The System that Became a Non-System: The End of Bretton Woods Fifty Years Later

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Introduction: a failure of policy cooperation

Bretton Woods is a steppingstone in the history of the post-war world. Many aspects of the system that was agreed in 1944 at the conference held in Bretton Woods, New Hampshire, notably the institutions and the dollar at the core of international trade and finance, remain in place to these days, albeit with some significant changes. What ended, on 15 August 1971, by Richard Nixon's unilateral decision, was the dollar convertibility at 35 dollars for an ounce of gold.

Nixon's resolution came at a difficult time for the dollar which had been under pressure for some years. Throughout the 1960s, and especially after 1965, increased government spending on social programmes at home, and the war in Vietnam had undermined international confidence in the economic policy of the United States. Because of the widening deficit in the US balance of payments, European governments were growing anxious over the risk of being left with dollars that couldn't be converted into their gold equivalent. During this period, almost two-thirds of the United States' cumulative deficit was transferred in the form of gold, mostly to Europe. By 1966 the US gold reserves had shrunk to the equivalent of 13.2 billion dollars, but only 3.2 billion of this was available to cover foreign dollar holdings as the remainder was needed to cover domestic holdings. Foreign central banks and governments held more than $14 billion, and this amount could, in principle, be converted into gold. The official dollar reserves, then, had grown larger than the US gold stock at the fixed gold–dollar parity.[1]

Economic and diplomatic relations between the United States and its partners soon came under strain. The situation exacerbated when domestic political pressures pushed the former into making foreign aid conditional on the removal of discriminatory barriers aimed at US exports.[2] In 1965, the Johnson administration adopted an inflationary policy that triggered global inflation, putting Europe and Japan under increasing pressure. France's response, between 1965 and 1968, was to convert its dollar holdings into gold, which served to further undermine confidence in the US currency. At the same time, the US public opinion was growing increasingly hostile towards the war in Vietnam and Congress was contemplating curbing foreign imports. Against this background, speculators were eager to bet on devaluations of the dollar, or revaluations of the European or Japanese currencies. Eventually, President Nixon decided to fold the system.

By then Bretton Woods had run for about 25 years, from 1946 when thirty-two countries set their par values.[3] This endurance was ensured by limited capital mobility and the willingness of the United States to offer monetary leadership by upholding the value of the dollar and providing liquidity internationally. The emergence of the dollar as the key international currency, coupled with sterling's relative decline, was an outcome that John Maynard Keynes and Harry Dexter White, the two architects of Bretton Woods, had not envisioned. But there was no other option; only the dollar could ensure capital for the post-war reconstruction and underpin the speculative

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[1] P. Subacchi, *The Cost of Free Money: How Unfettered Capital Threatens Our Economic Future*, Yale University Press, New Haven and London, 2020, pp. 52-53; B.J. Cohen, "Bretton Woods System", in *Routledge Encyclopaedia of International Political Economy*, ed. B. Jones, Routledge, London, 2002, p. 88.
[2] R. Solomon, *The International Monetary System, 1945-1976: An Insider's View*, Harper & Row, New York, 1976, p. 27.
[3] The full convertible phase lasted a bit more than a decade, from 1959 to 1971.

short-term capital movements that started in the 1950s. These would eventually undermine capital controls in most countries, making it difficult for monetary authorities to maintain a parity far apart from the fundamentals. Thus, the willingness of the United States to keep liquidity in the system – or to supply dollars 'on demand' – was critical for the whole international monetary system. This in turn proved to be pivotal for the post-war reconstruction and economic growth in western Europe. Dollars were supplied through private and official long-term capital outflows in excess of the current account surplus. The establishment in the late 1950s of the offshore 'eurodollar' market – dollars that circulate overseas outside of the Federal Reserve's jurisdiction – was a consequence of this excess and further contributed to expanding dollar liquidity.[4]

Under the Bretton Woods system currencies were effectively pegged to the dollar, and so the dollar was – and still is – the main form in which foreign central banks and governments held international reserves. Even if the system was predicated on fixed, but adjustable exchange rates, countries were reluctant to devalue their currencies when it was necessary to rebalance their external position. The British government, that had to devalue sterling in 1949 by 30[5] per cent to $2.80 took the brunt of what was perceived as a public humiliation even if it was needed to narrow Britain's current account deficit.[6] Upward adjustments were equally hard. In the late 1960s, Germany was confronted with the need to revalue the deutschmark as the dollar was under pressure, but the government stubbornly re-

[4] Subacchi, *The Cost of Free Money*, p. 51; C.R. Schenk, "The Origins of the Eurodollar Market in London: 1955–1963", in *Explorations in Economic History*, vol. 35, no. 2, April 1998, pp. 221-238.

[5] Britain restored convertibility for current account transactions in 1947 because of pressures from the United States. This triggered a run on sterling and in just a couple of weeks, Britain had depleted $3.5 billion of newly acquired funds. Convertibility was suspended on 20 August 1947 and exchange controls were put back in place.

[6] The Chancellor of the Exchequer Sir Stafford Cripps took the hit for the devaluation, that he had reluctantly pursued; after the devaluation his net approval rating, as recorded by Gallup, was down to 11 per cent, from 33 per cent in early 1949. P. Clarke, *The Cripps Version: The Life of Sir Stafford Cripps*, Allen Lane, London, 2002, pp. 518-519.

fused, arguing that the burden of the currency realignment should be borne by the French franc. France, however, was not keen to embrace austerity and deflationary policies to correct their deficits. When the franc came under pressure, the government decided to tighten exchange and credit controls to avoid being forced in a unilateral devaluation. Eventually, in October 1969, the German government[7] caved in and revalued the deutschmark by 9.3 per cent despite strong domestic opposition.[8] This decision, however, came after the French government's announcement in August 1969 of an 11.1 per cent devaluation backed by an International Monetary Fund (IMF) programme.

As capital controls were becoming more porous from the late 1950s and short-term capital mobility was increasing, the unwillingness to adjust the exchange rates made speculative attacks easier. As a result, the Bretton Woods system became more fragile and increasingly dependent on emergency finance to maintain stability. For instance, in 1956, the IMF was called in to provide emergency lending to Britain as the Suez Canal crisis put sterling under pressure; this provision far exceeded Britain's quota in the IMF. A series of currency crises ensued throughout the late 1950s and 1960s, resulting in increasingly larger rescues.

Many factors contributed to the end of the system of dollar convertibly that was at the core of the Bretton Woods agreements. While an in-depth discussion falls outside the remit of this article,[9] the unfolding of Bretton Woods points to an overall failure in policy cooperation and burden-sharing. Monetary adjustments required cooperation between the United States and western Europe, while

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[7] It was the government, not the central bank, that decided on whether to change the parity.

[8] P. Subacchi, "An economic and monetary 'experiment' gone too far?" in *Annals of the Fondazione Luigi Einaudi*, forthcoming; B. Eichengreen, *The European Economy since 1945: Coordinated Capitalism and Beyond*, Princeton University Press, Princeton and Oxford, 2007, pp. 191-192.

[9] For a discussion about the end of Bretton Woods see Subacchi, *The Cost of Free Money*, pp. 53-59.

a cooperative approach to such adjustments required readiness to compromise domestic objectives to stabilise the system. Cooperation was not helped by the fact that the post-war economic boom had begun to run out of steam, especially in Europe where the rapid catch-up growth of the 1950s and 1960s had ran its course, even though the productivity gap with the United States was not completely closed.[10]

We are still talking about Bretton Woods

Despite the unwillingness to cooperate was at the heart of the events of August 1971, over the years Bretton Woods has come to epitomise international policy cooperation. It is regularly invoked at times of crisis. In 2008, amid the worst financial crisis since the Wall Street Crash in 1929, the French President Nicolas Sarkozy called for a "new Bretton Woods"[11], although he did not provide the details of a thought-through proposal. Subsequently, in 2011 the G20 under the French presidency put the reform of the international monetary system at the core of its agenda, but without any significant outcome.

All plans aimed at re-establishing the spirit, if not the achievements of the Bretton Woods conference, have been unsuccessful. There are three reasons that account for this unsuccess. First, these plans have focused more on the myth[12] of Bretton Woods rather than on the context that made it possible. Indeed, Bretton Woods was not the result of a single conference, but was built over many years beforehand and predicated on the intellectual backdrop of the time.[13]

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[10] N. Crafts and G. Toniolo, "Reflections on the country studies", in *Economic Growth in Europe Since 1945*, ed. N. Crafts and G. Toniolo, Cambridge University Press, Cambridge, 1996, p. 576.
[11] J. Eaglesham and B. Hall, "Brown, Sarkozy Seek 'New Bretton Woods'", in *Financial Times*, 2 November 2008, https://www.ft.com/content/7be46fee-a92c-11dd-a19a-000077b07658.
[12] Harold James in this issue.
[13] Subacchi, *The Cost of Free Money*, p. 37. See also E. Helleiner, "A Bretton Woods Moment? The 2007-2008 Crisis and the Future of Global Finance", in *International Affairs*, vol. 86, issue 3, May 2010, pp. 620-627, https://doi.org/10.1111/j.14682346.2010.00901.x.

Second, calls for a new Bretton Woods seem to ignore that the system, like the subsequent non-system, glued network externalities embedded in the dollar as the key international currency, and not by policy cooperation. These externalities ensure the dollar's extensive use by lowering transaction costs, provide higher liquidity compared with other currencies and create inertia in monetary transactions. In other words, the dollar allows the functioning of the international monetary system. With the dollar being used in approximately 80 per cent of trade transactions and about 60 per cent of international banking claims and liabilities,[14] the current system is dependent on the dollar and there is no plausible substitute available yet. The creation of the euro in the late 1990s has increased the possibility of multiple international currencies coexisting. The euro is the world's leading international currency after the dollar, but it remains a regional currency. The Chinese renminbi is still an international currency in progress. Central bank digital currencies should facilitate payments, but without changing the fundamentals of the international monetary system.

The third and most important reason why calls for a new Bretton Woods has been unsuccessful relates to the role played by the United States. The Bretton Woods agreement was possible because the United States decided to abandon its isolationist policies which had been prevalent throughout the 1930s, to take an active role in setting up and leading the postwar economic order, so to pave the way for a more open and stable world economy.[15] Because of its economic strength, security and geopolitical leverage, the United States could

[14] That is, 80 per cent of export invoicing and 60 per cent of international and foreign currency banking claims and liabilities. Bertaut et al., "The International Role of the U.S. Dollar", in FEDS Notes, Board of Governors of the Federal Reserve System, Washington, 6 October 2021, https://doi.org/10.17016/2380-7172.2998.

[15] Subacchi, *The Cost of Free Money*, p. 38. The hegemonic stability theory was first elaborated by C.P. Kindleberger in *The World in Depression 1919-1939*, University of California Press, Berkeley and Los Angeles, 1973, 40th anniversary edition, 2013. Kindleberger's theory of hegemonic stability states that only a hegemon, or a dominant power, can step up and take responsibility for stabilising the liberal international order.

enable international cooperation within the context of the Bretton Woods system.[16]

The demise of Bretton Woods and the closing of the 'gold window' removed the fundamental feature on which the system rested. The world permanently shifted to an inconsistent framework – or non-system[17] – where fixed and floating exchange rates coexist. The removal of capital controls and the deregulation of domestic and international capital markets resulted in increased capital mobility.[18] A light-touch policy framework, embraced in the United States and Britain – the two countries that had led the Bretton Woods conference – by the governments of Ronald Reagan and Margaret Thatcher revolved around flexible exchange rates, reduced fiscal policies and government budget deficits to be balanced in the longer term. Monetary policy became the main policy tool for managing domestic demand. The fundamentals of growth and inflation would now determine the exchange rate and central banks, which would acquire operational independence over the years, would be the ones to intervene to smooth volatility.

The importance of the exchange rate and capital flows for domestic growth and full employment made the new non-system more interconnected than before. Starting in the 1980s, the advanced economies and many developing countries removed capital controls to stimulate international trade and expand output. It was the beginning of the financialisation of the world economy. Thatcher liberalised Britain's capital movements in 1979, followed by the French

[16] B. Eichengreen, "Bretton Woods After 50", in *Review of Political Economy*, vol. 33, no. 4, 2021, pp. 552-569, DOI: 10.1080/09538259.2021.1952011.
[17] J. Williamson, "The Benefits and Costs of an International Monetary Nonsystem", in *Reflections on Jamaica*, ed. E.M. Bernstein et al., Princeton Essays in International Finance 115, Princeton University Press, Princeton, NJ, 1976.
[18] Barry Eichengreen argues that pressure to ease restrictions on cross-border capital flows was such that the Bretton Wood would have not survived much longer, should the United States have not removed the dollar convertibility. B. Eichengreen, *Globalizing Capital: A History of the International Monetary System*, Princeton University Press, Princeton, NJ, 2019.

socialist government's "tournant de la rigueur" in 1983, which ushered in financial liberalisation within Europe.[19]

High international capital mobility ended up causing several episodes of financial instability between the 1980s and 2000s. With hindsight, financial liberalisation should have been stabilised with the creation of appropriate rules and international policy cooperation. But any attempt at policy cooperation after 1971 was directly obstructed by the belief in the market's ability to self-adjust. The damaging effects of this belief ultimately engulfed many developing countries, but rather than addressing the fundamental mismatch between capital flows and the policy tools needed to manage such flows, the crises were blamed on crisis countries' inability or unwillingness to embrace the necessary supply-side reforms. By confusing causes with effects, the problems eventually compounded and became explosive in the global financial crisis of 2008.

Capital controls did stay in place in some developing countries that were less exposed to international flows and transactions, and international pressure to liberalise. One of these countries was China, where constrains on the capital account remain in place, helping to reconcile exchange rate stability with domestic policy goals. I'll discuss China later in this article.

How the system should have worked

The Bretton Woods architects understood the importance of having an open trading system for individual countries to pursue policies leading to longer term economic growth by generating a level of global aggregate demand. Within this system all individual countries could then implement domestic policies to pursue the macroeconomic objectives of full employment without suffering inflation. But Keynes was also clear that difficulties with current account imbalances or with international financial flows could undermine in-

[19] Subacchi, *The Cost of Free Money*, pp. 56-58.

ternational trade if countries resorted to currency devaluations to adjust their current account imbalances. Exchange rates, therefore, needed to be fixed – so to avoid the risk of competitive devaluations – and capital mobility constrained. The international adjustment of current account balances could no longer be achieved through countries' interventions on their exchange rates, but through a workable process. Exchange rate stability and a curb on competitive devaluations were the necessary conditions for an open trading system.

Trade liberalisation was not directly dealt with at Bretton Woods, but the General Agreement on Tariffs and Trade (GATT) was eventually set up to manage the liberalisation of international trade. New institutions were created – the IMF and the World Bank – to manage, the former, a workable process of international adjustment of current account balances and, the latter, a sustainable system of international lending. The IMF was designed to oversee and approve changes in the exchange rates that were needed to correct "fundamental disequilibria" and so to prevent competitive devaluations – and beggar-your-neighbour policies. Limited capital mobility constrained countries from borrowing abroad, thus the multilateral financial institutions were conceived to provide both short term adjustment finance and long-term project and development finance. The IMF would provide short term funds to countries with temporary balance of payments problems – often to avoid currency devaluation. In line with the provisions in the Bretton Woods agreement, short term funds would be proportionate to the quota that each country paid in the IMF. However, as I have already discussed, the emergency funds supplied to Britain at the time of the Suez crisis opened the door to considerations other than the size of the quota, in allocating such funds.

I report here an anecdote that David Vines told me, that he, in turn, heard from James Meade. One day, early in 1944, during a meeting of the Board of Trade, Keynes sketched a plan for an open liberal world economy on the back of an envelope and passed it to Meade (Temin and Vines, 2014). Keynes remarked that at last he knew how the world economic system should be remade (Table 1).

TABLE 1
Objectives, Instruments and Institutions in Bretton Woods

Objective	Instrument(s)	Responsible Authority
Full Employment	Demand Management (mainly fiscal)	National Governments
Balance of Payments Adjustment	Pegged but Adjustable Exchange Rates	International Monetary Fund
Promotion of International Trade Economic Development	Tariff Reduction etc. Official International Lending	International Trade Organisation World Bank

This sketch clearly assigns a policy instrument to each objective and an institution responsible for pursuing each specific objective and operating each instrument. Keynes's intention for Bretton Woods was not just a financial system, but a system of global macroeconomic management. Indeed, without a clear path towards a more open trading system, macroeconomic stability would be difficult to maintain since currency devaluation would be much less effective at adjusting trade imbalances. At the same time, trade liberalisation would have been resisted if there were severe trade imbalances between countries.

Gradually it came to be more widely recognised that there were additional reasons why success in one part of the system might come to depend on success in another part. First, full employment and balance of payments adjustment must be pursed together – a lack of competitiveness must not put unacceptable pressure on full employment; and fiscal positions must not be allowed to put unacceptable pressure on the balance of trade. The second reason relates to the fact that trade adjustments take time, thus finance needs to be provided in the interim, so that the adjustment process can proceed in a way which is unimpeded by financial pressures. Finally, sustainable longer-term international lending and borrowing requires that exchange rates and interest rates settle at levels which support the initial absorption of resources by a borrowing country and subsequently enable that country's borrowings to be repaid; fiscal positions need to be consistent with this as well.[20]

[20] P. Subacchi and D. Vines, in *Oxford Review of Economic Policy*, forthcoming.

A patchy legacy

Fast forward to our days and the objectives of policymaking which underpinned the Bretton Woods system – a sustainable level of global aggregate demand, a workable process of balance of payments adjustment, a sustainable system of international lending, and an open trading system – remain relevant. The overall goal of strong economic growth, in substance, remains the same, it has become more complex as growth has to be not only strong, but also "sustainable, balanced and inclusive",[21] as put by the G20. At the same time the system, or non-system, has become more complex and less consistent. This is for a number of reasons.

First, the United States remains the world's largest economy, but its relative weight is lower than it used to be. In 1960 the United States accounted for around 40 per cent of the world's GDP, it now accounts for around 25 per cent[22]. Second, and related to the previous point, China's strong growth and development since the early 1980s and its integration in the international supply chains after it joined the WTO in 2001, has deeply changed the structure of the world economy. As this integration has happened in an uncoordinated manner and in the context of the non-system, it has turned China in to a free-rider[23] and created a sequence of macroeconomic imbalances, the resolution of which is not yet entirely clear.

Third, the world has become multipolar. Even if the dollar remains the key international currency, the United States, China and

[21] In their meeting in Pittsburgh in 2009, some months after the outburst of the global financial crisis, the G20 pledged to set the world economy on a path of "strong, sustainable and balanced growth". In 2015, In Antalya they committed to make growth "inclusive" as well. Group of Twenty, "Communiqué: G20 London Summit - Leaders' Statement", 2 April 2009, https://www. imf.org/external/np/sec/pr/2009/pdf/g20_040209.pdf; Group of Twenty, "G20 Leaders' Communiqué Antalya Summit", 15-16 November 2015, http://www.g20.utoronto.ca/2015/151116-communique.pdf.

[22] See World Bank Data: GDP (current US$).

[23] P. Subacchi and P. van den Noord, "Grappling with global imbalances: when does international cooperation pay?", in *Oxford Review of Economic Policy*, Volume 28, Issue 3, 2012, pp. 444-468.

the other systemically-important countries[24] need to see eye to eye. But China is a competitor and a challenge for the United States; the relationship between the two countries deteriorated substantially during the Trump presidency and has not yet recovered. This makes it difficult for the United States to broker and work by consensus, or, as during Bretton Woods, to canvass other countries to agree by using financial and security leverage.

Fourth, collective problems such as climate change and global health resilience have highlighted the importance of international policy cooperation for issues that are wide-ranging, cross-border and carry significant externalities. They require international cooperation in areas that policy thinking at the time of Bretton Woods would have considered as the domain of domestic policies such as, for example, land management, energy generation and natural resources endowments. Whereas in the post-war years risks were assessed and considered against the threat of a nuclear conflict, they are now linked to environmental deterioration and climate change, and the widespread disruption not only to the economic and financial system, but to societies and international security.

The legacy of Bretton Woods is embedded in the governance of the international financial institutions, the IMF and the World Bank, that in the aftermath of the end of the dollar convertibility had to rethink and re-adjust their objectives and purpose. The distribution of quotas and voting rights still reflect a world economy with the United States at its core. Indeed, the United States holds around 17.5 per cent of the IMF quota and 16.5 per cent of the voting rights, and 18.4 per cent of the World Bank quota and 15.1 per cent of the voting rights, granting it veto power in both institutions.

[24] The IMF classifies and monitors jurisdictions with Systemically Important Financial Sectors (SIFS). The methodology for determining SIFS focuses on interconnectedness, especially the structure of interlinkages that channel cross-border spillover effects, and the potential for price contagion across financial sectors. IMF, Mandatory Financial Stability Assessments under the FSAP (accessed 31 January 2022), https://www.imf.org/external/np/fsap/mandatoryfsap.htm.

As financial resources are linked to governance, an increase in resources is out of question without an overall reform of governance. The reform of the IMF quotas that the G20 committed to in 2010 took five years to be approved by the United States Congress. Even though this reform delivered a 100 per cent increase in total quotas, the resources remain limited vis-à-vis the need for a financial safety net to be deployed in the event of widespread financial instability.[25] This leaves the rest of the world dependent on the Federal Reserve and increasingly on the central bank of China, the People's Bank of China (PBoC), at times of crisis. During the global financial crisis, the Fed signed swap agreements totalling roughly $600 billion with the central banks of advanced economies along with those of South Korea, Singapore, Mexico and Brazil.[26] In March 2020, at the outburst of the Covid pandemic, these swap lines were reactivated and the amounts doubled. Over the last decade, the PBoC has signed at least 38 swap lines[27] with both developing and developed countries; it has a 350 billion renminbi swap line established with the United Kingdom.[28]

The World Bank now competes with private lenders, state-owned entities, and even sovereign states in supplying project and development finance. China as a whole (i.e. the country and its state-owned banks) has lent over 1.5 trillion dollars in loans and trade credits to more than 150 countries, making it the largest official creditor worldwide.[29] China Development Bank now has total assets (do-

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[25] In 2009 the IMF created a non-conditional liquidity line, which is comprised of the Precautionary and Liquidity Line and the Flexible Credit Line. The former is for countries with a sound economic track record and the latter is for countries with a structurally sound economy.

[26] M.J. Fleming and N.J. Klagge, "The Federal Reserve's Foreign Exchange Swap Lines", in *Current Issues in Economics and Finance*, vol. 16, no. 4, Federal Reserve Bank of New York, April 2010, p. 5, https://www.newyorkfed.org/medialibrary/media/research/current_issues/ci16-4.pdf.

[27] S. Bahaj and R. Reis, "Jumpstarting an international currency", in *Vox*, 21 September 2020, https://voxeu.org/article/jumpstarting-international-currency.

[28] Bank of England, *People's Bank of China swap line*, 12 November 2021 https://www.bankofengland.co.uk/news/2021/november/peoples-bank-of-china-swap-line.

[29] S. Horn, C.M. Reinhart and C. Trebesch, "How Much Money Does the World Owe

mestic and international) that exceed the combined total assets of the World Bank, the European Investment Bank, and all four major regional development banks.

The elephant in the room: China

The rise of China has been the defining story of the past three decades and the one that has fuelled the narrative of the power shift from west to east. It is a story, however, that has developed along a different path from that experienced by the other systemically-important countries. China is not a market economy – it is 'socialism' with Chinese characteristics or 'capitalism' with Chinese characteristics – and is not a liberal democracy. Its system, objectives and incentives are not aligned with those of the countries that were at the core of the Bretton Woods system. Hence the challenge of dealing with China is to work out how to get the best possible outcome when engaging and collaborating with a partner whose incentives are not aligned with those of the post-war international liberal order.

China is now the world's second largest economy, but it remains a middle-income country. It is the largest exporter and its growth still depends on external demand more than the Chinese leadership would like to be the case – to shift the model of growth from exports to domestic demand is a policy goal. It has a surplus, albeit narrowing, in its current account and a high aggregate saving rate. The yuan is part of the SDR basket – together with the dollar, the euro, sterling and the yen – but it is not a fully-fledged international currency. This is because, unlike the other issuers of international currencies, China maintains restrictions on its capital account. Liquidity is controlled by the central bank because convertibility is managed – in other words, capital movements are allowed, but through a complex regulatory framework that the monetary authorities use to finetune cap-

China?", in *Harvard Business Review*, 26 February 2020, https://hbr.org/2020/02/how-much-money-does-the-world-owe-china.

ital flows in line with the appropriate level of the exchange rate.[30] This is managed and adjusted as required to achieve the government's objective for economic growth, and the yuan is broadly pegged to a basket of currency.

To some extent, the Chinese authorities have replicated some of the features of Bretton Woods – capital controls, fixed exchange rate and adjustment by policy – and this has created a new version of the same old problem that sabotaged the Bretton Woods system, that is the development of trading relations which threaten the workings of the monetary system. Recall the issue with Germany in the late 1960s that was not prepared to revalue the deutsche mark that would have reduced the competitiveness of their exports and narrow the trade surplus with the United States. When Congress accuses China of 'currency manipulation' it is rewinding the same old story. In other words, the US trade deficit is a macroeconomic problem that comes from the lack of adjustment through the exchange rate.[31]

The question thus is not just whether the system that originated from Bretton Woods is still fit for purpose, but also how to fit China in it. China's impact is evident in the trilemmas – the macroeconomic trilemma and the political economy trilemma.[32] These were hard to suppress or to control under Bretton Woods, and gradually private capital generated volatility that then undermined then system. The Mundell-Fleming model was produced in the early 1960s to explain how that might happen. The logic of the original Mundell trilemma thus points either in the direction of closer cooperation (including perhaps political arrangements that constrain domestic choices) or

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[30] Controls, however, are porous, like it was the case during the Bretton Woods system, see P. Subacchi, *The People's Money: How China is Building a Global Currency*, Columbia University Press, New York, 2016, pp. 155-158.
[31] This also means that the corollary of this is that the solution should be macroeconomic and not based on tariffs.
[32] M.D. Bordo and H. James, "Capital Flows and Domestic and International Order: Trilemmas from Macroeconomics to Political Economy and International Relations", NBER Working Paper No. 21017, March 2015.

toward capital controls as a way of rescuing national policy autonomy.[33] The trilemmas are less binding for China.[34] Because it is a surplus country it does not need to attract capital inflows – but rather to prevent outflows. Because it is not a liberal democracy, it does not face the option of making short-term popular choices and leave the difficult ones for the longer terms and successor governments. By managing capital flows, it covers basic signals about domestic savers' confidence in the authorities in the same way as unfettered capital movements suppress indicators about government effectiveness.[35]

Conclusion: fit-for-purpose international financial institutions

Against this background the challenge is to re-think how China can fit in the current system and how to reduce financial instability – and geopolitical tensions. Thus, the key question continues to be how to ensure a level of global aggregate demand such as to enable countries to implement domestic policies to pursue full employment without suffering inflation. These were the macroeconomic policy objectives at the core of Bretton Woods and remain at the core of the current system.

International financial institutions – those that came out of Bretton Woods – are critical to the good functioning of the system, and to its relevance, effectiveness and even survival. However, they need to stay fit for purpose and continue to provide international public goods. International trade and international finance need a multilateral institutional framework to avoid a race to the bottom where the dominant countries – in terms of markets, resources, political and security clout – impose terms and conditions on smaller countries. The safety net should support countries that face an economic

[33] Harold James in this issue
[34] Subacchi and van den Noord, "Grappling with global imbalances: when does international cooperation pay?".
[35] Harold James in this issue.

or financial crisis and reduce the global systemic risk by preventing crises from spreading. However, a cooperative and coordinated approach to crisis resolution and crisis prevention is necessary to ensure that moral hazard risks are managed and the risk of future crises is reduced. To ensure resilience and sustainability, the global system must underpin development finance and channel it towards areas such as energy, the climate and global health.

Multilateral institutions are there also to act as arbiters among member states, smooth different views, pool information, monitor compliance and, as last resort, sanction those who break the commitments. They are pivotal, for instance, to extend a safety net to a system that remains structurally dysfunctional, in order to reset it every time it short-circuits. Above all, international institutions help countries compromise over competing domestic objectives and even special interests, and reconcile the desire for autonomy in domestic economic policies with the goal of keeping an open world economy without restraining economic integration. They act like a commitment mechanism that improves the quality of democracy by constraining special interest organisations. International commitments are indeed the foundation of a stable international order. [36]

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[36] Bordo and James, "Capital Flows and Domestic and International Order", p. 29; Subacchi, *The Cost of Free Money*, pp. 181-182; R.O. Keohane, S. Macedo and A. Moravcsik, "Democracy-Enhancing Multilateralism", in *International Organization*, vol. 63, 2009, pp. 1-31. See also K. Popper, *The Open Society and Its Enemies*, Princeton University Press, Princeton, NJ, 2013, one-volume edition; first published 1945.

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