Bretton Woods II: The Reemergence of the Bretton Woods System

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"One of the more remarkable features of the last hundred years of international monetary experience is the regularity with which one regime has superseded the other."[1] In fact, the fixed and floating rates have juggled for a dominant position with relative frequency over time. All of these regimes have been guided by the trilemma, which forces one to examine monetary policy, fixed exchange rates, and capital controls in an effort to discern the best two options given a set of circumstances and goals. Bretton Woods was a 1944 attempt by the United States and Britain to bring about an increase in trade utilizing a combination of fixed exchange rates and monetary policy. Although this system reverted to a floating exchange rate in the early 1970s, it reemerged as of the late 1990s.

This paper is divided into four sections. Section one identifies and characterizes the various groups that make up the Bretton Woods II framework. It studies their interaction as well as the motivations behind their roles within the Bretton Woods II framework. Section two provides a summary of both the similarities as well as the differences between the current system as compared to its predecessor. An analysis of the stability and sustainability of the system is contained in section three and a conclusion is provided in section four.

1 The Framework of the New Regime

The Asian economies of the late 1990s were in crisis; seeing a substantial as well as sudden reversal in capital flows. In considering their development strategy, Asia chose to follow the periphery strategy employed by Europe under Bretton Woods after the second world war. Thus they adopted a policy of an undervalued exchange rates, imposition of capital controls, accumulation of reserves, and encouraging export-led growth by sending goods abroad, and more specifically, to the system's center country.

The Bretton Woods II model classifies countries into three distinct groups: the center, the current account region and the trade account region; often referred to as the periphery. The trade account region, Asia, promotes growth via exports. In order to keep the prices

[1] Eichengreen (1995)

of their exports low, they keep an undervalued exchange rate taking on one of two forms. Some currencies such as the Chinese renminbi, the Hong Kong dollar and the Malaysian ringitt are formally pegged to the US dollar. Many others however, such as India, Korea, Taiwan, Thialand and Japan among others, are characterized by a managed float. They are not explicitly pegged to another currency, but they do intervene heavily when their currency appreciates.

Europe, Canada, Australia and most of Latin America comprise the capital account region. The current policy of these countries has been to allow their currency to float. Their governments have stayed out of international capital markets and there has been virtually no change in their official reserves over the last decade.[2]

The center is comprised of only one country, the United States that serves as the structure's intermediary. The States do not try to manage their exchange rate, nor do they accumulate official reserves; their willingness to be at the center of this system is motivated by growth. The United States' current account deficit, which last year was about 4.7 percent of GDP, has been financed by official inflows from the trade account region and from private investors in the capital account region under this system.

While the United States is running a current account deficit, Asia's current account is presently in surplus, helping to propel export growth through undervalued exchange rates. Furthermore the periphery also accumulates US reserves and thus provides cheap financing for the US current account deficit. The weak Asian currencies have the effect of making imports expensive, maintaining a low level of consumption and a high level of savings. This enables the periphery to finance export-led growth via high domestic savings.

Motivated by growth, the periphery's goal is seen to be two-fold; first to absorb the unproductive labor supply into the industrial sector wherein the new workers earn a higher wage while keeping the overall wage low by their influx. Secondly, the government strives for the accumulated capital stock to produce competitive goods relative to those produced

[2]Dooley, Folkerts–Landau and Garber (2003)

in other countries once all of the underemployed are absorbed into the industrial sector. As Dooley, Folkerts-Landau and Garber point out though, the cost of achieving both of these goals rapidly is high, both economically and politically. The government faces increasing costs per unit time; the slower the absorption, the greater the pool of potentially disruptive excess labor.[3]

2 A Comparison with Bretton Woods I

It becomes apparent that Bretton Woods and it's successor have been compared for a variety of reasons. Both regimes subscribe to the same choices given the trilemma. The role of the core country, the United States, has remained unchanged within the systems' framework. The periphery, despite name changes, still exists and promotes growth via exports aided by the undervalued exchange rate.

Despite similar classification, the two regimes do differ in a number of important ways. One difference is that Bretton Woods held exchange rates fixed and moreover they were fixed to gold rather than the dollar. It can be noted however that even though the system was nominally gold based, it was really a gold-dollar system. Under Bretton Woods II exchange rates in Asia, by and large are not fixed, but rather operate on a managed float system. This requires government intervention when the currency appreciates too much.

During the first regime's era, the core was the United States and the periphery Europe. Currently, the new periphery consists of the emerging markets in Asia, while the core has remained unchanged. Different from its elder sibling however, is the existence of a third block, the capital account counties. These countries, the former periphery, have "neither the periphery's scope for catch-up nor the reserve-currency country's ability to live beyond its means. . . "[4]

When comparing the frameworks the US and their current account also represent a

[3]Dooley, Folkerts–Landau and Garber (2004)
[4]Eichengreen (2004)

fundamental divergence. While in Bretton Woods the US ran a current account surplus throughout the 1960s, the US in recent years has been running large current account and trade deficits. Therefore the flows required to sustain the current system are larger than those associated with the initial Bretton Woods system. In fact, it is true that these flows have been comparatively higher.

The world has changed dramatically since Bretton Woods. The European periphery countries of the 1960s are different than those of East Asia today. Europe has a shared history, and at the conclusion of World War II was looking to rebuild institutions that could facilitate collective action and transnational governance.[5] On the other hand, Asia's stages of economic development, and therefore policy priorities, are less homogeneous, making definition of collective interests more difficult. This carries implications for the stability of the current regime.

3 Is Bretton Woods II Stable and Sustainable?

The case for the emergence of a new fixed exchange rate regime is fairly strong. With still keeping in mind the differences between the two systems, the similarities are striking. This then begs the question as to how long this new regime will last. Will it, like Bretton Woods, last a few decades with changes and modifications made along the way, or will it fall apart in a shorter time frame?

Certainly there have been conflicting view points on the longevity of Bretton Woods II. The proponents of the stability of the system have argued that the regime will remain in place for quite some time in view of the fact that there is a current Chinese rural population of 200 million underemployed workers yet to be absorbed into the modern sector. This suggests that it will remain committed to its strategy of export-led growth for a decade, perhaps even two given its ability to absorb at the rate of only 10 to 20 million per year.[6]

[5] Eichengreen (2004)
[6] Eichengreen (2004)

It has been asserted that although there was no periphery in the inter-Bretton Woods period, there are other countries looking to form the new periphery.[7] India is an example of a country already looking to join its Asian counterparts.

Meanwhile several issues have arisen to counter claims of sustainability. The current arrangement has created incentives to free ride and opt out of the cheap dollar financing cartel. As Roubini and Setser point out, "Individual Asian countries at some point will have an incentive to diversify out of the US dollar reserve into Euro reserves, so as to avoid capital losses, should their currencies appreciate relative to the dollar."[8] Over time this incentive strengthens as the US debt accumulates and the risk of major depreciation increases, giving rise to a collective action problem. All central banks may be better off if none try to diversify its reserve holdings. However as the risks of dollar depreciation grow, each central bank has an incentive to defect as a means of protection from potential large losses.

The current regime has been keeping US interest rates below what they would otherwise be, helping the interest-sensitive sectors of the economy. If Bretton Woods II is to be sustained, those sectors of the US economy that compete with Asian exports would be increasingly crowded out and the associated job losses and weakness of employment in the US manufacturing sector would lead to protectionist pressure.[9] The US will most likely not allow its manufacturing base to decline as sharply as a sustained Bretton Woods II system would imply.

Within the current framework, if Asia retains its managed exchange rate, most of the downward pressure on the US dollar will be channeled toward the Euro. This is not sustainable, as Europe cannot allow its tradable sector to be crowded out by its Asian competitors. This pressure could have one of three possible outcomes. The first is for Europe to join Asia in pegging or managing its currency thereby expanding Bretton Woods II's periphery. Another, and more likely option, is for Europe to put political pressure on the Asian

[7]Dooley, Folkerts-Landau and Garber (2003)
[8]Roubini and Setser (2004)
[9]Roubini and Setser (2004)

economies to allow their currencies to appreciate. The final option is for a European upsurge in protectionism.[10]

4 Conclusion

Bretton Woods II is in fact a close relative of the initial system. The differences however that distinguish the one from the other, present a new set of challenges in keeping the system stable and sustainable. While there are arguments both for and against a collapse in the short term, the current system's future hinges largely on Asia's willingness and ability to act as a collective unit, coupled with Europe's reaction to increasing pressure on the Euro.

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[10] Roubini and Setser (2004)