A new international Bretton Woods System?

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Abstract
The aim of this brief article is to argue the case for a new international Bretton Woods system of payments and exchange rate regime. The lessons of the 1930s breakdown of the international monetary system provide important historical parallels with the current crisis. A brief history of the birth and the causes of the demise of the post-war Bretton Woods regime are also examined. The final section explores the possibilities of implementing the more modest Davidson Plan, which acquires its inspiration from Keynes's original "Bancor" proposals during the negotiations that preceded the formal Bretton Woods agreements.

JEL: B5, B14, B16, B23. Key Words: money; debt; crisis; Bretton Woods, Bancor, capital; monetary.

Introduction

The only solution to the current crisis lies in the transformation of the existing international monetary and financial architecture. Unfortunately, economic theory has become disconnected from history. Much of the present malaise has been the result of historical amnesia and myopia. As the historical memories of the Great Depression have receded, so too have the lessons of that era been neglected. Yet history can only solve those problems for which there are some precedents. It seems that the bitter lessons of the 1930s depression will need to be revisited. This implies that the prevailing economic orthodoxies should be subjected to an imminent and comprehensive critique. The myth of the efficacy of the free market can no longer be legitimised. Equally, prevailing neoclassical and monetarist theories have lost most of their credibility in the face of the present crisis. As long as these orthodoxies continue to inform economic policies, these recurrent crises will inevitably re-appear with even greater destructive consequences.

The guiding principles to this transformation should be the "socialisation of investment" and the "euthanasia of the rentier". This implies the re-regulation and nationalisation of the financial system. In other words, the time has come to overthrow the ruling neoliberal order and reinstate state intervention and forms of indicative planning to re-activate a sustained recovery and restore full employment as the cornerstone of macroeconomic policy. The restoration and maintenance of full employment, however, presupposes that each nation cannot engage in "beggar-thy-neighbour" type policies by running successive balance of payments surpluses and thereby "exporting" unemployment onto its rivals. This problem was quite rampant during the 1930s depression and its solution formed the basis of Keynes's proposals for an international clearing union, or the "Bancor" regime during the Bretton Woods negotiations in 1944 (Lucarelli, 2011). A very brief analysis of these trade and payments imbalances and the collapse of the gold standard regime during the 1930s might provide a useful context and also reveal some striking parallels with the asymmetries afflicting the existing international monetary system.

Keynes's original "Bancor" plan

The collapse of the international monetary system under the aegis of the gold standard was the central event in the prolongation of the 1930s depression. Deprived of a universally accepted means of payments and reserve asset, the international financial system

experienced a period of anarchy, which spilled over into the rise of economic nationalism and autarchic trading blocs. After the stock market crash of 1929, a scramble for liquidity ensued in which US investors recalled their funds from abroad. This action merely triggered a vicious cycle of protectionist "beggar-thy-neighbour" policies as the indebted countries of Europe and the primary producing countries sought to protect their own domestic markets. A cumulative process of severe deflation, accompanied by a sudden collapse in income and output, characterised this depressive spiral as each country imposed import restrictions and capital controls. The outbreak of this "tariff mania" after the Hawley-Smoot Tariff enacted by the US authorities in 1930, culminated in the emergence of protectionist trading blocs and the ascendancy of national autarchic policies. In the words of H.W. Arndt (1963):

> The combined effect of the fall in world prices, the contraction of international trade, the recall of short-term funds and the failure of continued American long-term investment brought about financial and economic crises in almost every country and in most of them set going cumulative processes of decline similar to that which was going on in the USA. The worst hit were the overseas primary producing countries which were brought to the verge of bankruptcy by the fall in agricultural and commodity prices, and the European debtor states, whose economic prosperity had been built up on continued foreign borrowing. Pressure on its gold and foreign exchange reserves forced one country after another to protect its currency by exchange rate depreciation or exchange control. At the same time, the efforts of every country to maintain its exports and protect its balance of payments by imposing increasing tariffs and import restrictions still further diminished the flow of international trade and increased the difficulties of every other country. The American slump and depression cannot be said to have caused the world depression, but they upset the unstable economic equilibrium of the world and gave the impetus to a similar economic decline in other countries. (Arndt, 1963: 19)

The existence of the gold standard regime made it more difficult for deficit countries to adjust to these external shocks. Under this regime it was not possible, in theory at least, for countries to adjust their respective exchange rates in the event of a capital flight or adverse terms of trade. Since the relative value of all currencies was kept stable in terms of the gold standard, any imbalances in their international payments could not be corrected by an adjustment in the exchange rate but had to be corrected by an adjustment of national price or income levels. In other words, the fixed exchange rate pegged to the gold standard, tended to impart a powerful deflationary tendency in the deficit countries. The whole edifice of the gold standard had been constructed on the foundations of a competitive market economy. In this regime, the price mechanism constituted the sole means of exchange rate adjustment. Before World War I, the gold standard had functioned quite smoothly as the free convertibility of national currencies fostered a multilateral settlement of international payments. If a country incurred a trade deficit, it would automatically experience a deflationary adjustment and an outflow of gold reserves. Conversely, a trade surplus would attract an inflow of gold reserves and a rise in nominal incomes and prices.

After World War I, however, this international trade and payments equilibrium had disappeared. The United States emerged as the principal creditor nation to replace Britain as the major international investor. Despite the emergence of the United States as the principal creditor nation, its status as a reserve currency nation and "central banker" for the international payments system did not evolve until after World War II with the signing of the Bretton Woods Agreements which established a fixed, though flexible exchange rate system

based on gold/dollar convertibility. During the inter-war years, however, the decline of Britain and the gold standard had only accentuated the chronic instability in international monetary relations. The UK itself had become a net debtor country and could no longer act as the "central banker" for the international capitalist economy. The inevitable breakdown of the gold standard in 1931-33 was caused by the acute disequilibrium in the international balances of payments as countries resorted to autarchic "beggar-thy-neighbour" policies and competitive devaluations.

The Keynes plan proposed during the Bretton Woods negotiations in 1944 involved the creation of an International Clearing Union, which would act as an international central bank and issue its own currency, the Bancor, the value of which would be determined at a fixed price to gold. Each member country would establish a fixed but adjustable exchange rate in relation to the Bancor. International payments balances would be settled by using the Bancor as a unit of account. The Bancor would have very limited convertibility; countries could purchase Bancors but could not convert them into gold. In other words, Bancor reserves would remain within the system to avoid the possibility of a drain on reserves. Each country would also be allocated a quota of Bancor based upon their levels of imports and exports. The essential aim of Keynes's international clearing union was to prevent the onset of competitive devaluations and to mitigate the deflationary tendencies caused by the reluctance of surplus countries to reflate and stimulate aggregate demand for the deficit countries. The pre-war system had imparted a contractionary bias which forced the deficit countries to adjust internally by imposing deflationary policies. Keynes had envisaged an international system which would reverse this deflationary bias and impart an expansionary impetus which would allow deficit countries to pursue full employment policies. This necessarily implied that the surplus countries would be obliged to incur more of the burden of adjustment.

The dilemma arose that the surplus countries could continue to accumulate foreign exchange reserves almost without limit, as long as the central bank could sterilise the inflationary effects. The deficit countries, on the other hand, would eventually run out of foreign exchange reserves and be exposed to speculative attacks on their currencies. In this sense, the burden of adjustment would be borne almost entirely by the deficit countries, which would be forced to enact contractionary policies and experience higher levels of unemployment. These asymmetrical shocks would ultimately depress international effective demand and have an adverse effect on the exports of the surplus countries themselves. As Crotty contends:

> There can be no doubt that the international financial system that Keynes proposed and defended in the early 1940s had as a major objective the facilitation of high rates of growth and low rates of unemployment in its constituent countries. Under the prevailing system, serious payments imbalances created deflationary pressures on deficit countries. The ensuing contractions that developed in these countries could then spread to surplus countries through the erosion of their export markets. In the extreme instance, this chain of events had the power to generate a world-wide slump. (Crotty, 1983: 62)

The Keynes plan had proposed that any country which experienced severe and prolonged balance of payments deficits (equivalent to half of its Bancor overdraft), would be charged interest on its Bancor account. It would also be obliged to devalue in order to prevent the outflow of capital. On the other hand, the surplus countries would be forced to reduce their

balances of payments surpluses and revalue their respective exchange rates. To prevent the deficit countries from incurring the entire burden of adjustment, Keynes proposed that the surplus countries, which had accumulated a Bancor balance equivalent to more than half of their overdraft credits, would be charged interest at 10 per cent per annum. If their credit balance exceeded the total value of their permitted overdraft at the end of the financial year, the surplus would be confiscated. The overriding aim of these rules was to force surplus countries to clear their international balances and force them to incur some of the burden of adjustment. Unfortunately, Keynes's Bancor plan was defeated by US opposition, led by their delegate H.D. White, at the Bretton Woods conference. The US dollar, tied to gold at a fixed price of 35 dollars per ounce, would instead perform the functions of reserve asset, unit of account and means of payments for the international monetary system based upon fixed but adjustable exchange rates (Skidelsky, 2000).

The Davidson Plan

The dollar/gold convertibility regime established by the Bretton Woods agreements had inherited a serious flaw, which became more evident as the US economy began to experience growing balance of payments deficits during the late 1960s. Robert Triffin (1961) was one of the first prominent economists to warn of the impending demise of the Bretton Woods system as a result of the role performed by the US dollar as an international means of payments and international reserve asset. The “Triffin dilemma” as it became known, essentially states that in order to supply the international economy with US dollars, the US itself would be obliged to run burgeoning balance of payments deficits to avoid a drain on international liquidity. But the very growth of these US deficits would ultimately undermine the role of the US dollar and hasten a series of crises. This contradiction would set in motion cycles of expansion and contraction of international liquidity and generate systemic instability.

After the demise of the Bretton Woods system in 1971-73, these destabilising flows of short-term speculative capital became more pervasive as countries abolished capital controls and deregulated their financial markets. As the issuer of the global reserve currency, the US enjoyed the enormous benefits of dollar seigniorage. In other words, the US was no longer constrained by dollar/gold convertibility. Unlike the rest of the capitalist countries, the US could finance its burgeoning balance of payments deficits by the issuing of US dollar-denominated bonds and securities without the limits imposed by the accumulation of foreign exchange reserves. US policy makers could now pursue an unfettered strategy of restoring their international competitiveness by resorting to successive dollar devaluations. The dollar crisis therefore not only imparted an inflationary impulse, which forced other countries to impose quite severe deflationary policies, but successive dollar devaluations also threatened to erode the competitiveness of their capitalist rivals in Europe and Asia (Parboni, 1981).

The problem of growing international payments imbalances has since emerged as a major source of financial instability. Indeed, the current crisis is quite unique because international “money” ceases to have a standard unit of value, analogous to the dollar/gold convertibility system or the 19th century gold standard regime under the aegis of *Pax Britannica*. In the absence of an objective standard of value, currencies only possess “fiat” values, which are governed by future expectations under the guise of hedging and speculative operations performed by the foreign exchange and derivatives markets. In the event of a credit crunch, the US dollar assumes its role as a safe haven and reserve asset. Paradoxically, even though the international economy might experience an increase in the

supply of US dollars as a result of the easing of US monetary policy, the velocity of circulation tends to fall as US dollars are hoarded. As long as deflationary forces remain quite robust, an increase in international liquidity is thwarted (Vasudevan, 2009: 31). It can be surmised that the existing system of deregulated financial markets and worsening payments imbalances cannot be sustained. Sooner or later, an irreversible dollar crisis will appear which will signify the end of the existing fiat money regime. At this moment, the political imperatives for international monetary reform will become irresistible.

In the tradition of the Keynes plan, Davidson (1992-93) has devised a more simplified plan to reform the international financial and monetary architecture. Davidson proposes an International Money Clearing Union (IMCU), similar to the original Keynesian Bancor system. Although a fixed exchange rate regime is proposed, countries would be allowed to adjust their respective parities to reflect permanent structural changes in unit labour costs and current account deficits at full employment equilibrium (Arestis, 1999). At the same time, nation states would not surrender their control of the national banking system and would preserve their ability to pursue independent fiscal policies to maintain full employment. According to Davidson, the basic architecture of the IMCU would be designed:

1. to prevent a lack of global effective demand due to any nation(s) either holding excessive idle reserves or draining reserves from the system;
2. to provide an automatic mechanism for placing a major burden of adjustment on the surplus nations;
3. to provide each nation with the ability to monitor and, if desired, to control movements of flight capital; and finally
4. to expand the quantity of the liquid asset of ultimate international redemption as global capacity warrants (Davidson, 1992-93: 158).

The basic features of the Davidson plan involve the issuing of an international reserve asset to provide liquidity in the form of the International Money Clearing Unit (IMCU), which would be held exclusively by central banks. IMCUs would only be convertible into the deposits of a nation's currency in the clearing union and act as a unit of account between central banks. An overdraft facility would also be created for short-term creditor balances and a trigger mechanism established to prevent creditor nations from accumulating excessive credit balances as a result of running persistent current account surpluses: The excessive credits can be spent in 3 ways:

1. on the products of any other member of the clearing union;
2. on new direct investment projects and/or
3. to provide unilateral transfers (foreign aid) to deficit members (Davidson, 1992-93: 160).

Davidson also recommends the forcible confiscation and redistribution of the surplus countries' credits to the deficit countries in the unlikely event that these credits are not eliminated. On the other hand, if a deficit country experiences persistent current account deficits at full employment, this would constitute evidence that the country is living beyond its means and cannot maintain its existing standard of living. In this case, the deficit country would be obliged to undertake an internal adjustment with the imposition of contractionary policies. Davidson's plan effectively abandons Keynes's original idea of a world central bank and substitutes a more modest international clearing union, which would issue IMCUs. However, the basic Keynesian idea of shifting the burden of adjustment to the surplus

countries forms the cornerstone of the Davidson plan. These arrangements would doubtless impart an expansionary rather than a contractionary impetus to the global economy.

Conclusion

It should be conceded that despite the desirability and urgency of these reforms, the outcome will be ultimately determined by the configuration of political power and geo-political imperatives. It appears that the US monetary authorities would be very reluctant to surrender their privileges of dollar seigniorage until the outbreak of a major irreversible dollar crisis. The present international monetary system hinges upon very fragile and perilous foundations. The whole system is based upon the willingness of surplus countries (mostly in East Asia) to continue to accumulate US dollar reserves in order to finance successive and cumulative US balance of payments deficits. This very delicate "balance of financial terror" to paraphrase Summers (2004) can be described in Gramscian terms as a state of "catastrophic equilibrium" which is propagated purely on the basis of political convenience but which could quite easily unravel with devastating consequences reminiscent of the 1930s experience.

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