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FROM BRETTON WOODS TO THE EURO: HOW POLICY-MAKER OVERREACH FOSTERS ECONOMIC CRISES

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Pierre Siklos

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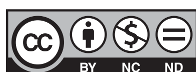

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ABOUT THE AUTHOR

To Pierre Siklos, the world's central banks are as much research centres as they are financial institutions. He has held seven visiting researcher positions at central banks in European and Asian countries, including Germany, Hong Kong, Hungary and Japan. Pierre has also held more than 20 visiting fellowships at leading academic institutions, such as the International School of Economic Research in Siena, Italy, Oxford University in the United Kingdom and Princeton University in the United States.

He has a particular interest in central bank independence, the governance models of central banks and the challenges that arise in an interdependent world. To that end, he has compared and contrasted how European models of integration differ from those in Asia. His work in applied time series analysis and monetary policy focuses on inflation and financial markets.

At Wilfrid Laurier University, where he teaches macroeconomics, Pierre is the director of the Viessmann European Research Centre. Pierre is a former chair of the Bundesbank Foundation of International Monetary Economics at Freie Universität in Berlin, Germany. He is also a research associate at Australian National University's Centre for Macroeconomic Analysis in Canberra, and a senior fellow at the Rimini Centre for Economic Analysis in Italy. Pierre serves on the editorial boards of *Economics Research International*, *Economic Systems* and the *Journal of Economic Research*, and is the former managing editor of the *North American Journal of Economics and Finance*.

Pierre earned his Ph.D. in economics from Carleton University and his M.A. in economics from the University of Western Ontario. He joined CIGI as a senior fellow in 2009 and is fluent in English, French and Hungarian.

SUMMARY

This paper considers the relevance of the Bretton Woods system for the prospects of reform of the international monetary system and in the context of the ongoing euro area financial crisis. It explores the challenges that must be met in attempting to reform the present international monetary system and euro area policies. After considering what resonates, and what does not, from the Bretton Woods regime of fixed exchange rates, it examines some of the key lessons from that era. The paper concludes that policy makers at Bretton Woods promised too much in terms of the stability and durability of the policy regime, and 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 their members. In particular, the Bretton Woods system failed because the agreement paid virtually no attention to governance issues. Finally, in terms of the current situation in the euro zone, policy makers have failed to recognize that the problems are not purely economic; domestic political considerations are important too. A political-economy approach is required for the design of new international monetary arrangements. The same principles apply today when we contemplate the survival of the euro zone. Politicians need to be more realistic and less ambitious, lest they create the preconditions for the next global crisis.

INTRODUCTION*

The Bretton Woods system of fixed exchange rates ended almost 40 years ago. Enough time has elapsed that there ought to be a clear-eyed view of its contribution to the evolution of the international financial system and of its place in the history of exchange rate regimes. Remarkably, policy makers continue to be fascinated by the policy strategy that underpinned the Bretton Woods arrangements, even though economists hold decidedly mixed opinions on the actual performance of the system. In 2008, at the height of the global financial crisis, then British Prime Minister Gordon Brown called for a "new Bretton Woods" international financial architecture (Reuters, 2008). In doing so, he echoed the desire of other political figures, such as Paul Volcker, former chair of the US Federal Reserve Board, to remake the international monetary order based on what they believed had been a successful strategy. A key attraction of Bretton Woods was the belief that it represented the high watermark of international cooperation in coordinating responses to economic crises.[1]

Now, nearly four years after the Lehman Brothers bankruptcy in September 2008, there are far fewer calls for a "new" Bretton Woods, as domestic considerations displace the urgency that forced nations to react to the global financial and economic crisis. Notably, in spite of the ongoing travails in the euro zone, European policy makers evince little desire to return to the fixed exchange rate system that predated the creation of the euro. Instead, cooperation or coordination is sought through other avenues such as monetary policy cooperation and global financial regulations. Nevertheless, some of the conditions that led the 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 and a form of peer review of members' economic policies, persist today. Witness the emphasis that euro area heads of government and the European Union have placed on fiscal rules that enshrine a form of peer review, if not complete supervision (see, for example, European Commission, 2011).[2]

Still, some academics and policy makers remain concerned about the role of floating exchange rates. Whereas in 1984, the US General Accounting Office (GAO) convened experts to debate the merits of floating exchange rates (GAO, 1984), concluding that they 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 (Murray, Schembri and St-Amant, 2003). Indeed, evidence of the insulating properties of the exchange rate during the Great Depression era underscores the case for this kind of strategy (Choudhri and Kochin, 1980). The current view is that a floating exchange rate does not represent a coherent policy strategy unless the anchor of the policy is clearly defined.[3] Even Canadian policy makers have raised the possibility that floating exchange rates have not entirely lived up to their billing.[4] This only goes to show that, as Frankel (1998) put it, the right choice for an economy when choosing an exchange rate regime can change over time.

Although today's circumstances are very different from those at the time of the Great Depression, there appears to be a return, or perhaps the threat of a return, to "beggar-thy-neighbour" types of policies in the present era. This tendency is manifested in a resistance to exchange rate appreciation, the imposition of taxes or fees to limit capital mobility, differential rules and oversight of the financial sector, and the ever-looming threat of trade protectionism. These are precisely the elements that contributed to the economic misery of the late 1920s and 1930s. Where exchange rate regimes do not permit adjustment via this strategy, painful internal devaluations are the order of the day.[5]

How then to explain the continuing appeal of the Bretton Woods era? After all, the agreement ratified by 1946 did not fully take effect until the main participants were able to offer convertible currencies in the late 1950s. Moreover, if the end of the Bretton Woods era is dated from President Nixon's 1971 decision to sever the link between the price of gold and the US dollar (set at $35/oz.), this international arrangement can be said to have lasted only about a dozen years. Consider the next big experiment in coordinated

* Earlier versions of this paper were presented at the Chatham House-CIGI workshop, "Search for Post-Crisis Growth Models and Policy Tools for Macro-Coordination" in London, December 2010 and "The Euro: (Greek) Tragedy or Europe's Destiny?" symposium, University of Bayreuth, January 2012. I am grateful for comments received by participants at these events.

1 To some extent, the creation of the Bretton Woods system and the European Monetary Union (EMU) represent reactions to earlier breakdowns of the international monetary system, which were themselves hastened by repeated military conflicts.

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

3 See Rose, 2011 for the latest restatement of this view.

4 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."

5 For some euro zone members, such as Greece, this is the only way out. Some countries with ambitions to join the European Union, such as Latvia, have voluntarily chosen the internal devaluation route (a requirement under the treaty that secures future members' entry).

policy making, namely the creation of the euro zone. Although the EMU was born in stages, starting with the Maastricht Treaty in 1991 and ending with the introduction of the euro in 2001, it is already showing signs of severe stress a mere dozen years after the euro began circulating as the common currency among some European Union member states. What are the common features between the Bretton Woods and the EMU regimes, and what role flaws in their design may have played in their evolution?

The next section of this paper examines the economic constraints that were implicit or explicit in the Bretton Woods system and argues that insufficient attention to governance issues set the system up for failure. The paper then considers the aspects of Bretton Woods that resonate with some policy makers and scholars today and those that do not, before asking, where do we go from here? The paper concludes with some lessons that policy makers in an organization such as the Group of Twenty (G20) may wish to consider if they are to successfully create the conditions for a new international monetary regime. The bottom line is that politicians need to temper their ambitions for grand redesigns or major reforms. Crises cannot be avoided and their frequency may be lessened if no grand reforms are attempted. Put differently, by all means fix what is broken, but do not assume that everything currently in place needs fixing.

THE INGREDIENTS OF A LASTING POLICY FRAMEWORK

There are other monetary standards (for example, gold and inflation targeting) that have easily outlasted the Bretton Woods agreement. Why some monetary standards outlast others is not entirely clear. In the case of the gold standard a benign economic environment, combined with a determination on the part of political authorities to maintain a regime that bound their economies together, was clearly a factor. In the case of inflation targeting, the lessons from the stagflation of the 1970s and early 1980s, convincing academic evidence about the desirability of low and stable inflation, as well as the realization that central banks can reasonably control inflation but little else, contributed to the popularity of inflation targeting. It was known almost from the start that the original Bretton Woods articles contained a fatal flaw, since called the Triffin paradox. At the risk of oversimplification, the paradox emerges from the fact that if there effectively remains only a single world reserve currency, the US dollar,[6] having the United States permanently run a balance of payments deficit would be the only way to avert a worldwide shortage of US dollars and sustain worldwide trade and economic growth. While this is technically feasible, there is the question of whether, and at what level, such a deficit might become unsustainable. Gordon Brown, for example, saw Bretton Woods as a regime that delivered low and stable inflation combined with sustained economic growth while international trade rose substantially. Perhaps proponents of the Bretton Woods arrangement feel that an agreement among a large number of nations is a signal achievement worth replicating. Moreover, and in spite of the development of devices to reduce potential shortages of US dollars (for example, central bank swap arrangements with the US Federal Reserve), and the potential for a multipolar currency world, where the euro and the Chinese renminbi would supplement the US dollar as stores of value, the central elements of the Triffin dilemma remain valid to this day (Bini Smaghi, 2011).

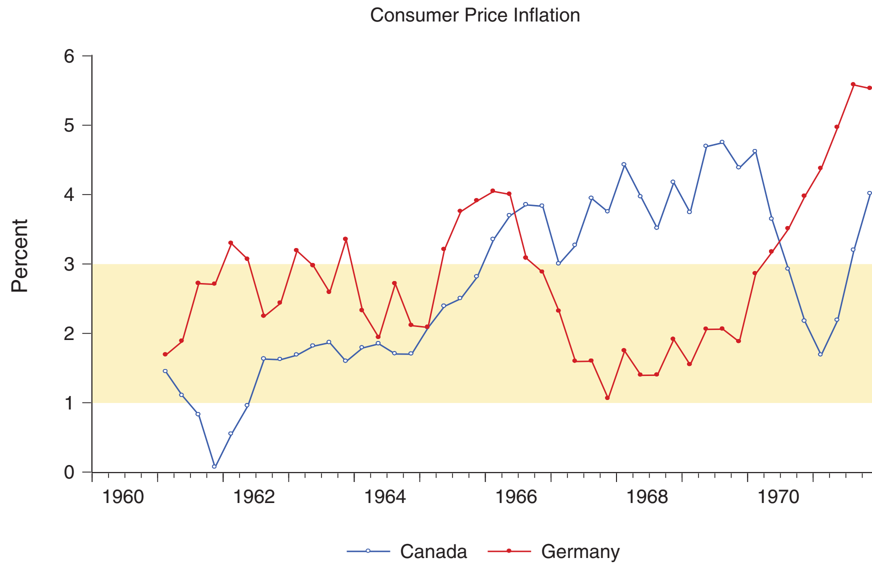
One day, a policy maker may look back at the era of the "Great Moderation" in a similarly wistful manner. The term was famously used by Ben Bernanke, chairman of the board of governors of the US Federal Reserve System, to describe the period from approximately the mid-1980s to mid-2007, when inflation was also low and economic growth stable, with relatively few large shocks hitting the world economy. Consider Figures 1 and 2 below, that compare inflation and real GDP growth during the Bretton Woods era with 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. Figures 1a and 1b illustrate the Canadian and German experiences. Both are open economies; the latter a large one, the former an archetypical small open economy. By today's standard of low and stable inflation (that is, the one to three percent range adopted by many central banks), both economies performed well until perhaps the first of two oil price shocks in the 1970s. Real GDP growth is seemingly volatile, but mean growth rates are 5.18 percent for Canada and 4.21 percent for Germany for the 1960–1972 period. Turning to the period since 1998 (Figure 2b), real GDP growth, now shown for Canada, Japan and China, appears more stable, but divergences across the three countries are striking. Canada is included for continuity with the Bretton Woods era, while China and Japan respectively are the poster children for fast-growing emerging market economies (EMEs) and mature economies stuck in a long slump. However, 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.[7]

6 Quantities of gold could not be combined with US dollars in sufficient quantities to offset a potential shortage of the US currency.

7 Mean economic growth rates, with standard deviations in parentheses, are as follows for the Bretton Woods (BW) and post-Bretton Woods (PBW) periods considered: BW, 5.18 percent (1.80) for Canada, 4.21 percent (2.42) for Germany; PBW, 2.37 percent (2.17) for Canada, 0.63 percent (1.80) for Japan, and 8.90 percent (2.63) for China.

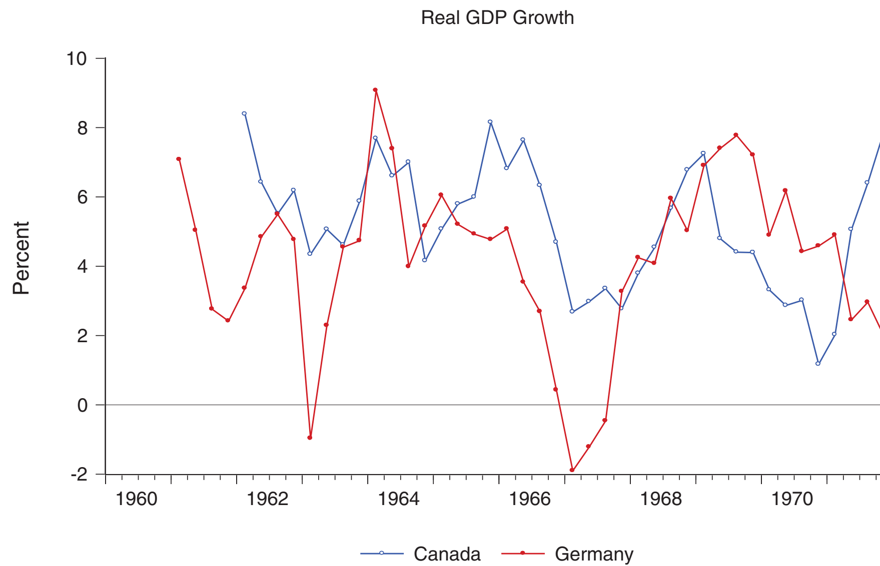
Figure 1: Economic Performance during the Bretton Woods Era: Selected Illustrations

Figure 1a



Source: Siklos (2011).

Figure 1b



Source: Siklos (2011).

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 Selected Countries, Post-Bretton Woods: 1998–2009

Figure 2a

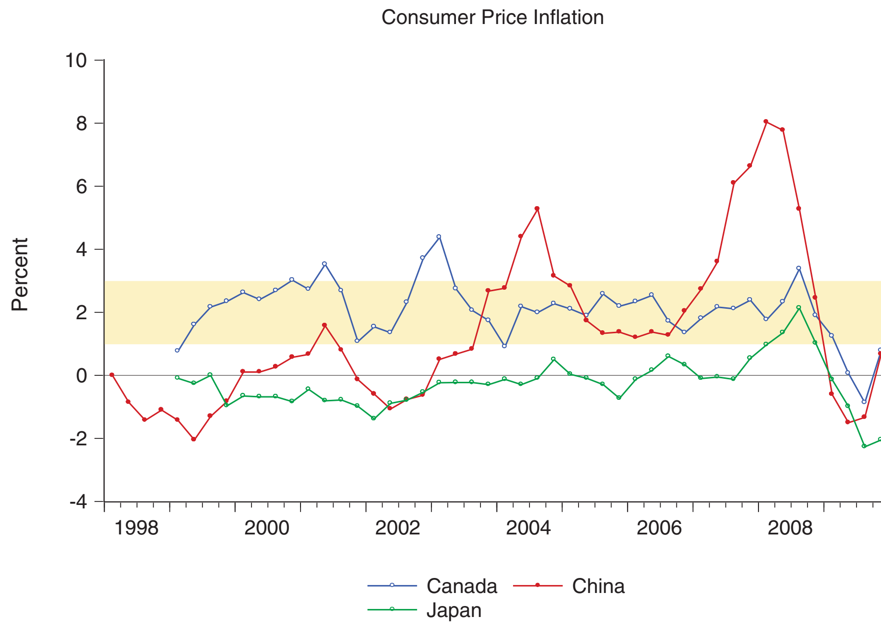
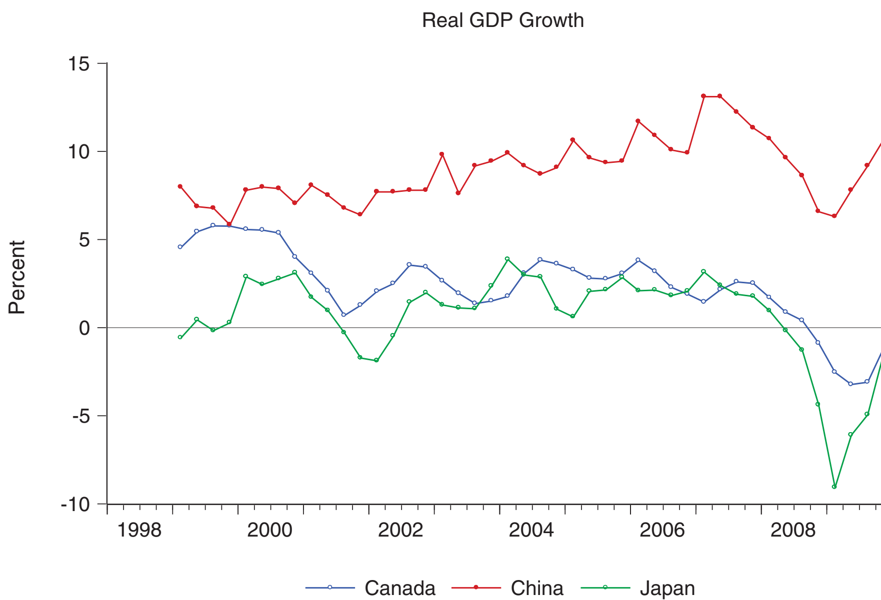


Figure 2b



Data for Figures 2a and 2b are quarterly and are from the IMF's International Financial Statistics CD-ROM.

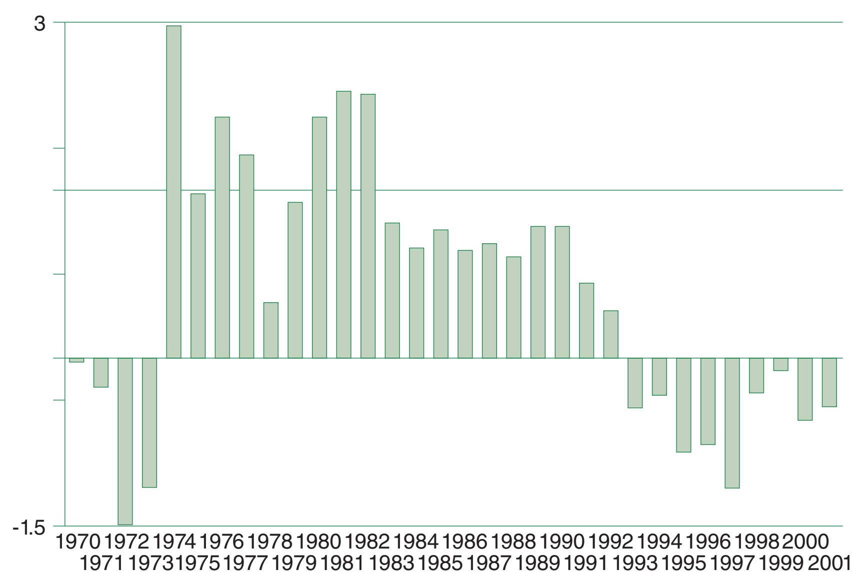
Turning to inflation, the comparisons highlight the differences in policy regimes, with Canada having adopted an inflation target, while the other two economies, Japan and China, did not. Inflation targeting did not bring with it a "Great Moderation" in overall economic performance, but succeeded in anchoring inflation.[8] Since the exchange rate regimes differ widely across the economies considered, it is 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. One cannot, however, exclude the possibility that the design of institutions and economic governance more generally are also elements in the mix.

What matters, as in the Bretton Woods system, is not *just* the economic performance recorded during the era, but, as importantly, the buildup of imbalances and other inconsistencies that led to the ending of the era. In other words, an era should be judged as much by its economic aftermath and not exclusively by the record of accomplishment during its existence. Moreover, the rate at which imbalances build up during an era can affect its longevity. It is 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 in the current account, as shown in Figures 3a and 3b, or in financial terms, as shown in Figure 4, where the foreign exchange reserve accumulations of selected Asia-Pacific economies are plotted. Figure 3a clearly shows the buildup of imbalances in the industrial world over many years, which then suddenly and persistently turn negative in the early 1990s. A slightly different perspective is provided in Figure 3b. In spite of the global financial crisis of 2008–2010, the problem of global imbalances, which appeared to be falling for a time, is once again becoming more prominent. Figure 4 reveals a different side of the imbalances question. The sharp rise in foreign exchange reserves in most Asia-Pacific countries, particularly beginning in the 1990s, is an expression of "exorbitant privilege," the term coined by former French President Giscard d'Estaing to explain the United States' ability to shift the burden of its liabilities onto other countries.

8 This can perhaps be explained by the "anchoring" phenomenon (Kahneman, 2011: 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 two percent — the mid-point of the one–three percent inflation target range — and the monetary authority will endeavour to deliver this value.

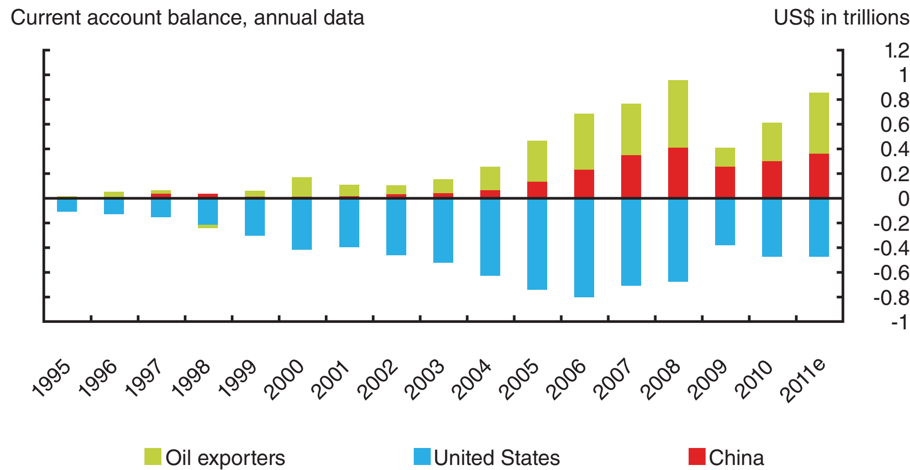
Figure 3: Current Account Imbalances: Industrial Countries

Figure 3a



Source: Edwards (2004).

Figure 3b



Source: Reprinted from *North American Journal of Economics and Finance* 14, no. 2, J. Murray, L. Schembri and P. St-Amant, "Revisiting the Case for Flexible Exchange Rates in North America," copyright (2003), with permission from Elsevier.

It is worthwhile to consider the positive aspects of the Bretton Woods accord that continue to resonate today, 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 cooperative solutions. They are (not in order of importance): a recognition that economic shocks are transmitted across borders and that cooperative solutions are desirable;[9] the importance of defining rules of conduct to constrain the likelihood that bad policies will be practised while allowing sufficient flexibility to deal with cases where "bad luck" requires some adjustment and cost sharing among members; and that the whole (a concern for global considerations) can be greater than the sum of its parts (purely sovereign concerns).

Given that accords of the Bretton Woods type do contain potential benefits, the following would be the implications for an attempt to design and operate a new international financial architecture. First, externally imposed constraints are either superior to discipline in policies that originate domestically or, rather, external discipline can usefully supplement purely domestically oriented policy. Next, 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 sustaining it over time even when there are occasional setbacks in the form of a temporary loss of credibility.[10] Finally, any successor to the current regime, whether of the Bretton Woods type or some other variety, must be flexible enough to recognize that there is a trade-off between the principle of national sovereignty and the recognition 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, the future of the euro zone is a current and ongoing concern. Even Jacques Delors, former president of the European Commission, whose name is inextricably linked to the EMU project, has admitted that the eventual member states of the euro area did not give sufficiently serious consideration to the one necessary condition for the EMU to be a success, that is, the requirement that member states cooperate (Moore, 2011). Instead, imbalances, hidden from view, at least to some,[11] continued to build until the entire project was threatened, because insufficient surveillance was combined with a failure of will to consider some of the challenges associated with a single currency. This outcome was the inevitable result of policy makers' attempts to "overreach" in terms of promises made about the stability and durability of

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

10 In other words, trust is a "stock" that needs building, while credibility is a flow that changes over time.

11 See the "black swan" phenomenon (Taleb, 2010).

the policy regimes, combined with a bias that rejects the possibility of failure.[12]

LOOKING BACK AT THE BRETTON WOODS SYSTEM: CHALLENGES AND CONSTRAINTS

The appeal of arrangements that tie the hands of their 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 and the launch of the euro are examples of cooperative arrangements that eventually necessitated a form of coordination.[13] The recent history of the G20 and the European Union teaches us, however, that the more cooperation is required, the less likely it is to be achieved, as economic considerations, which are sensitive to external pressures, go against political motives overwhelmingly dominated by domestic pressures.[14]

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 separating or identifying one kind of approach from the other is not always straightforward. At the outset it must be emphasized, of course, that a Bretton Woods-style arrangement contains elements of both cooperation and coordination, which likely also contributes to its appeal for many policy makers.

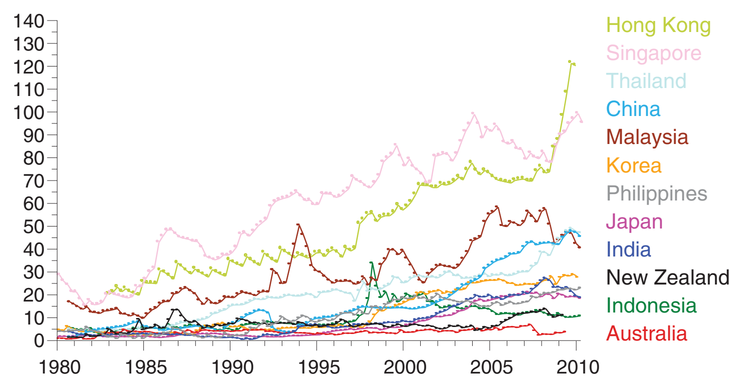
As shown by Obstfeld and Rogoff (2002), a cooperative-type solution is possible even if individual countries pursue independent behaviour in the conduct of policy. In other words, a solution can be desirable from a global perspective even if sovereignty over the choice of domestic policies is retained. As Murray (2011) points out, the 1980s saw important contributions in economics, which, on balance, suggested that cooperative solutions yield small welfare gains. Cooperation in maintaining exchange rate regimes is what economists have foremost in mind. Of course, models (for example, 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 attain in practice. In particular, these models did not consider what might happen if the transmission of economic shocks changes over time. Figures 5a, 5b, 6a and 6b below illustrate this by plotting the dynamic conditional correlations in real GDP growth between the United States 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 eve 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 United States and selected Asia-Pacific nations.

12 Consider the European Commission's Economic and Financial Affairs report EMU@10 (2008), which claims: "Fiscal policies have supported macroeconomic stability" and that "[T]he euro has acted as a powerful catalyst for financial market integration." Among the remaining challenges, only "potential growth remains low" is highlighted while the report bemoans the fact that "the public image of the euro does not fully reflect EMU's successful economic performance."

13 Coming up with a neat distinction between cooperative and coordinated arrangements is far from simple. What I have in mind are regimes where participants end up adopting similar goals, but without a formal set of rules, as in the case of inflation targeting, broadly speaking, versus regimes where behaviour is governed by an explicit set of rules, as would be true of the members of the euro zone who had to abide by the provisions of the Maastricht Treaty. Clearly, there exist intermediate cases where both forms coexist to a degree.

14 Other reasons include the fact, as noted most recently by Eichengreen (2011), that grand coordination experiments over exchange rates such as the Smithsonian and Plaza Accords of the 1970s and 1980s did not "constitute a ringing endorsement of this kind of coordination. It would be sometime before something similar was attempted again."

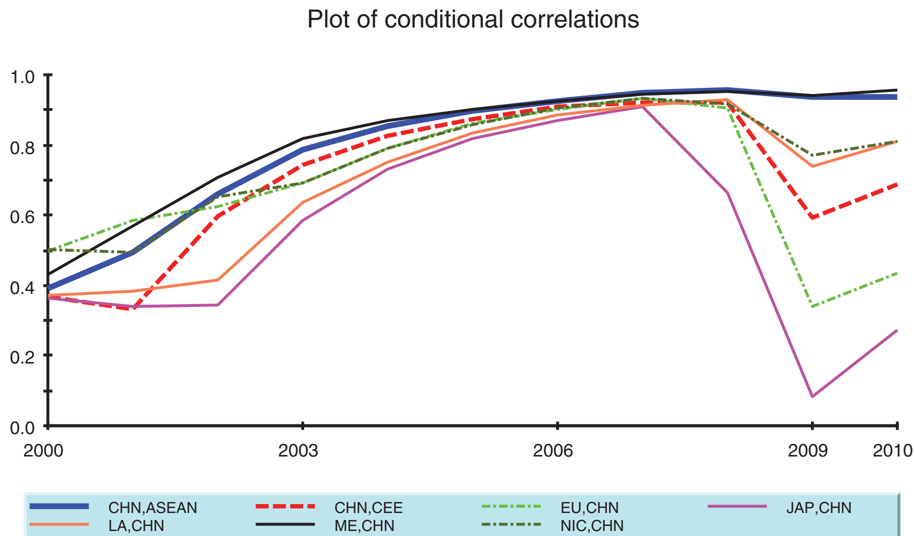
Figure 4: Foreign Exchange Reserves in Select Asian Economies



Source: Filardo and Siklos (2011).
The data are foreign exchange reserves to GDP ratios for the countries shown.

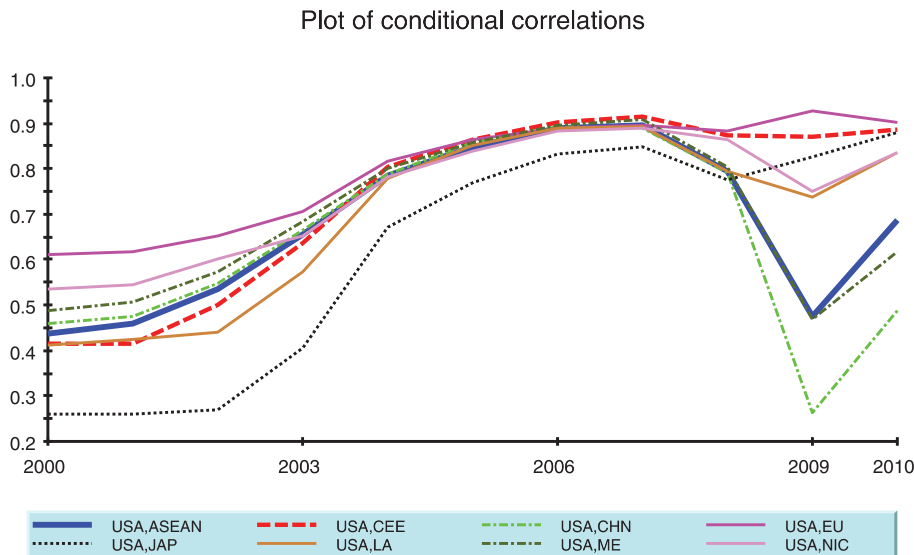
Figure 5: Dynamic Conditional Correlations in Real GDP Growth — Select Regions of the World versus the United States and China

Figure 5a



Source: Siklos (2011).

Figure 5b

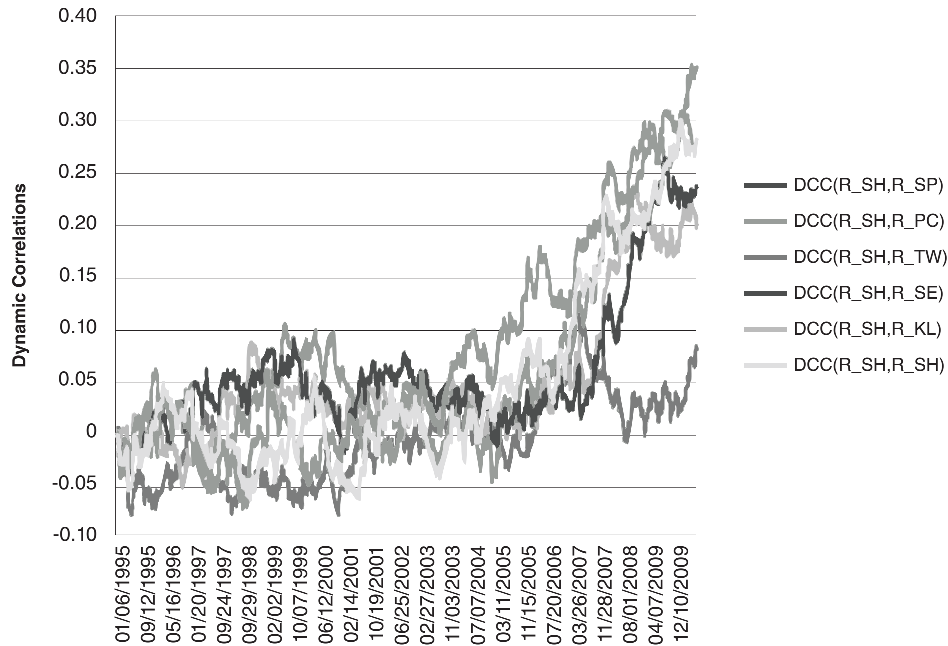


ASEAN	Asian Economic Nations	LA	Latin American countries
CEE	central European countries	ME	Middle Eastern countries
EU	European Union	NIC	newly industrialized countries
JAP	Japan	USA	United States

Source: Siklos (2011). Countries in each region follow IMF definitions.

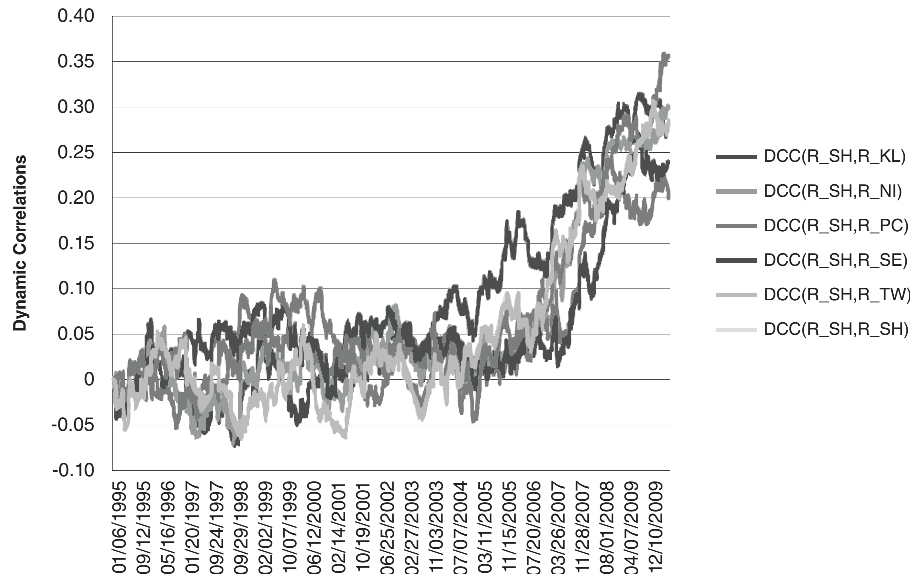
Figure 6: Dynamic Conditional Correlations in Stock Returns — Select Regions versus China and the United States

Figure 6a



Source: Burdekin and Siklos (2012).

Figure 6b



Source: Burdekin and Siklos (2012). 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.

The recent crisis, however, also highlights the fact that in spite of the so-called globalization of trade and finance, economies can easily decouple. While it is not clear, a priori, how globalization leads to coupling or decoupling in business or financial cycles, the results shown here ought to provide additional incentives to reach cooperative solutions on monetary and fiscal strategies. There is evidence, based on recent G20 and Group of Eight meetings, indicating that politicians resist these pressures and are happy to "muddle through," that is, implement some reforms in stages, ignoring the pleas of opinion makers or other politicians about the need to be more bold, and react to the crisis of the moment until sufficiently pushed to adopt the correct strategy. The predictions from the models referred to above also have implications for an alternative strategy that would involve limiting exchange rate movements or setting global goals (such as the recent US proposal to set specific limits on current account imbalances), as these require setting constraints, which may vary across countries, thereby complicating the ability to make mutually consistent decisions. This can only be accomplished if, say, a supranational authority is in place and has the tools, and the ability, to enforce the necessary consistency. The foregoing distinctions are important because there have been hints from policy makers in some emerging markets (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 EMEs and advanced economies.

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 (Klein and Shambaugh, 2010; Rose, 2011). Given this backdrop, the Bretton Woods era, born out of the ashes of World War II and the debilitating experience of the Great Depression, might have been expected to have had a longer and more successful life. Yet, the exchange arrangement inspired in part by John Maynard Keynes, but ultimately fashioned by the United States (Boughton, 2002; Bordo and Eichengreen, 1993), eventually met a series of challenges it could not survive. In no particular order of importance, these were: the reaction to the two oil price shocks of the 1970s (see also Figures 1a and 1b), which inspired countries to adopt different responses that ultimately proved inconsistent with the Bretton Woods ideal of stable exchange rates (Rogoff, 1985; Fischer, 1990);[15] 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; and 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 referred to previously.

It would be remiss not to mention the attempts to revive features of the Bretton Woods system in the form of the Plaza and Louvre Accords of 1985–1987.[16] It can be argued that by artificially appreciating the yen against the US dollar, pressured by the United States, Japan set the stage for its now almost two "lost" decades of deflation and low economic growth (Hamada and Okada, 2009). At the same time, Germany was becoming increasingly preoccupied by the drive towards closer European economic (and political) integration; the impending fall of the Berlin Wall would lead Germany to turn inward as it sought to cope with the shocks. These attempts at exchange rate manipulation are also, no doubt, on the minds of Chinese and other policy makers as the global economy seeks to recapture some semblance of balance, yet-to-be precisely defined by the political authorities. Since the global economy is now more multipolar than it was during the 1980s, it seems doubtful that a current-day James Baker, secretary of the US Treasury at the time of the Plaza and Louvre Accords, would command the moral suasion to produce an exchange rate realignment of the kind engineered almost 25 years ago.

In light of the criticisms leveled at current US economic policies from all quarters, it is useful to further consider the backdrop for the creation of Bretton Woods 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.[17] Perhaps most importantly, the major players at Bretton Woods felt, at least initially,[18] that a coordinated response was required to prevent actions by individual countries, especially the most influential ones, that ignored the potential negative externalities on the world economy from the single-minded pursuit of

15 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 Bretton Woods era, competitive devaluations during the gold standard period of the early twentieth century ended up loosening monetary policy sufficiently to help lift the world out of its great slump. See Eichengreen, 1992a.

16 See Poole, 1992 and references therein.

17 The seminal work deconstructing the gold standard is Eichengreen, 1992a.

18 While John Maynard Keynes and Harry Dexter White, two of the central characters in the Bretton Woods 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.

policies driven exclusively by domestic considerations. Meeting this objective of coordinated response 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, in private or in public, to keep members in line.

It is helpful to briefly summarize the principal features of the Bretton Woods system to understand what it is about the system that continues to resonate today, and what does not.[19] The following represents the core of the agreement reached at Bretton Woods. First, currencies had to declare a par value in terms of gold and the US dollar; the relationship was fixed at $35/oz. The US dollar, by default, would represent the nominal anchor of policy. Currencies could fluctuate in a zone of one percent above or below the announced par value. Changes (that is, 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; sanctions (for example, expulsion from the IMF) were to be the last resort.[20] A system-wide redefinition of par values would require majority approval as well as the support of "large" members.[21] Secondly, convertibility was required on current account transactions, but controls on the flow of capital were permitted. Membership in the IMF 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 permitted a trigger to set in motion a form of rationing. The clause has never been invoked. In spite of the system's built-in flexibility 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" (Bordo and Eichengreen, 1993: 28). Implicitly, however, the system involved a peg to the US dollar, an expectation that the one percent tolerance band would be maintained via foreign exchange intervention and an appropriate mix of domestically determined fiscal and monetary policies. The inability of the architects of international standards and arrangements at Bretton Woods to communicate or lay out in detail how the system was intended to work was precisely the same problem that would recur in the construction of the EMU based on the Maastricht Treaty. The Treaty was fairly clear about how to get to the EMU, but not so particular about how the monetary union would work, let alone survive the test of time.

History was not terribly kind to the Bretton Woods system. The arrangement took more than a decade to come into full effect. 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), the advent of 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 system. All of these events have been ably documented in a variety of places, including Bordo and Eichengreen (1993) and James (1996).

BRETTON WOODS: WHAT CONTINUES TO RESONATE TODAY, AND WHAT DOES NOT?

The creators of the Bretton Woods system did not give much thought to economic governance as this term is understood today. Essentially, the victorious powers got the international framework they wanted, although the United States was seen as largely dictating the shape of the new international monetary system. Eventually, responsibility and accountability shifted back and forth between the United States and the major industrial economies in the Group of Seven until the global financial crisis of 2008 forced an expansion of consultations to a larger and more diverse set of countries, the G20. In the meantime, institutions were created or existing ones were tasked to deal with issues that arose (such as the Financial Stability Forum and its successor, the Financial Stability Board, and the Bank for International Settlements). With an enhanced role for EMEs, including those with different political systems than most of the industrial economies, the economic governance problems became more acute.

No amount of effective cooperation is possible unless some of the pressing governance questions are resolved, such as the thorny issue of the most powerful members of the G20 agreeing to treat other members as equals. Drawing upon some of the results mentioned earlier, it may be preferable to give international organizations 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 model, though early indications are that it has not been up to the task or is still too new to be judged

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19 Readers can consult many other works for fuller details, most notably Bordo and Eichengreen, 1993. The current version of the Articles of Agreement can be found at: www.imf.org/external/pubs/ft/aa/index.htm.

20 Hence, a 10 percent 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.

21 That is, members whose quota (contribution to the creation of the Fund) exceeded 10 percent of the total. Not surprisingly, when the IMF was created, economic size dictated influence within the organization and the financial contribution required to operate the Fund.

impartially at this stage. In an attempt to persuade markets and the public that Europe's debt crisis can be controlled under existing treaties, the European Commission revealed amendments to the 1997 Stability and Growth Pact with a view to increased surveillance measures on member states, which triggered the excessive deficit procedures (European Commission, 2011). These new measures 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 IMF. The amendments failed to persuade markets and policy makers outside the euro area that the governance problems were resolved and, as this was written, France and Germany took additional steps by proposing treaty changes to enshrine a form of budget discipline among the member states. The so-called Fiscal Compact was agreed to by most, but not all, EU member states in December 2011. Notably, the United Kingdom and the Czech Republic, neither of whom has yet adopted the euro, refuse to participate in the new Treaty.

The "exorbitant privilege" that the US dollar continues to enjoy is also a fact that marks the Bretton Woods era and continues to preoccupy 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 for an alternative reserve currency. The central place of the US currency is both a threat and an opportunity going forward. It is a threat because US economic policies are entirely focused on domestic considerations; however, it also represents an opportunity, since, under the present circumstances, the emergence of China, India and Brazil, most particularly, should create incentives for the major economic powers, including the United States, to find cooperative solutions that retain a sufficient amount of national autonomy. Of course, such incentives will require that a reluctant US Congress — regardless of which party is in power — take account of any international implications of its legislation. Overcoming this problem requires the recognition that, with power, there is responsibility. Perhaps US politicians can be persuaded that cooperation can actually reverse the perception, held in some quarters, of America's waning importance or influence. Note that the currency of the world's largest currency bloc, the euro area, will not even enter the picture until national governments effectively deal with the sovereign risks of its members.

Finally, just as imbalances built up over time under the Bretton Woods system, so today do imbalances, arguably perhaps of a different kind, continue to threaten the world economy (see also Figures 3a and 3b). Back in 1945, when the system was being created, reliance was on the nominal exchange rate anchor to provide the requisite incentives to ensure that domestic fiscal and monetary policies would guarantee the survival of the policy framework. Unfortunately, as previously discussed, how the regime was supposed to function was never fully explained. Today's issues are similar, but also include the macro-prudential concerns that became central in the aftermath of the global financial crisis of 2007–2009. Although policy makers are now better able to define how monetary policy functions both in normal and in crisis times, a great deal of uncertainty surrounds the role of fiscal policy, and even less is known about which macro-prudential tools to use and their effectiveness.[22]

Although several elements of the Bretton Woods system continue to resonate, today's environment likely has many more different considerations compared with the conditions that policy makers confronted in 1944. In retrospect, it is clear that a series of aggregate supply shocks — namely the oil prices shocks of 1973-1974 and 1978-1979 — contributed to preventing a revival of a Bretton Woods-style arrangement, whereas 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 of the state of macroeconomics today, all fiscal and monetary authorities are well aware that these two types of shocks require different policy responses.[23]

Arguably, one of the most important differences between then and now is the degree to which capital is mobile. Moreover, given especially the attempts to curtail the flow of "hot money," there are very few voices calling for a return to the restrictions on capital flows that marked much of the Bretton Woods period. In part, this is because these capital flows are seen as vital for emerging markets' development, although a case can be made that the ease of capital mobility may have slowed the pace of financial development that must surely accompany the rapid economic growth and catching-up phase of EME development.[24] Nevertheless, unlike the earlier era, policy makers today are not simply concerned about current account imbalances, but also the associated financial imbalances. More tellingly, since many of these imbalances accrue as a result of domestically driven

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

23 One parallel between the 1960s and the events of 2007–2009 not frequently discussed is that, in each period, the largest economic power, the United States, was fighting a financially debilitating war.

24 The current low interest environment encourages stronger capital flows and exchange rate systems that are relatively inflexible and amplify these flows so that they behave pro-cyclically. Consequently, Magud, Reinhart and Vesperoni (2011) suggest that regulations limiting access to foreign currencies in emerging markets may well prove to be a beneficial macro-prudential policy.

economic agendas, the resulting spillovers, we now know, can threaten the global economy.

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 2008-2009, 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 (Eichengreen and Park, 2008).

At the heart of the Bretton Woods standard is the anchoring of expectations to a form of exchange rate stability. Yet, despite complaints about exchange rate volatility, there is 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 goal against which the monetary authorities can be held to account. Indeed, such a system has the virtue of being relatively transparent and has 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.

At the end of World War II, a large number of Allied countries could be considered victors, but for all practical purposes, only a single power, the United States, would dominate politically (and certainly economically) for decades to come. In 2012, it can no longer be said that, in economic terms, we live in a unipolar world. Indeed, a perceptible shift seems underway towards a type of bipolarity, with the United States and a group of EMEs — the BRICS countries (Brazil, Russia, India, China and South Africa) — vying for economic influence with the euro area, which is, in principle, also a large competitor, but seemingly hobbled by a serious internal failure of coordination. As a result of this substantial shift in economic power since 1945, there are expectations that any international economic agreement involving a mixture of cooperative and coordinating elements will require some symmetry in contrast to the Bretton Woods standard, which was firmly built on an asymmetric relationship between the United States and the rest of the world. Furthermore, 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 message from politicians intent on redesigning international agreements is being drowned out by signals emanating from domestic policy makers, who warn about the severe limitations and risks associated with major reforms of this kind.

LESSONS LEARNED FROM BRETTON WOODS

History tends to favour incremental steps towards the reform of institutions and international policies. If this is the case, then Bretton Woods represents an aberration unlikely to be repeated. The fact that G20 politicians have scaled back their ambitions to create a new Bretton Woods-type arrangement — in spite of the global financial system's "near death" experience in 2008 — captures the inherent reticence of politicians to give up more sovereignty than is absolutely essential. Indeed, EMEs continue to see trade and competitive exchange rates as the surest path to creating economies that will eventually be mature enough to be significantly driven by domestic aggregate demand, and are resisting demands by the United States that they do at least part of the '"rebalancing" believed necessary to restore sustained global growth. The resulting impasse does not augur well for reaching even a modicum of a cooperative solution to the imbalances that plague the world's economy. Part of the difficulty is that economic solutions that are seemingly sound on purely economic principles may run up against political constraints within the EME block of countries. Whereas Bretton Woods 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 complicated by the fact that not all of the major participants play by democratic accountability rules. How this can be overcome remains unclear.

As stated in the previous section, the Bretton Woods system largely involved technical issues. All international agreements, however, have political aspects. As has been noted, its creators did not think through how the Bretton Woods regime would actually function. Perhaps, as Meltzer (2003: 620) points out, it was because "central bankers had a modest role" 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.

In retrospect, Bretton Woods asked 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 Bretton Woods case almost right from the start; although considerably more is known now about how economies function, finding the right balance is once again likely to evade policy makers unless they wish to negotiate an agreement that is far more complex than is desirable. It may be preferable to set broad limits on what countries can do to satisfy purely domestic considerations, and provide the necessary tools and resources to international organizations to independently assess member countries' policy stances — this in itself will require a commitment to transparency that is enforceable — while devoting increased attention to managing crises when they do happen. As Reinhart and Rogoff (2009) make clear in *This Time Is Different*, crises do occur on a regular basis and are likely unavoidable, while policy makers harbour the illusion that reforms can always prevent the next one from emerging. If there is no foolproof way to avoid a recurrence of crises, the international community should have at least some mechanism in place to deal with the "unexpected" when it happens, instead of being forced to react in an ad hoc manner, as was the case in the 2007–2009 crisis. This can only be accomplished by instilling the logic of collective action in policy makers. [25]

Bretton Woods teaches us that international standards that are based on faulty or incomplete thinking about the consequences of a system, or how a 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 such as Bretton Woods give a false sense that we know far more about how economies function and how they are likely to react to shocks emanating from different sources than we really do. The global financial crisis of 2008-2009 and the recent crisis in the euro zone have revealed that, contrary to the notion subscribed to until recently by most economists, namely that price stability and financial stability go hand in hand, the two can be quite separate phenomena. Instead of reaching for the moon, policy makers should acknowledge their past mistakes. In particular, central banks have stubbornly resisted acknowledging their complicity in the events that led up to the crisis of 2007–2009 — and should aim for undertakings that seem feasible and likely to elicit broad support. Grand designs and the reshaping of an entire financial architecture require more time than the typical political cycle permits and, surely, not everything about the existing regime is broken.

CONCLUSIONS

Several broad conclusions can be drawn from the foregoing review of the failure of certain policy regimes to last or provide the kind of economic stability so desired by policy makers and the public.

First, grand designs such as the Bretton Woods 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. Time and again, politicians overreach and agree to rules or create institutional arrangements that are inherently flawed.[26]

Second, the planning horizon of politicians is shorter than that of central bankers, and the reconsideration of treaties that are difficult to change is fraught with complexity. Treaty changes, moreover, are time-consuming to negotiate and have political and economic benefits that are likely to bear fruit only well after some future election. There are insufficient incentives to implement economic governance standards that are resistant to economic crises.

Third, unless politicians are willing to cede national sovereignty to supranational agencies (which may well dilute democratic accountability) or create rules so inflexible that they cannot accommodate alternative decision-making principles during crises, there is little reason to hope that any of the reforms to euro area governance currently being contemplated will resolve problems once and for all. 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 the ability of central banks to maintain their independence while supporting the notion of democratic accountability. Hence, 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 (Siklos, 2002 and 2010). 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. There are, no doubt, many challenges associated with such a proposal, such as who would issue the directive and how long it might remain in place, but a discussion of these matters is well beyond the scope of this paper.

25 Policy makers might greatly benefit from consulting Mancur Olson's (1965) seminal work on the behaviour and management of groups.

26 It is interesting, but beyond the scope of this paper, to consider whether politicians' desire to overreach is due to overconfidence in their ability to design durable policy regimes, or an inability or unwillingness to consider whether certain events represent the seeds of a crisis that is likely to be the responsibility of their successors in government.

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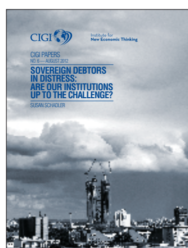

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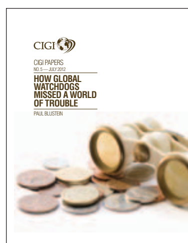

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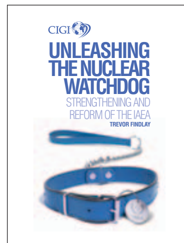
Paul Blustein

Based on interviews with scores of policy makers who worked on the Financial Stability Forum (FSF) and thousands of pages of previously undisclosed documents, this paper examines the FSF and brings to light the failure of regulators to keep pace with the globalization of the financial system.



UNLEASHING THE NUCLEAR WATCHDOG: STRENGTHENING AND REFORM OF THE IAEA

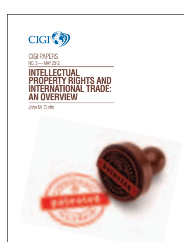
Trevor Findlay

Since its establishment in 1957, the IAEA has evolved deftly, and today, fulfills irreplaceable functions in the areas of nuclear safeguards, safety and the promotion of peaceful uses of nuclear energy. Based on more than two years of research, this paper concludes that while the IAEA does not need dramatic overhaul, it does need strengthening and reform.

A FLOP AND A DEBACLE: INSIDE THE IMF'S GLOBAL REBALANCING ACTS

Paul Blustein

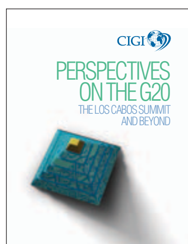
The need for economic cooperation among major powers is greater than ever, and a well-coordinated plan aimed at shrinking imbalances is seen as highly desirable. This paper is a detailed account of the initiatives, led by the IMF, to address imbalances prior to the 2008 global financial crisis.



INTELLECTUAL PROPERTY RIGHTS AND INTERNATIONAL TRADE: AN OVERVIEW

John M. Curtis

This paper examines extraordinary changes in intellectual property law and policy over the last 20 years, many as the result of their intersection with international trade and numerous international trade agreements brought into force during this period.



PERSPECTIVES ON THE G20: THE LOS CABOS SUMMIT AND BEYOND

CIGI Experts

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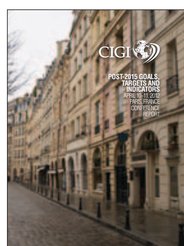

POST-2015 GOALS, TARGETS AND INDICATORS

Barry Carin and Nicole Bates-Eamer

The UN Millennium Development Goals have been remarkably successful in mobilizing resources to address the major gaps in human development, but future goals must reach beyond traditional development thinking. This conference report discusses possible indicators for 12 potential post-2015 successor goals.

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