THE UNFINISHED TASK OF BRETTON WOODS: CREATING A GLOBAL RESERVE SYSTEM

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As we celebrate the achievements of Bretton Woods some seventy years ago—the creation of the World Bank and the IMF—we have to be mindful of what might have been done that was not. When Keynes came to Bretton Woods, he had (at least) two ambitions. One was to rid the UK of the status of the reserve currency. He understood how adverse being the reserve currency was for the UK economy. But Keynes was an internationalist: he did not simply want to foist the UK's problems on some other hapless country. He wanted to create a global reserve currency (for reasons that I shall explain shortly). He succeeded in the first objective, but failed in the second, but not for want of trying.

The United States was the central culprit. It was not that the United States did not believe in international institutions: the country was, after all, behind the creation of the United Nations (having perhaps come to realize the costs of not joining the League of Nations). It was to play a central role in the creation of the two new international

1. Much of my work in this area has been done with Bruce Greenwald, to whom I owe a great debt. See Greenwald, B. and J.E. Stiglitz, "A Modest Proposal for International Monetary Reform," in S. Griffith-Jones, J.A. Ocampo, and J.E. Stiglitz (eds), *Time for a Visible Hand: Lessons from the 2008 World Financial Crisis*, Initiative for Policy Dialogue Series (Oxford: Oxford University Press, 2010), pp. 314–344; and Greenwald, B. and J.E. Stiglitz, "Towards a New Global Reserves System," *Journal of Globalization and Development*, 1, 2 (2010). Some of the ideas here are elaborated in greater detail in Stiglitz, J.E., *Making Globalization Work* (New York: WW Norton, 2006). Financial support from INET is gratefully acknowledged.

economic institutions, the IMF and the World Bank. (It did not, however, sign on to what was supposed to be the third pillar of the new international economic order—an international trade organization, which was meant to prevent the kind of protectionism that had seemingly played such a role in the genesis of the Great Depression). But the US Treasury—long captured by the special interests of its own financial markets, and, to this day, still more parochial in many ways than either the White House or the State Department—seemingly saw the UK's weakness as an opportunity for the US dollar to become the new reserve currency. The Secretary of the Treasury, Henry Morgenthau, opposed the creation of a new global reserve currency. He did not seem to understand the disadvantages of being the reserve currency. The advantages of being able to borrow at a low interest rate may have been more apparent than the disadvantages of the resulting appreciation of the currency and weakening of aggregate demand. Perhaps he and the Treasury Department that he headed placed excessive value on the seeming hegemony that being the reserve currency might give to the reserve currency country.

Keynes thus left Bretton Woods with one of the two missions accomplished: UK ceded the mantel of the reserve currency to the US, but he failed to create a new global reserve currency.

There are, of course, three interacting reasons for this failure, which has proven to be so consequential: a failed understanding of the principles that govern international economics; a failure to be able to predict the evolution of the global economy, and what might be needed in response; and a failure of politics. It is the third that played the central role. It is important to understand the reasons for the failure if we are to rectify it: we have had ample opportunity to correct the mistake in the ensuing seventy years and to adapt to the changing global economic environment. Moreover, there have been significant increases in our understandings of the principles of economics. It is the politics that continues to be the impediment. One hopes that if we come to appreciate the consequences of *what we have not done*, there will be greater resolve to finish the unfinished business of Bretton Woods. I will argue here that while there was a compelling case for creating such a global reserve currency in 1944, changes in the global economy since have made doing so even more imperative.

Keynes' overarching concern was the lack of global aggregate demand. It was this that brought on the Great Depression. Many (including Paul Samuelson) assumed that,

with the end of World War II and the enormous source of demand that it provided, the economy would revert to recession. These concerns turned out to be wrong, but for reasons that are just now coming to be well understood.

The early part of the 20th century was a period of enormous economic transformation—a movement from agriculture to manufacturing; the huge increases in agricultural productivity were a double-edged sword. Though it meant that fewer and fewer people were required to work to meet the world's food needs, the surplus labor had to move from agriculture to manufacturing, and from the rural to the urban sector. Markets do not make these transformations well on their own. Incomes of farmers in the United States fell by some 50 to 75 percent in the space of three years, from 1929 to 1932, and this decline in income meant that they couldn't afford to move, and couldn't afford to get the education and training required for the "new economy" of the time. They were trapped, and so was the economy. The war added demand, but it was also a major industrial policy, helping people move and to get the training required. After the War, the GI bill provided a college education for anyone who had fought in the war (which was almost all young males) and wanted it.[2]

There were four other reasons that the pessimism about a return to depression turned out to be unfounded. The first was that whatever the causes of the Great Depression, the debt accumulated by many in America in the years prior exacerbated it, deepening and lengthening the downturn. The deflation associated with the Depression made matters worse, as the effective leverage increased further. By contrast, the high savings rate during the war meant that households left the war with a large legacy of savings. Indeed, the deficit was in their household assets, their durable goods.

The second was that though there were global imbalances, with the US having large surpluses, the Marshall plan helped "recycle" these surpluses to the European countries desperately in need of help. Later, global financial markets would allow developing and emerging countries to borrow large amounts, thereby supporting global aggregate demand.

The third was that the US government itself continued with strong expansionary government policies, under both Truman and Eisenhower. Indeed, Eisenhower, a Republican, supported massive infrastructure, education and technology programs,

2. Delli Gatti, D., M. Gallegati, B. Greenwald, A. Russo and J.E. Stiglitz, "Mobility Constraints, Productivity Trends, and Extended Crises," *Journal of Economic Behavior & Organization*, 83, 3 (2012): 375–393; Delli Gatti, D., M. Gallegati, B. Greenwald, A. Russo and J.E. Stiglitz, "Sectoral Imbalances and Long Run Crises," in F. Allen, M. Aoki, J.-P. Fitoussi, N. Kiyotaki, R. Gordon, and J.E. Stiglitz (eds), *The Global Macro Economy and Finance*, IEA Conference Volume No. 150-III (Houndmills, UK and New York: Palgrave), pp. 61–97.

so much so that even though the country had left the war with a record debt-to-GDP ratio, in most years the government continued to run deficits.[3]

The fourth was that inequality fell precipitously from the heights reached during the roaring 1920s. As a rule, those at the top consume a far smaller fraction of their income than those at the bottom, so that unless something offsetting occurs (like the creation of a housing bubble), a growth of inequality will lead to a reduced aggregate demand.[4] After World War II, the reverse occurred: greater equality led to stronger demand.

Today, we have in some ways returned to the "under-consumption" era of the 1930s. Emerging markets and developing countries that had sustained global aggregate demand learned the heavy lesson of the 1997 crisis: those running large deficits risked a financial crisis in which they would lose their economic independence to the IMF and their creditors. They also learned the advantages of running a surplus: export-led growth proved to be the most effective development strategy ever conceived; lower exchange rates could help sustain these exports in manufacturing, which enabled the emerging markets to reduce the knowledge gap separating them from the advanced countries—a gap even more important than the gap in resources.[5] Countries could get a lower exchange rate by building up reserves.

The fundamental law of trade, though, is that the sum of surpluses must equal the sum of deficits. If deficits are a problem, threatening economic stability, they are like a hot potato: a reduction of a deficit by one country must show up either in an increase in the deficit of another or a reduced surplus. And if the surplus countries actively and successfully managed to maintain their surpluses, then the reduced deficit by one country *will* be manifested in an increase in the deficit of another. As countries realized the risks of deficits, each struggled to make sure that it would be some *other* country that had the deficit. The United States, the reserve currency country, became the deficit country of last resort.

Triffin long ago pointed out the unsustainability of such a course of events:[6] these deficits, year after year, meant that confidence in the reserve currency country

3. U.S. Federal Reserve Bank of St. Louis, "Federal Surplus or Deficit [-] as Percent of Gross Domestic Product" (2014), available at http://research.stlouisfed.org/fred2/series/FYFSGDA188S (last accessed December 30, 2014).
4. See Piketty, T., *Capital in the Twenty-First Century* (Cambridge, MA: The Belknap Press of Harvard University Press, 2014); and Saez, E. and G. Zucman, "Wealth Inequality in the Unites States Since 1913: Evidence from Capitalized Income Tax Data," NBER Working Paper 20625 (2014). The latter estimate that the average saving rate for the wealthiest 1 percent of Americans was 36 percent from 1986 to 2012. In the years before the crisis, savings for the bottom 80 percent of Americans was negative; see Stiglitz, J.E., *Freefall: America, Free Markets, and the Sinking of the World Economy* (New York: WW Norton, 2010).
5. Greenwald, B. and J.E. Stiglitz, *Creating a Learning Society: A New Approach to Growth, Development, and Social Progress* (New York: Columbia University Press, 2014).

diminished.[7] If confidence weakened enough, the country could no longer serve effectively as a reserve currency.

But there is another problem: the demand for reserves by others leads to a higher value to the reserve currency (the dollar), contributing to a trade deficit, weakening aggregate demand. If the reserve currency country is to maintain full employment, this has to be offset somehow. The healthiest way is an investment boom; but if investment outpaces underlying demand, there will eventually be excess capacity, and it will not be sustained. In the case of the US tech bubble of the 1990s, the excess capacity was reached extraordinarily quickly. The US tried a second way—engineering a consumption bubble based on a housing bubble; but for obvious reasons, that too could only be a short-run palliative. The more typical way is to run fiscal deficits, as the US did in the Reagan and Bush years, and in the aftermath of the 2008 crisis. But this strategy exposes the country to a new form of the Triffin Paradox with the same consequences—the eventual erosion of confidence. Alternatively, the country striving not to expose itself to excessive indebtedness cuts back on government spending, and sinks into a recession or an extended malaise—only slightly better for confidence, and worse for global demand.

The consequences of this fundamental problem for global demand have been exacerbated by three forces reminiscent of the pre-World War II era: growing inequality in most countries,[8] with many households, firms, and governments burdened by heavy debt, and the need for structural transformation, indeed two transformations—now not from agricultural to manufacturing, but from manufacturing to the service sector; and a transformation necessitated by massive changes in global comparative advantage. As we noted, markets do not make these transformations smoothly on their own; and in the absence of government assistance, there is a high risk of getting trapped into structural stagnation.

In addition, there are two further factors making matters worse today. We noted that surpluses need not be a problem if the surpluses can be recycled, either through foreign assistance or through financial markets. The scale of the surpluses has

6. Triffin, R. *Gold and the Dollar Crisis: The Future of Convertibility* (New Haven, CT: Yale University Press, 1960).
7. There are but two ways that other countries can accumulate reserves in the reserve currency. The reserve currency country can have a trade deficit or it can make (net) investments abroad. In recent years, reserve accumulations have reflected a huge trade deficit.
8. Piketty (2014), op. cit.; Stiglitz, J.E., *The Price of Inequality: How Today's Divided Society Endangers Our Future* (New York: W.W. Norton, 2012).

become huge. But contrary to Bernanke's assertion of a savings glut,[9] savings do not exceed the investment needs of the global economy, which are huge—retrofitting the global economy to face the challenge of global warming and providing the basic infrastructure required by developing and emerging economies. The problem is that private financial markets have shown themselves not up to the task, either for the process of allocating capital or managing risk.[10] The Bretton Woods institutions themselves have not grown at the scale required, and the new institutions (the BRICS bank or the Asian Investment Fund), even when fully funded, will also be insufficient to fill the gap.

The irony is that these failures in global financial markets have occurred even though there has been a large increase in capital flows over the past seventy years. We are in a world markedly different from that of 1944—or even the early 1970s when the original Bretton Woods system broke down. Then, there was a hope that private markets might be stabilizing. Some might even have hoped that these capital flows could substitute for more and better official coordination among central banks. In the late 1990s and the years preceding the 2008 crisis, a market fundamentalist triumphalism even led the IMF and the US Treasury to advocate stripping away restrictions on capital movements. Even then, some academics pointed out that there was neither theory nor evidence in support of this view.[11] Now there is a broad consensus against such unfettered flows, reflected in recent IMF positions.[12]

These volatile capital flows, rather than sustaining global aggregate demand, may actually undermine it, in several ways. Worried about the consequences, countries have an incentive to build up even more reserves. The large exchange rate fluctuations to which they give rise have asymmetric effects, with those enabled to expand consumption doing so far less than those induced to contract consumption.[13]

9. Bernanke, B., "The global saving glut and the U.S. current account deficit," a speech at the Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia (March 10, 2005).
10. Wolf, M., *The Shifts and the Shocks* (New York: Penguin Press, 2014); Stiglitz (2010), op. cit.
11. Stiglitz, J.E., *Globalization and Its Discontents* (New York: W.W. Norton Company, 2002).
12. See International Monetary Fund, "The Liberalization and Management of Capital Flows: An Institutional View," (2012), available at http://www.imf.org/external/np/pp/eng/2012/111412.pdf (last accessed December 28, 2014), and several studies the IMF has conducted in recent years to support it (http://www.imf.org/external/pubs/ft/survey/so/2011/NEW040511B.htm).
13. Greenwald, B. and J.E. Stiglitz, "Financial Market Imperfections and Business Cycles," *Quarterly Journal of Economics*, 108, 1 (February 1993): 77–114.

Moreover, they make the prospects of moving from a single reserve currency to a multiple reserve currency less propitious. Shifts in confidence about the different currencies can lead to large destabilizing movements in the relative exchange rates among the reserve currency countries.

Changing institutional arrangements, especially in Europe, and ideologies, have compounded the problems. The eurozone has introduced into that region the kind of rigidity associated with the gold standard. The structural problems associated with the design of the eurozone itself have interacted with the region's commitment to austerity to reduce the deficits of the deficit countries, and increase the surplus of the surplus countries, increasing deficits elsewhere in the world, and weakening global aggregate demand.[14] But the austerity ideology has found adherents around the world, even as the IMF and others have shown the adverse economic effects.[15]

The world has once again entered into an era of deficient global aggregate demand. Excessively loose monetary policy and deregulation may have, at various times and places, provided a temporary respite. But now there is a significant risk of having entered into an extended period of malaise.

There is an obvious response: finish the work of Bretton Woods. As I have suggested, what Keynes argued for then is even more important today: a global reserve system. It is doable. Indeed, within the IMF there is an embryonic form of such a system in SDRs (special drawing rights). The International Commission of Experts on Reforms of the International Monetary and Financial System appointed by the President of the United Nations General Assembly in the aftermath of the 2008 crisis which I chaired (2010) urged this, and laid out a number of ways by which it could be done. Numerous countries, including China, Russia, and France, have at various times called

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14. Note that since the sum of deficits must equal the sum of surpluses, a reduction in deficits by one country must result in either an increase in deficits of others or a reduction of some countries' surpluses. Stiglitz, J.E., "Crises: Principles and Policies: With an Application to the Eurozone Crisis," in J.E. Stiglitz and D. Heymann (eds), *Life After Debt: The Origins and Resolutions of Debt Crisis* (Houndmills, UK and New York: Palgrave Macmillan, 2014), pp. 43–79; Stiglitz, J.E., "Can the Euro Be Saved? An Analysis of the Future of the Currency Union," *Revista di Politica Economica* (forthcoming).
15. The argument that there could be expansionary contractions (Alesina, A. and S. Ardagna, "Large Changes in Fiscal Policy: Taxes versus Spending," in Jeffrey R. Brown (ed.), *Tax Policy and the Economy*, Vol. 24 (Chicago: University of Chicago Press, 2010), pp. 35–68) was quickly refused by Baker (Baker, D., "The Myth of Expansionary Fiscal Austerity," Center for Economic Policy and Research working paper, October 2010), Jayadev and Konczal (Jayadev, A. and M. Konczal, "The Boom Not the Slump: The Right Time for Austerity," Roosevelt Institute working paper, 2010), and the IMF (International Monetary Fund, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," in *World Economic Outlook: Recovery, Risk, and Rebalancing*, Washington, DC: IMF, 2010, pp. 93–124). The argument that countries with debt to GDP ratios that were in excess of 90% would face slower growth (Reinhart, C.M. and K.S. Rogoff, "Growth in a Time of Debt," *American Economic Review: Papers & Proceedings*, 100 (2010); Reinhart, C.M. and K.S. Rogoff, "Growth in a Time of Debt," Working Paper 15639, National Bureau of Economic Research, 2010, available at: http://www.nber.org/papers/w15639, last accessed January 1, 2015) was subsequently critiqued by Herndon, T., M. Ash, and R. Pollin, "Does High Public Debt Consistently Stifle Economic Growth? A Critique of Reinhart and Rogoff," University of Massachusetts Political Economy Research Institute, Working Paper no. 322 (April 15, 2013).

for it. Even those at the highest level of the US administration have realized its virtues, but focusing more on the short-term benefits of the exorbitant privilege that being the reserve currency affords in being able to borrow cheaply, than on the long-term adverse consequences to domestic demand and growth, they ultimately pushed back and have been the major impediment now to the creation of a global reserve system—as they were back in 1944, seventy years ago.

Our report argued, however, that there was still a way forward: a coalition of the willing, agreements among other countries to develop reserve currency arrangements among themselves. We explained how, eventually, pressure would be brought to bear even on the US, even if it mistakenly tries to reap the benefits of the exorbitant privilege.

The current system is inequitable and unstable. And the current system poses a risk for an extended period of underperformance of the overall global economic system. We are paying a high price for our failure to do what should have been done in 1944.

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