THE WORLD FINANCIAL CRISIS*

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The Bretton Woods System (1942-1944)

The Second World War provided unique opportunities for friendly and leisurely financial negotiations between the United States, Britain, and other Western countries which were at that time considered as lesser allies. Friendly because of the non-competitive climate engendered by brotherhood in arms, and by the very generous lend lease agreements; leisurely because of the time needed to build up the forces which landed in Normandy. The Bretton Woods system, which was born in the same month as the successful invasion of Europe, is, in our view, a cocktail mixture of seven components, three of them inherited from the recent past. These were:

i) *Fixed exchange rates* which had been adopted by the United States, Britain and France under the 1936 Tripartite Agreement. These countries were soon joined by Belgium, the Netherlands and Switzerland. The recent experience of two bouts of uncontrollable or competitive devaluations had convinced everybody that exchange rates should not fluctuate from day to day.

ii) *Bilateral credits* between central banks and government had been developed in the thirties out of the necessity to export goods in principle, but often unemployment in fact.

iii) *Two reserve currencies* had, since the twenties, enjoyed this status - the advantages of which for national financial activities were then more apparent than the constraints they imposed on governments, industry, and labour; they were, of course, the mighty dollar and the already shaken pound.

The other four ingredients were war-time inventions (although, as in the case of most inventions, the nucleus was already in existence). They were:

iv) *Multilateral credits*, or two-step lending, from the creditors to an

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institution(the IMF) and from that institution to the debtors.

v) *An international definition of the price of gold* which replaced a set of national definitions. The 35 U.S. dollars price per troy ounce a (strange unit of weight for people used to the metric system) had prevailed for ten years and was chosen for no other reason than this seniority. The price of gold was such that the yearly supply exceeded the non-monetary demand by an amount which no one at the time thought of justifying, let alone projecting into future years.

vi) *Balance of payments adjustment to be carried out,if necessary, by the debtor countries only.* This can be seen either as a decision based on Protestant ethics (accumulation is virtuous and falling into debt is sinful), or as a result of superior American influence (America expected to remain a creditor for ever and a day).

vii) *Majority decisions, with American and British veto rights.* The first part of this ingredient seems quite obvious at present, while the second was just as obvious at a time when the United States and Britain were, by far, the most important Western military and political powers.

Of course, some of the components of the Bretton Woods system would have been very different in 1924 or in 1964; as they were, they seemed reasonable at the last stage of a war in which Germany and Japan were being completely destroyed, and at a time when France and other occupied Western European countries had no means of expressing political, economic or financial views.

The Next Twenty Years (1944-1964)

These two decades can be seen as a long prologue to the present drama. Let us find out what happened to the seven main Bretton Woods' ideas.

i) Exchange rate stability was, on the whole, well maintained in developed Western countries, the exceptions being the unavoidable readjustment of 1949, a sensible minor German and Dutch revaluation in 1961, and lastly some French and Canadian vagaries.

ii) Of the reserve currencies, the pound sank into its final decline, while the dollar was contested first by private foreign investors, then by private foreign bankers, and finally by foreign central banks (of course the methods of contestation varied from one group to another).

iii) Bilateral debtors were subject to more and more constraints. The movement was from commercial conditions (interest, guarantees, timing of reimbursement); to external economic policy conditions (e.g. undertakings to use exchange control rather than customs duties); to internal economic policy conditions (putting one's house in order through unpopular taxes or wage limitation); and lastly to frankly political conditions (stopping a war the creditor did not approve of, or supporting him in the United Nations). As long as the main creditor was America, she succeeded in imposing each of these conditions on her debtors, for example at the time of the Dutch "police action" in Indonesia (1949),or when Britain and France became involved in the Suez war (1956).

When they became creditors, the French tried to follow this example - over the American war in Vietnam. Their attempt failed, and they were accused of sabotaging the world financial system, and of "rocking the boat we are all in".

iv) Multilateral credits and resulting balance of payments adjustment processes worked well, but in a European context, through the European Payments Union (1950-1957),rather than in the framework of the IMF. The reduced activity of the latter,we are now speaking of the period 1944-1964,was due partly to insufficient resources, partly to over conservative management,and partly to a multilateral lending mechanism far more complicated than that of the EPU.

v) In spite of fairly fast world price inflation coupled with a fixed selling price, the supply of new gold did surprisingly well; but the non-monetary demand, enhanced by the comparatively low price of the metal, soared much more than was anticipated. By 1964, the absorption of all newly mined gold by institutions or persons other than the central banks (industry,jewellery, dentistry, hoarding) began to seem probable in the not too distant future.

vi) The voting procedures of the IMF remained practically untested. It is difficult to gauge whether their existence played a backstage role in various financial negotiations.

Taking an overall view, one can pass a favourable judgment on the first twenty years of the Bretton Woods'"Brave New World." In 1964 its two weaknesses which,could have been remedied then,appear to have been:

i) A price of gold which became out of date. In Balzac's days, "la femme de trente ans" was an ageing woman; in our days, thirty years may be the limit of the usefulness of a gold parity.

ii) An involvement of world finance in world politics. This vice was foreseen by Keynes in the speech he delivered at the christening of the IMF and

IBRD. According to Harrod he said:

"I hope that there is no malicious fairy, no Carabosse, whom some one has overlooked and forgotten to ask to the party. For if so the curses which that bad fairy will pronounce will, I feel sure, run as follows:- 'You two brats shall grow up politicians; your every thought and act shall have an arrière-pensée; everything you determine shall not be for its own sake or on its own merits but because of something else.'

"If this should happen, then the best that could befall, and that is how it might turn out, would be for the children to fall into an eternal slumber, never to waken or be heard of again in the courts and markets of mankind".[1]

It seems to us that Carabosse won the day, in spite of brave efforts by the founders of the IMF. Can one imagine, for instance, the American representative on the Board of Directors agreeing to an IMF credit to the Netherlands at the time of the "police action" in Indonesia, or to Great Britain at the time of Suez? Or can one visualise a high level policy discussion in Washington nowadays in which someone would say "The French are right, and the IMF should not lend us anything more until we have solved our balance of payments problem by internal economic policy measures"?

Of course, it is easy to be wise after the event. So let us be modest and add that, only five years ago, no one could have predicted the strength and the successes of the speculators. In our opinion, it was they who conducted the main onslaught on the Bretton Woods system, much more than any politician or economist.

The Present Drama (1964-1969)

Like most classical dramas, the present financial one is in five acts- the last of which has not yet been played at the time of writing. The main characters are the United States, Germany, Britain, France, South Africa, and the speculators. Minor roles can be attributed to some other members of the group of Ten (Italy, Belgium, the Netherlands, and Switzerland which is the eleventh member of this group). The rest of the world does not really matter, whatever it may think.

Act One (November 1967. Scene 1 in London; Scene 2 in Basle).

The twilight of the pound - The alignment was:

Against the pound	For the pound	Neutrals
The speculators	Britain	The United States
France		Germany

1. HARROD, R., *"The Life of John Maynard Keynes"*, Macmillan, London, 1951. The quotation has been slightly shortened.

By November 1967, most of the world thought that the 2.80 dollars per pound exchange rate could not be maintained. The issue was not the principle of the devaluation, but the extent. The British chose one-seventh, which was judged neither too little nor too much, and the accompanying measures were politely found adequate by the official financial circles, so the damage for Britain was limited. The victors were the speculators, who made large profits, and the French, who proved how wise they had been to block the admission of a country with such a weak currency into the Common Market.

Act Two (Four months later; only one scene, in Washington).

Gold's hour of glory. - The alignment was:

For a rise in the price of gold	For the status quo	Neutrals
South Africa	The United States	Germany
France	Britain	Italy
The speculators		Belgium
		The Netherlands

The Washington meeting had two strange characteristics: the battle was lost before it began, and the victors were not represented. Thus the discussions were on the organization of an orderly retreat. This succeeded,and the participants decided that there would be two gold markets, and also declared that they felt that their own official gold stocks were high enough,that they would not buy any more for the time being, and that they would not sell on the free market at 38, 40 or 42 dollars, an asset which they insisted was worth only 35 dollars to them. An unstable equilibrium - with an "Alice in Wonderland" background - has lasted now for more than a year.

It may be worthwhile wondering why the American government fought so hard to save a gold parity,a mere figure for the academic economist,which was by then 34 years old. The reason is that a rise of the price of gold in terms of all currencies (a possibility foreseen in the IMF agreement) inevitably means a drop in the gold content of the dollar, or, to use a horrible expression, a devaluation of the dollar. This was found to be politically impossible.

"From the beginning of the war onwards, and in the early post-war years, the United States gold reserves continued to rise. Foreign countries treated dollar holdings as the equivalent of gold holdings; the dollar became the leading international currency. During the period of dollar shortage, the devaluation of the dollar would have been an obvious nonsense. Revaluation would not have been selective enough in correcting the structural disequilibria between the various exchange-rates. It seemed more appropriate to bridge the dollar gap by providing aid to Western Europe, and to agitate for other world currencies to devalue by varying amounts as against the dollar. This is what happened in September 1949.

"Since 1958, the position has changed: the United States has had a large overall balance of payments deficit, and her gold reserves have been falling rapidly. But there has been strong and most universal opposition in the United States to the idea of devaluation.

"Some of the arguments are similar to those of the European 'classical' Conservatives. This fixity of the exchange-rate between the dollar and gold is a matter of national prestige: to change it would be to admit to a national defeat.

"Secondly, the United States has had, as one of its major policy objectives in international affairs, the building of a stable economic and monetary system in the Western world. This system should be based on fixed exchange-rates and convertibility.

"Thirdly, since the dollar had become a reserve currency, the devaluation of the dollar would be a severe blow to all the States which had their reserves in dollars. Their confidence in the leadership of the United States would be drastically weakened.

"Finally, a dollar devaluation would be, as it were, a free gift to the two main world gold producers, the Union of South Africa, and the Soviet Union. Obviously the American Government was unlikely to be enthusiastic for a policy of this kind.

"These were the constraints which deterred the American Government from devaluing."[2]

The victors were, as shown above, France, who wanted revenge on the dollar; South Africa, who wanted a higher price for her main export; and the speculators, who wanted a quick profits. A European would think nowadays that speculating is not less ethical on gold than on securities, copper or silver. But this is obviously not the view in Britain or America.

"The rush was on because speculators - some avaricious, some panicky, some merely prudent, had become convinced that the U.S. and its partners could not much longer maintain the $35 price.

"If the U.S. could no longer sell gold to all takers at $35 an ounce and the price were allowed to rise to meet the demand, the speculators stood to make a handsome profit, just as they had in the devaluation of the pound sterling last November.

"Having tasted blood then, many scented another kill and, in their wild

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2. KIRSCHEN, E.S. and associates, *"Economic Policy in our Time"*, North Holland Publishing Company, 1964.

buying, ripped and clawed at the remaining gold stocks in the Gold Pool.

"Who were the speculators? The identity of most was veiled in the secrecy of Swiss Bankers' files, but they were situated throughout the world. Perhaps as much as 40 per cent of Swiss bank purchases were destined for safekeeping in the coffers of Middle Eastern sheiks and oil potentates. Latin American businessmen, affluent overseas Chinese, Asian generals-all claimed a piece of the action. The central banks of may smaller nations with precarious national reserve margins, including some Communist Eastern European countries, had undoubtedly joined in to protect themselves. More in sorrow than in greed, European corporations moved into the buying to hedge their foreign-currency holdings. So did some wealthy Americans with numbered Swiss accounts, although it is illegal for U.S. citizens to own gold bullion".3

Act Three (Scene 1, two months later, near the Sorbonne in Paris; scene 2, one month later, at the Elysee, also in Paris).

The Tarpeian Rock is quite near the Capitol.

France's triumph in the gold battle was extremely short-lived. A redheaded stateless student of German origin led a revolt against the organization of the French University, against the French Government, against the Mass Consumption Society. When the fumes of tear-gas dissolved, the French Government won an electoral triumph, and the French franc lay gravely wounded. A ten year creeping inflation in France had joined its effects with those of private capital frightened and seeking refuge abroad and with those of an enormous (13 per cent) wage increase for most of the labour force. From now on, the speculators were reinforced by a strong French contingent. The official reaction was to grant credits to industry in order to allow it to invest and thus remain competitive in spite of the wage increases. Industrialists saw their chance of a quick kill if either the franc was devalued or the mark was revalued; so they left investment for later, and sent their cash to Germany.

Act Three ends thus with no winners, and the French state as a probable loser.

Act Four (Scene 1 in Bonn five months later, in November 1968; scene 2 also in Bonn, on the next day; scene 3 in Paris, a week later).

Les Journees des dupes - For the first scene, the alignment was:

For a revaluation of the Deutsch mark	Against a revaluation of the Deutsch mark
United States ,	Germany
Britain	(The Common Market Commission)
France	
The speculators	

3. *THE TIMES*, London, March 21st, 1968.

The first day's battle was mainly everybody against Germany; the Common Market Commission, which believed in stable exchange rates was the Germans' only ally, but had been firmly turned out of the debating room at French insistence.[4] The United States, Britain and France all saw in a revaluation of the mark their main chance of avoiding a devaluation of their own currency.

The German government, on a majority vote, instructed its delegates to stone-wall. Why should Germany, they argued,take corrective exchange measures when it had behaved according to all sound economic rules: little inflation, little unemployment, and healthy long term growth?

So on the next day, it was the turn of the French to be isolated, with everyone asking them to soothe the foreign exchange markets by gracefully agreeing to devalue their currency. This was accepted by the French delegates, and rejected, a few days later, by the French Government.

Act Four had thus no winner and no loser - the suspense continued. Act Five, at the time of this lecture, that is five months later,has not yet been played, but something is bound to happen before the end of the year 1969.

The Main Solutions

The problems of international finance have now become so numerous and so urgent that temporary expedients can only be of benefit to the speculators. We shall conclude with an outline of some of the main solutions.

Fluctuating exchange rates. This return to the conditions of the early twenties and the early thirties is the darling of many academic economists, who cherish the idea of more flexibility in economic mechanisms, either through the laws of the market, or through the action of skillful policy makers. The trouble is that fluctuating exchange rates (even under the modern form of sliding parties) would mean hell for the trader and for the industrialist, compelled to add exchange rate forecasting to the list of their professional skills. In this matter, the opinion of economists matters less than that of producers of goods and services.

A revaluation of gold in respect of all currencies. Such a revaluation should amount to something like 50 per cent (25 per cent is already a fact in the Zurich market and the Rueff 100 per cent is unnecessary). It would be very useful in the present juncture, by boosting international liquidities and allowing the world monetary authorities time (something like fifteen years)

4. Some witnesses affirm that the Commission's delegates did try to influence the discussions by hiding in the cloakroom.

to think of more fundamental solutions.

A concerted modification of present parities. This solution is essentially short-term, and can very well be combined with the preceeding one, which entails medium term effects. One could imagine that the present dollar exchange rates would go down 5 per cent for the mark, up 5 per cent for the pound, up 10 per cent for the French franc.

Of course, this would play havoc with the European Common Market agricultural policy.

A wiser world and new means of payment. We believe that a day will come somewhere round the year 2,000 when all Western nations will realize that it is in their interest to create a truly supra-national body to manage world financial affairs. This happened in the last century for the Universal Postal Union, and at the beginning of the present century for the International Court of Justice in the Hague. Both institutions can claim credit for having resisted national pressures for the sake of the whole world. When the time is ripe, and only then, the optimum solution will become politically feasible. This will mean that decisions will be taken by majority, with no country enjoying either *de jure* or *de facto* right of veto; the end of privileged reserve currencies; a world currency, of which the special drawing rights are a timid forerunner; and the final exit of gold, not thrown away as a "barbarous relic", but, like silver at present, performing an honourable and valuable role as an industrial and artistic metal.