Bretton Woods, R.I.P.

Richard Nixon unilaterally closed the gold window 40 years ago today.. No longer would the U.S. permit other countries to exchange their dollars for gold and by breaking that link, he ended the Bretton Woods international financial regime and ushered floating exchange rates that characterize the modern era.

Since nearly the day it died, there have been policy makers, investors and academics who have called for a new Bretton Woods. It is perfectly understandable. The macro-economic performance under Bretton Woods was remarkable. Real per capita income growth throughout the industrialized world was higher than during any monetary regime since 1879, according to Anna Schwartz, Milton Friedman's co-author to the landmark "A Monetary History of the United States". Inflation and its variability and persistence were low. Nominal interest rates were low and stable.

Paradise Lost

Less examined is the link between Bretton Woods and the superior macro-economic performance. Surely, there were other factors and forces that contributed to the favorable economic outcomes besides international monetary regime. These include the reconstruction after the war, the deploying of technological advances accelerated by the war effort, the unleashing of pent-up consumer demand, vigorous labor movements, and low commodity prices, including oil.

Bretton Woods is exaggerated in another way. Although the agreement was struck in 1944, it did not really become operational until 1959. That means in practice, it lasted a dozen years. Moreover, within years of its launch it became under increasing strains and increasingly it was understood not to be sustainable.

Contrary to popular misconceptions, Bretton Woods was not a fixed exchange rate system. It was designed as an adjustable peg, but politicians were reluctant to make adjustments, often for domestic considerations. A speculative attack or financial crisis often seemed necessary to provide a sufficient spur.

In addition to the unintended rigidity, Bretton Woods was also vulnerable because only the U.S. dollar was required to be convertible to gold. In this the French Gaullists and the American policy makers were in agreement. U.S. national self interest would make it reluctant to supply its gold to the rest of the world. The French economist and advisor Jacques Rueff saw this as did Robert Triffin (who spent some time at the Federal Reserve). Neither saw Bretton Woods as a sustainable order.

Golden Rule: He with the Gold makes the Rules

Discussions of Bretton Woods often focus on economic and monetary mechanisms and make little effort to consider the political conditions or the distribution of political power. What made possible the Gold Standard of the 19th century and Bretton Woods was that one country, Britain and the United States respectively, had sufficient power to enforce an international monetary order.

The distribution of political and economic power is in flux. This is after all part of the significance of the rise of a couple dozen emerging markets and especially China. A new financial architecture would institutionalize existing interests and power relationships. It does not seem realipolitik for China, for example, to accept a new institutional arrangement when trends suggest so strongly that it will have more global economic gravitas in 5 years and 10 years than it does today. Yet, it does seem in its interest to harangue about the current order.

This is one of the unexpected tragedies of Bretton Woods. At the end of WWII, the terms of a new international economic order had to be addressed for practical as well as ideological reasons. It could do nothing but reflect the power relationships at the time, but they were not sustainable in extremis.

While the U.S. still has a preponderance of power, the economic and political crisis has weakened it. The U.S. remains engaged in unpopular wars in Iraq and Afghanistan which pre-occupy its foreign policy and tax its resources. It does not have the strength to impose a new international financial order. The recent debt ceiling debate revealed a political dysfunction that undermines U.S. status arguably more than the S&P decision to cut its triple-A rating.

At the same time, there is no other country or group of countries that can have the power to impose a new regime on the U.S. In this context, calls for a new Bretton Woods agreement or a new international monetary order seem either utopian or simply a thinly veiled criticism of the U.S.

No Global Monetary Union

At Bretton Woods, Keynes proposed the creation of an international reserve asset he called "bancor". Some of the recent calls for the increased use for Special Drawing Rights to supplement and supplant the dollar as a reserve asset are very much in this vein.

A decade ago there was concern that the IMF was becoming increasingly irrelevant. The crisis has brought it back to the thick of things—now ironically back to Europe, where its initial important programs were. In addition to IMF participation in numerous aid packages for Europe since 2008, the G20 have delegated authority to it to monitor, advise and report on a range on macro-economic variables in order to redress global imbalances.

The other dimension of the irony is that the European debt crisis is partly caused and/or the policy response is hampered by having monetary union without political union. The calls for new international reserve asset seem to be a call to globalize this grand experiment while the jury is still out.

Weak Coordination

Although there was some fanfare at the time, there has been little progress. Global imbalances appear to be growing again. During the dog days of 2008-2009, there were numerous efforts for cooperation between the U.S., Europe, and Japan. Yet they were not very deep, and the response to recent renewed market volatility underscores the lack of coordination now.

Confronting a dramatic appreciation of the franc, and having lost a fortune on paper (unrealized) from its previously ineffective intervention, the SNB moved in early August to try to deter inflows. The Japanese yen is the other key safe haven currency. The coordinated intervention after the Japanese earthquake/tsunami was a one-off emergency situation and there was no inclination to repeat that. After the SNB took first mover advantage, Japan had little choice but to take action to minimize the risk of a new surge in an already appreciating currency. It intervened and increased in asset purchase program (QE).

The ECB responded to heightened tensions in the sovereign bond market and the freezing up of the European interbank market through liquidity provisions and renewed bond purchases. It was reluctant at first to buy Spanish and Italian bonds, but promises of new austerity measures, saw the ECB reverse itself.

Similarly, the Federal Reserve's policy step of putting a date on "extended period" was not a function of international cooperation or coordination. The Federal Reserve was responding to news that the U.S. economy grew at the anemic rate of 0.8% (annualized) in

H1 11 (the risk is that Q2 GDP is revised lower) and the general poor domestic economic performance. By driving down the U.S. interest rates, including the 2-year yield to within the Fed funds range and a new record low in 10-year yield near 2.25%, the FOMC announcement achieved at least part of what it sought under its recent $600 bln Treasury purchases plan.

A Trilateral Future?

It may not be polite to speak ill of the dead, but Bretton Woods has been romanticized. On the 40th anniversary of its death, the conditions do not exist for a new international economic order. The recent policy responses confirm that domestic considerations remain primary. This is especially telling now when economies are fragile and the political and economic elite in numerous countries are also facing crisis. The observation, as banal is it may be, nationalism continues to be a powerful inhibitor to the construction of a new international economic order.

The debates at Bretton Woods between the U.S. Henry Dexter White and Keynes for the U.K. turned on rights and responsibilities of the creditor and debtor. The U.S. position has shifted. It was the world's largest creditor in 1944 and now it is the world's largest debtor. It need not be a status quo power. Ironically, as China's net creditor status rises, (it is already the second largest in the world behind Japan), it may be drawn to White's arguments while the U.S. may find Keynes' arguments more compelling.

The current constellation of forces may seem conducive for the resurrection of the old trilateral. The dollar bloc is still the largest and most vital. There is no doubt that the Federal Reserve responds to domestic economic conditions, but many of its actions benefitted foreign banks more than U.S. banks. Even the bulk of reserves created to fund the $600 bln of Treasuries found their way to foreign banks. The Deutschemark bloc is now the euro bloc, with Germany the regional hegemon. Greater integration rather than less is likely to be born from the fires of crisis. The yen bloc was always the weakest part of the trilateral view. A yuan bloc may be more compelling, though it does not appear imminent.

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