

# A NEW BRETTON WOODS OR MONETARY COMPETITION?

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To answer the question whether we should convene another Bretton Woods, we must find out what the problems are that would have to be solved by another such conference and what actually happened in July 1944 that was so marvelous.

## Problems and Memories

The problems of today, which some people would solve with a new international agreement, are monetary and financial in character. It is felt that

1. Exchange rates between the dollar, the yen, the euro, and the pound sterling are too volatile, tend to over- and undershoot, and that real exchange rates tend to be over- and undervalued.
2. Capital flows of hot money are so large that they can suddenly cause deep financial and economic crises in countries that can least afford them.
3. New financial instruments of a more risky nature multiply the width of swings under (1) and (2).
4. The linkage of stock exchanges and banks make a global meltdown increasingly likely in the event of a crisis of confidence in one of the principal advanced nations.

The memory of 1929 and a few scares such as those in the summers of 1987 and 1997, together with a superficial understanding of the functioning of world capital markets, have made many people inclined to call for international concerted action. The magic word is a new “architecture” for the world financial system.

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The prestige of Bretton Woods is in no little measure based on a misrepresentation of the agreement itself and of its effects on the evolution of the world economy up to the oil crises of the 1970s. Many believe that the prosperity of the quarter century following Bretton Woods is a proof of the aptness of Keynesian recipes for the postwar. Many more think that the regime of fixed exchange rates and the work of the IMF and the World Bank explain the avoidance of the kind of isolationist and beggar-my-neighbor policies that characterized the aftermath of World War I.

### John Maynard Keynes and Harry White

The approach of John Maynard Keynes when he engaged the British Treasury in negotiations with the U.S. Treasury was that of a firm believer in multilateralism. He was lucky to encounter a like-minded but crusty negotiator on the other side of the table in the person of Harry Dexter White. They and their governments wanted to avoid the kind of monetary, financial, and commercial conflicts among nations typical of the 1920s, when the allies insisted on war reparations, and the 1930s, when Western powers sought to go it alone. In this sense, the Bretton Woods spirit was a very positive atmosphere in which to start the reconstruction of the civilized world. Another common trait of both negotiators was their belief that as free a trade system as possible had to be built if prosperity was to return, and that an all out effort had to be made to stop money and finance from standing in the way of commerce. In this sense, the spirit of Bretton Woods made an outstanding contribution to peace, prosperity, and democracy.

Throughout his life, however, Keynes put his faith in government management of the economy to rescue the market from its failures. This is especially true in matters monetary and financial. In his first economic work, *Indian Currency and Finance* (1913), Keynes wanted to do away with the currency board arrangement in India under the Raj: he called for a central bank with monetary discretion and for government management of investment. In the following years, whether he stood for free trade or protection, whether he wanted to keep the gold standard or do away with it, he proposed all sorts of supra-national central banks and new international moneys to supplement or take the place of gold, the pound, or the dollar. In the 1941 paper he circulated around the British Treasury, he proposed an International Clearing Union and a new managed money called “bancor” (see Meltzer 1988: 233–48). The object for him was that a dearth of liquidity should not stand in the way of reconstruction finance. This is the idea he took to the negotiations with the Americans and which

formed the basis for the idea of the International Monetary Fund (IMF), for the scarce money clause, and for the size of the fund on which debtor nations would be able to call, given the foreseeable payments deficits of the war-stricken European nations.

Harry White was a convinced New Dealer. He and Henry Morgenthau, secretary of the Treasury, did not believe in *laissez faire* and thought that government should be responsible for the overall performance of the economy. He especially believed that postwar reconstruction depended crucially on monetary stability, as can be guessed from the title of the paper he circulated in late 1941–42, “A Plan for a Stabilization Fund of the United Nations and for a Bank of Reconstruction of the United and Associate Nations” (see Gardner 1994: 164).

## The Institutions of Bretton Woods

What came out of Bretton Woods? First, the IMF. This institution was supposed to help countries maintain a fixed exchange rate, by financing short-term balance of payments deficits. The IMF also would report on the macroeconomic disequilibria that endangered the solidity of the external position of countries and upbraid them accordingly. But the clause allowing measures to be taken to right situations of currency scarcity was never used. The IMF was also to become a central bank à la Keynes by issuing Special Drawing Rights (SDRs).

It is not so much the IMF, as the obligation undertaken to keep the economy in balance and the exchange rate fixed that worked as a brake on the Keynesian policies that many European governments, especially British Labor and Conservative governments, endlessly tried to pursue. The failure of the attempt to make the pound convertible, in August 1947, as the United Kingdom had promised to do in the “Anglo-American Financial Agreement,” was due to the insistence of the British to plan their economy, to lower their interest rates artificially, and to follow unremittingly expansionist policies. The picture was very different in Germany, where Ludwig Erhard, who was economics minister from 1949–57, freed the economy one weekend. The thorough application of *laissez faire* turned out to be more consistent with the Bretton Woods aims than all the finicky devices aimed at making internal Keynesianism compatible with a freely functioning international economy. After Erhard, many countries freed capital flows and slowly freed exchange rates. Those actions, rather than the attempts of the IMF to act as the money-printing central bank, are the positive financial and monetary legacy of Bretton Woods.

The second institution was the World Bank. Its avowed aim was to help in the reconstruction of a war-torn world. In fact, it played a very minor role, since the crucial element for reconstruction turned out to be none of the institutions and measures agreed at Bretton Woods but rather the Marshall Plan. The World Bank has changed its spots over the years. Its contribution to the prosperity of developing nations is a matter for contention. Be that as it may, its varied roles bear no relation to today's monetary and financial problems outlined at the beginning of this paper.

### Matters of Commercial Policy

A third question was discussed in the run up to Bretton Woods bearing fruit much later than 1944: the freeing of international trade. In the Anglo-American conversations on matters of commercial policy, a great obstacle was the wish on the part of many British to maintain imperial preference, a sort of Zollverein set up in Ottawa in the wake of the 1932 depression, when Britain gave up its secular commitment to free trade (Gardner 1994: 167). Then it was the turn of the Americans to reject the British proposal to slash tariffs at one go, preferring instead to come to case by case agreements. Finally, in the document signed by both parties in November 1945, titled "Proposals to be considered in an International Conference on Trade and Employment," disagreements were merely pasted over. This was ominous for the future of a third institution that never came to be: the "International Trade Organization."

The proposed charter of the ITO was, as a result of the long discussion over widely differing points of view on commerce, a very involved and complicated document. American opinion found that, in the process of giving way to British views on trade and employment, a very interventionist and statist document had been drafted. By rejecting it in 1950, Congress deemed it was furthering the cause of multilateralism.

There was however a surprise development in store. It turned out that both the United States and the United Kingdom were signatories to a "Protocol for the Provisional Application of the General Agreement on Tariffs and Trade," signed in Havana in 1948. Thus was the GATT born. Although it only had a small office with scant means in Geneva, it carried out sterling services in the cause of free international trade. The Dillon, Kennedy, and Uruguay Rounds, and the creation of the World Trade Organization, have followed from that Agreement and show that modest attempts to do the politically impossible can be effective.

## What Sort of Bretton Woods Do They Want Now?

In sum, Bretton Woods was not very effective in setting up institutions to govern global money and finance. Neither did it fulfill the expectations of its begetters that it would give the benefits of *laissez faire* without the pain of monetary competition, orthodox macroeconomics, and unrestricted international trade. In fact, Bretton Woods ushered in an era of world prosperity because it was the unwitting midwife of a return to a free economy.

There is no denying that the present fabric of global money and finance at times looks fragile. It is a matter for empirical studies to decide whether exchange rates are too volatile, whether options and other derivatives are destabilizing, and whether information technology and the Internet make information move too fast, amplifying shock waves through the system. What remedies if any are to be taken does not seem to me a matter for an international conference, but rather for the regulators of the different financial markets.

Setting up a cartel of central banks does not seem to me the answer to our fears. The fact that monetary zones may be getting larger and new international currencies may be appearing, such as the euro, does not mean that we should work for a single world currency managed by a group of central bankers who are not responsible to anyone but themselves. Even more fearful would be attempts to make this cartel responsible to some world political authority.

## Monetary Competition

Many people think that a system of competing currencies, such as we have now with the U.S. dollar, the yen, the euro, the pound, and others, is inherently unstable. They take no account of the inverse of Gresham's law—whereby people choose good quality money over bad or simply reduce their use of unreliable money and financial instruments—which experience shows works slowly but surely.

Suppose that the demand for money depends on national income and the rate of exchange for other currencies, especially those most used in international trade: demand for money grows with income and is inversely related to devaluation. Suppose also that central bankers supply money to obtain seignorage or to collect the inflation tax, which comes to the same thing, and that seignorage is inversely related to over-issue, precisely through the operation of the inverse of Gresham's Law. The result would be two automatic stops on the over-issuing of base money by central bankers:

1. If there are no controls on exchanges or capital flows, an immediate stop would operate—namely, the flight to another, sounder currency. Such a system functioned to satisfaction in Scotland during the 18th and 19th centuries.
2. If controls were imposed, ordinary people would reduce their use of money and financial instruments, with a fall in the inflation tax but also a loss of welfare.

But if the main central bankers banded together, they could decide to inflate in unison. As is well known, due to the fact that expected inflation is discounted by the public, maximum collection of the inflation tax can only be obtained with randomly variable inflation. What a nightmare! I sleep more easily when central bankers compete.

### Appendix: International Monetary Competition

Let there be the pound sterling, the U.S. dollar, the yen, and the euro. The exchange rate of the pound is a weighted average of its rates against the other currencies, such that if the pound rate goes up the currency is devaluing:

- (1)  $e_{\pounds} = \pi (\pounds/\$, \pounds/Y, \pounds/\epsilon)$ , where  $\pi$  is a weighted average operator of exchange rates.
- (2)  $\pounds^D = D (y/e_{\pounds})$  and
- (3)  $\pounds^S = S (i)$ , where  $i$  is the seignorage or inflation tax.
- (4)  $\delta \pounds^D / \delta y > 1$ , a positive elastic income demand for money,
- (5)  $\delta M^D / \delta e_{\pounds} < 0$ , which is the inverse of Gresham's Law.
- (6)  $d \pounds^S / di > 0$ , where central bankers will respond with more issue when seignorage increases. But,
- (7)  $i = i (e_{\pounds})$ , where  $i$  is the inflation tax or seignorage.
- (8)  $di/de_{\pounds} < 0$ , so that seignorage falls with devaluation, given 5.

Seignorage only increases with issue when the monetary zone expands, due the high relative quality of the money in question.

The final result would be that the quantity of money increases with real income:

- (9)  $\pounds^D = \pounds^S = \pounds (y/e_{\pounds})$ , from 2, 3, 5 and 8.

But if all currencies were over-issued together the brake in 5 would not operate, as happened when the IMF issued special drawing rights. In the 19th century, self-denying rules were used, such as the gold standard, where

- (10)  $\pounds + \$ + Y + \epsilon = M_W = k Au$ , with  $k$  as a constant greater than one, to stop  $M_W$  from overexpanding concertedly.

## BRETTON WOODS OR MONETARY COMPETITION?

Competition among the currencies to get optimum seignorage may also be enough to control world inflation over the long run. But if there is a cartel, nothing stops the whole lot of them to agree to mild (or temporarily runaway) inflation.

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