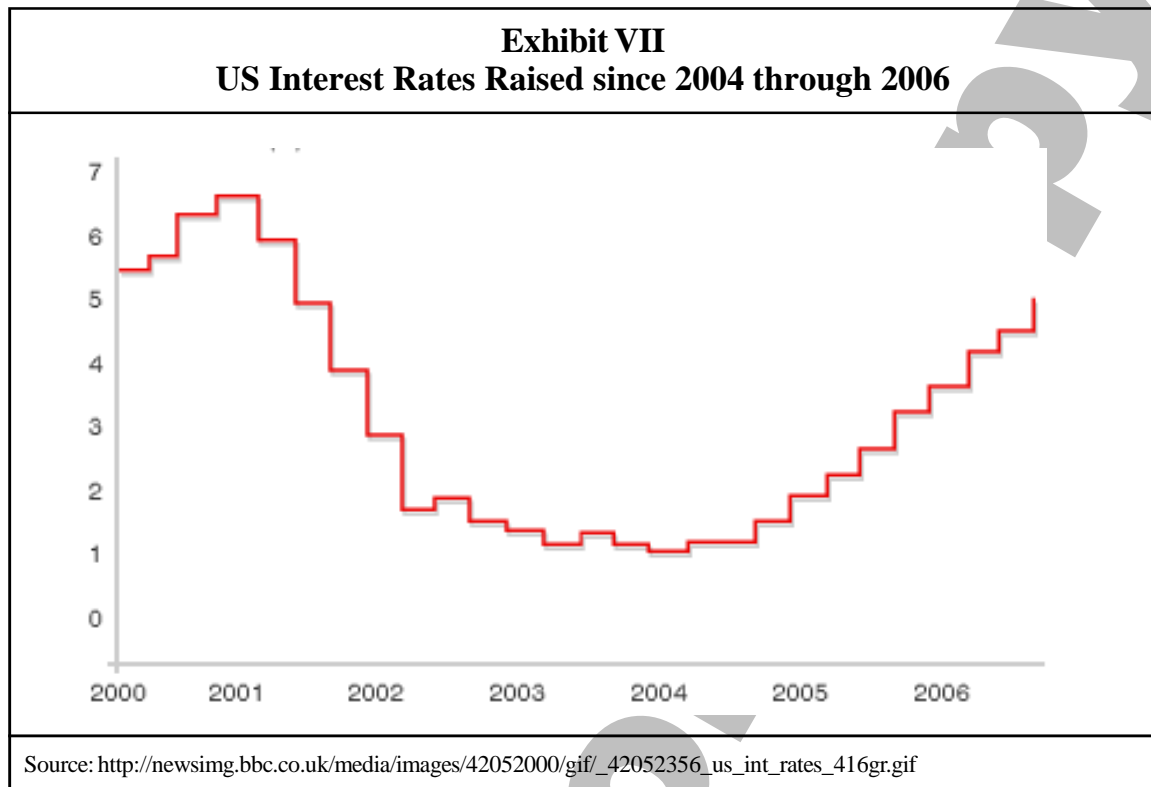


⁸ Holmes Steven A., “Fannie Mae Eases Credit To Aid Mortgage Lending”, <http://query.nytimes.com/gst/fullpage.html?res=9C0DE7DB153EF933A0575AC0A96F958260&sec=&spon=&partner=permlink&expnd=permlink>

With Gramm-Leach-Bliley Act of 1999, peeling away part of the Glass-Steagall Act of 1933, finance industry got deregulated. Regular banks, mortgage houses, investment banks and other financial institutions gradually consolidated their functionalities. In this ambience, increasing financial innovation evolved. Consequently, with the aid from computer-programmed high business mathematics, so many complex derivatives and derivatives of derivatives like Collateral Debt Obligation (CDO) and Credit Default Swap (CDS) came up in the role of diversifying risk elements and promising alluring returns compared to low yields of treasury bills. No wonder the derivatives have formed about 80% of the global liquidity while money and securitised debt together constituted a mere 20% of the liquidity (Exhibit VI). Deregulatory regime – not insistent upon the capital adequacy norm – gave the banks a long leash to leverage their lending up to 30–40 times their base assets.



Sensing the formation of a ‘bubble’ from past experience of the dotcom bubble in 2000, the Federal Reserve began raising interest rates progressively so as to prevent a sharp downturn in the housing market. Between June 2004 and July 2006, little by little, interest rates got increased for 17 times and inched up from 1% to nearly 5% (Exhibit VII) which inadvertently led to mounting defaults mainly by subprime borrowers, sparking rising enclosures, falling home prices. The mutually negative influence of enclosures and home prices worsened the situation and induced intentional defaults even by the prime borrowers. The upshot was the burst of the housing bubble. This rendered the whole array of home mortgage derivatives and the derivatives of the derivatives toxic, resulting in a crisis of confidence and credit crunch, which led to the fall of famed Wall



Street institutions and emergence of a financial ice age crying out for the thawing governmental bailout. For, the credit freeze has begun to affect the real sector by triggering the chain-contraction in consumption, investment, output and employment not only in the US but also in the rest of the integrated world.

Debate over the Revival of Bretton Woods

By facilitating low interest rates that fuelled the housing bubble, 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. The interest rates became low because the surplus dollars gained by trade surplus countries such as Japan and China and other Asian countries with respect to the US were not used to raise the standard of living of the trade surplus countries themselves but deposited in US treasury securities. As the famous economic journalist Martin Wolf writes, “China has about 800 million poor people, yet the country now consumes less than half of GDP and exports capital to the rest of the world”⁹, mainly to the US. Hence, the growing need is to revive the Bretton Woods system to prevent the repeat of a financial crisis having international ramifications.

⁹ Judis John B., “Debt Man Walking: The US, China, Japan and the Foundations for a New Bretton Woods”, http://www.japanfocus.org/_John_B__Judis-Debt_Man_Walking__The_US__China__Japan_and_the_Foundations_for_a_New_Bretton_Woods/, November 20th 2008

Detractors, however, point out that it is not the foreign exchange regime under the informal post-Bretton Woods system that accounted for the financial crisis. 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. What hold the key to pre-empt the crisis are keeping pace with financial innovation, putting in place effective financial regulations and the rigorous implementation thereof at national levels. Regulators ought to ensure that the financial statements of the firms must mirror an accurate picture of their activities so that market participants would not indulge in hankering after higher yields without an adequate appreciation of the risks involved. Even the declaration of the G20 summit of the mid-November 2008 conceded, “Regulation is first and foremost the responsibility of national regulators who constitute the first line of defence against market instability.”¹⁰

Some analysts say that since globalisation and financial integration led to the spread of a national crisis into global proportions, to overcome the crisis and to avert its recurrence, therefore, requires a coordinated effort at global level, which harks back to similar efforts made during the original Bretton Woods conference. While giving into the need for synchronised coordination on a worldwide scale, the more perceptive analysts, however, differ on the issue of reviving Bretton Woods which was actually born out of the plan to regulate the foreign exchange rate in such a way as to secure the advantages of the gold standard while disallowing the disadvantages of the floating system. To Brown, Bretton Woods II does not mean a reinstatement of the original Bretton Woods system, but building a new Bretton Woods, “building a new international financial architecture to function as an early warning system”, which should act as “a crisis prevention mechanism for the whole world” by monitoring “cross-border financial transactions”.¹¹ To Sarkozy, however, Bretton Woods II means replacing the dollar as the single international currency so that when the US sneezes, the rest of the world would be spared of catching the cold. While Brown’s proposal for regulatory and early warning reform makes sense, Sarkozy’s seems to be wide off the realm of reality since the euro has little presence in Asia while China does not want the yen of Japan to be the dominant currency even in Asia, not to speak of the world at large. Ironically, the US financial crisis (2008) “has, if any, strengthened the dollar as the least untrustworthy of global currencies”.¹² Behind the dollar’s surprising strength lies the fear factor. During global economic disturbances investors of emerging economies run for “safe havens like the U.S. dollar. The demand drives up the price relative to other currencies. In four of the past five recessions since the 1970s, the greenback finished the downturn higher than where it started”.¹³ Thus, there is no need to revive Bretton Woods system to ensure an accepted global currency into the role of which the dollar fits without Bretton Woods even in times of crisis. If at all Bretton Woods II is to be envisioned, it ought to be envisioned for some other purpose and not for the original foreign exchange-related issues.

¹⁰ “G20 Declaration: Full Text”, <http://news.bbc.co.uk/2/hi/business/7731741.stm>, November 15th 2008

¹¹ “Prime Minister Gordon Brown on the global economy”, <http://ukinusa.fco.gov.uk/en/newsroom/?view=Speech&id=7518632>, October 13th 2008

¹² “Debt Man Walking: The US, China, Japan and the Foundations for a New Bretton Woods”, op.cit.

¹³ Reed Stanley, “Why The Dollar Is Getting Stronger”, <http://www.spiegel.de/international/business/0,1518,593061,00.html>, November 27th 2008

That other purpose is advocated to be plugging the loopholes of weak financial regulations relating to securitisation, CDS, capital adequacy requirements, credit rating agencies, etc., that have been blamed to have engendered the financial crisis of 2008. These loopholes are alleged to have constituted the fatal bleeding of the financial system by a thousand cuts. As followers of Hyman Minsky, the godfather of modern financial crisis hypothesis, argue, a systemic financial crisis is a normal consequence of an unregulated capitalism as it tries to achieve ever-higher growth through unfettered private financial system plying easy credit and speculative finance. This is because the vice of speculation, during an economic upswing, slowly blocks all rational thinking and brings in the economic breakdown. Hence the need is for the socialisation of the banking system and the necessary regulation across the whole world through Bretton Woods-style concord.

But the adherents of the great economic thinker Joseph Schumpeter put the counter argument that each wave of growth is characterised by financial innovations, for example, the railway age by joint stock companies, the automobile age by hire purchase and the present digital era by credit cards, mortgage securitisation, derivatives, derivatives of derivatives and a few others. The dynamism of deregulated financial market has made all this possible. If any regulation is injected, it would simply take away that vitality of the capitalist system. Moreover, strict regulations – contrary to intention – would greatly contribute to increasing opacity in the financial markets by forcing the disingenuous smart guys to devise devious ways to bypass the system.

The apologists for regulations, however, disagree. They posit that unregulated financial capital has not only the power to create asset bubbles as with the dotcom in the 1990s and the housing in the 2000s. It also has the propensity to pop the bubbles because of its tendency for speculative movement. This tendency is exemplified by a growing trend of movement of profits from non-financial sector to financial sector from 14% in 1960 to 39% in 2008 with financial sector profits mostly accruing from unproductive speculation rather than productive business. It is again the atmosphere of deregulation which had made it possible for financial egg heads to repackage the subprime assets and for the credit rating agencies to bless them with high saleability stamp. Hence, regulation is a must; and that by an international body, since the agencies of the financial market have got unrestrained international presence. Moreover, in view of world's total stock of financial assets getting three times as large as global GDP, it becomes more imperative to go for the Bretton Woods II.

The boat of Bretton Woods movement is once again on the float as the financial tsunami with its epicentre at the US has rippled across the whole world. But the question revolves around what is needed: More of the same Bretton Woods that was set up in the 1940s to deal with the protectionist foreign exchange rate chaos or a Bretton Woods-type confluence of nations to thrash out an all together a new framework of international financial architecture. It cannot be the former, for the Bretton Woods system, based on fixed rates, cannot coexist with free capital markets. And if it is the latter, should it not be a misnomer to call it Bretton Woods II? Moreover, on either way, does the world really pine for a Bretton Woods moment? And if it really does, would that moment ever come, given the fact that “the G7 is not working” and the G20 is “too unwieldy in moving from discussion to action”, as commented by the World Bank President Robert Zoellick.¹⁴

¹⁴ “International economic architecture: cleaning up the mess?”, <http://www.brettonwoodsproject.org/art-563052>, November 27th 2008

Annexure I
Gold Standard Mechanism: Its Shortcomings and Shine Sides

The gold standard was a commitment by participating countries to fix the prices of their domestic currencies in terms of a specified amount of gold. Since under this standard, a fixed domestic price for gold was maintained by the adopting countries, the rate of exchange between their currencies was necessarily fixed. As an exemplar, the US fixed the price of gold at around \$20 per ounce and Britain fixed the price at around £4 per oz. Therefore, the exchange rate between dollars and pounds – the ‘par exchange rate’ – came to be around \$5 per dollar.

Gold standard deprives the government of the discretion to use monetary policy to offset real shocks. It therefore logically follows that real output is more variable under the gold standard. This is empirically proved by the fact that the coefficient of variation for real output was 3.5 and the average unemployment 6.8% between the gold standard years 1879 and 1913, compared to post-gold standard years between 1946 and 2003 when the relevant figures were 0.4 and 5.9 respectively.

Because exchange rates were fixed, the gold standard caused price levels around the world to move together by trade balance induced auto-adjustment process called the price-specie-flow mechanism. Suppose that a technological advantage resulted in higher economic growth in the US compared to the UK. The money supply represented by gold specie being nearly fixed, the US prices would fall compared to that of the UK. Consequently, US exports would be cheaper and the UK imports would be dearer. This would cause trade surplus in the US and trade deficit in the UK, ending up in the flow of gold specie from the US to the UK. In the US, the gold inflow standing for increased money supply would raise the prices. In the UK, the gold outflow standing for decreased money supply would lower the prices. This would continue till the ratio between prices of the US and the UK got restored to the par exchange rate. Gold standard countries being vulnerable to foreign shocks, prices were highly unstable in the short run. But its great merit lay in its long-term price stability as evidenced by the average annual inflation rate of 0.1% between the gold standard years of 1880 and 1914 as against the average of 4.1% between the non-gold standard years 1946 and 2003.

Compiled by the author from Bordo Michael D., “The Concise Encyclopedia of Economics: Gold Standard”, <http://www.econlib.org/library/Enc/GoldStandard.html>