

# Unravelling of the Bretton Woods Twins

ALOK SHEEL

The Bretton Woods twins – the International Monetary Fund and the World Bank – have become largely irrelevant for both developed and developing countries. The market has enthroned the us dollar as the international reserve currency, with little role for the IMF which has lost its role as international lender of last resort. And the World Bank's capital is inadequate to meet the massive requirements of infrastructure in the developing world.

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With the second world war still raging, delegates of 44 allied nations met at Bretton Woods in New Hampshire in the United States (us) in July 1944, to put in place an institutional framework to rebuild the financial and economic system destroyed by the Great Depression and the war. This iconic conference spawned two of the most influential institutions of global economic governance of the post-war period. Both the International Monetary Fund (IMF) and the World Bank now appear to be unravelling on account of their inability to adjust to tectonic shifts in the global economy over the last few decades.

One of the chief objectives of the Bretton Woods conference was to repair the international monetary system that had fallen apart during the Great Depression of the 1930s when the us abandoned the gold standard to battle deflation. By pegging the dollar to gold, and other international currencies to the dollar, the stage was

now set for the decline of the pound sterling as the former was canonised as the premier international reserve currency on the back of the growing economic and geopolitical hegemony of the us.

The IMF was assigned two important roles in the new international monetary system, namely, surveillance to ensure that exchange rates do not become misaligned, and providing liquidity to tide over temporary external imbalances (IMF, *Articles of Agreement*, Article 1 (iii) and 1 (v)).

The gold standard put in place at Bretton Woods was a hybrid one, as monetary authorities were given some headroom for monetary expansion in excess of the gold stocks held by central banks. Only central banks could demand to exchange currencies for gold. The expectation was that such an eventuality was unlikely to materialise.

## Breakdown of Mark 1

This monetary system, Bretton Woods Mark 1, broke down in 1971 because the us Federal Reserve accommodated fiscal expansion fuelled by loose Keynesian policies and growing current account deficits. When it appeared that France might ask the us to exchange dollars for gold, President Richard Nixon announced in 1971 that the dollar could no longer be

exchanged for gold. Its value was now pegged to, well, the dollar itself – a free float against other currencies.

In Bretton Woods Mark 2, major reserve currencies floated against each other. Implicit in it was the belief that capital flows would simply be the counterpart of current account balances. The IMF consequently advocated and pressurised countries towards free cross-border capital flows (*Articles of Agreement*, Article 1 (iv)) to nudge current accounts into equilibrium through market-determined exchange rate adjustments.

Between the idea and the reality, however, falls the shadow, in the words of a famous English poet. East Asian economies, including Japan and China, leveraged Bretton Woods Mark 2 to grow at record levels by supplementing domestic demand with external demand by undervaluing/pegging their exchange rates against the dollar through market intervention. This, *inter alia*, led to a ballooning of global imbalances, with capital now flowing “uphill” from developing to developed countries.

IMF exchange rate surveillance was expected to prevent and address such misalignment under its Articles of Agreement. Determining and measuring equilibrium exchange rates however is an inexact science.<sup>1</sup> Moreover the IMF’s writ is effective only where conditionalities can be imposed on countries borrowing from it, whereas those with negatively misaligned exchange rates never needed to borrow from it. Markets were also impotent in correcting such misalignments as they penalised only deficit countries, and not surplus countries as noted long ago by John Maynard Keynes.

With exchange rates so misaligned, the IMF “foresaw” a financial crisis coming. However, like the equilibrium exchange rate, predicting financial crises is also an inexact science. Instead of the dollar collapsing on account of the disorderly unwinding of global imbalances as predicted,<sup>2</sup> it actually strengthened despite the source of the crisis emanating from the us on account of its safe haven status.

With major emerging markets running large current account surpluses, the IMF’s ineffectual surveillance was

matched only by its declining importance in providing liquidity support. Indeed, it was the larger emerging market economies, most notably China, which provided the liquidity for a leveraged consumption boom through a new shadow banking system in western economies. This underpinned record global growth and apparent macroeconomic stability in the run-up to the global financial crisis in what came to be characterised as the “Great Moderation”.

The large stockpile of hard currency reserves of emerging markets and the lagged outcome of large current account surpluses acted as a form of self-insurance as a result of which they no longer needed to turn to the IMF for liquidity support during the global financial crisis. Countries that needed additional liquidity support to reassure markets turned instead to the us Federal Reserve whose deep dollar pockets and nimbleness the lumbering IMF cannot match.

The exorbitant privilege bestowed on the dollar by the market, unwittingly strengthened by the IMF nudging countries towards unrestricted cross-border capital flows, has now made the IMF, which bailed out the United Kingdom in 1976 and India in 1991, irrelevant as lender of the last resort. Not only is the us Federal Reserve effectively the international lender of last resort, it is also the prime mover of global liquidity through its macroeconomic policies that determine the direction and force of cross border capital flows. Prompted by emerging markets within the Group of Twenty (G-20), the IMF has since retracted its advocacy of unrestrained cross border capital flows to cushion them from destabilising volatile capital flows.

### From Mark 2 to Mark 3

Bretton Woods Mark 2 broke down with the global financial crisis of 2008, as leveraged private consumption in advanced economies collapsed, signalling a permanent downward shift in demand and consequential unwinding of global imbalances. There is, however, now talk of a new Bretton Woods Mark 3 (Bibow 2010), with public debt in advanced economies, sustained by loose monetary policy, central-bank-rolling the revival

of private consumption. The us economic recovery is thus riding a housing mortgage market almost fully underwritten by fully nationalised state-owned enterprises.

Bretton Woods Mark 3 can be sustained over an extended period only by the us on account of the large international demand for dollars and perhaps by Japan where public deficits can still be funded for some more time by private domestic surpluses. Other countries may be forced to adjust sooner rather than later by the market, as in the case of peripheral Europe, thereby undermining the risk-free status of sovereign debt that underpins financial intermediation.

So where do we go from here? It is possible that major emerging markets, stung by the experience of the global financial crisis, may change their growth models by relying more on domestic demand, leading to some kind of Bretton Woods Mark 4, whose contours are still to emerge. This, however, requires bold structural reform. It is, therefore, also possible that if the current financial regulatory overhaul initiative weakens with the recovery, there could be a reversion to Bretton Woods Mark 2, with all its attendant financial risks. Either way, the IMF is unlikely to play a major role in regulating cross-currency exchange rates.

The World Bank was the second leg of the Bretton Woods system with the objective of reconstructing the physical infrastructure of war-ravaged Europe. This was understandable since the soft infrastructure (human resources) was already in place. As a result, Europe recovered relatively quickly, and the World Bank’s resources were redeployed in developing countries. At some point in time it also shifted its focus from physical to soft infrastructure, with “poverty” alleviation rather than economic growth becoming its main focus. It is not entirely clear why

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this was done, as its new constituency had a huge deficit in both physical and soft infrastructure, and both were necessary for a durable uptick in trend growth.

Once the infrastructure in Europe was repaired, and Bretton Woods Mark 1 broke down, the major shareholders of the twin institutions could easily fund themselves from the market and were moreover backstopped by their central banks. Balance of payments crises now became a structural feature of developing economies because of their limited market access to reserve currencies used for balancing their external accounts. They had no other mechanism to deal with an external payments crisis other than to turn to the IMF.

### World Bank's Tiny Resources

At any rate, the resources of the Bretton Woods institutions ceased to grow significantly once the European project was complete. This was painfully apparent once some large, poor, third world countries started growing fast, becoming “emerging markets”, and their developmental needs rose exponentially. The World Bank's net disbursements currently stand at around \$15 billion a year, of which half comprises concessional “International Development Agency (IDA)” aid for poor countries, enough to finance only two to three major infrastructure projects each year. The major shareholders of the World Bank clearly missed a trick here, for they could have intermediated and redirected the global savings glut to filling the infrastructure deficit in developing countries that were becoming new engines of global growth even as the trend growth was declining in ageing advanced economies. In the absence of this, capital flowed uphill from emerging markets to finance leveraged consumption in advanced economies, thereby sowing the seeds of instability in global financial markets culminating in the recent crisis.

Even as World Bank lending was increasingly subject to supply constraints, with the larger emerging markets accumulating substantial foreign currency reserves for “self-insurance” against external crises, the IMF was becoming subject to demand constraints, compelling it to increasingly turn to

fund poverty alleviation, such as its PRGF (Poverty Reduction and Growth Facility), thereby constrained to duplicate the functions of the resource-starved World Bank.

The Bretton Woods system, therefore, had become systemically irrelevant for all but poor, developing economies, by the time the global financial crisis broke out. Its majority shareholders, comprising developed countries, for whom these institutions were set up, no longer needed it for themselves, and were loathe to scale up their operations commensurate with the funding requirements of developing countries. They were consequently transformed from being growth-enhancing and stabilising mechanisms to aid giving institutions.

The global financial crisis provided a historic opportunity to adjust to the winds of change in the global economy to make the Bretton Woods institutions relevant again. The G-20 however failed to do so. It moved to substantially enhance the resources of the IMF by a factor of four to five – not because these were earlier inadequate to insure poor developing countries, for which IMF's resources were adequate, but because these were now required for peripheral Europe. Despite having a reserve currency, these countries became unexpectedly vulnerable to developing country-type balance of payments crises on account of a flawed monetary union that deprived them of both a central bank backstop and fiscal support from stronger members of the union. Europe and the eurozone now account for over 80% of outstanding General Resources Account credits of the IMF. As already pointed out, the larger emerging markets were self-insured and had no need for these enhanced funds.

### Solving the European Crisis

The big bazooka to resolve the European crisis, however, was always in Europe, as the embattled countries needed funding in their own currency (Sheel 2012). It was the European Commercial Bank's (ECB) “whatever it takes” Outright Monetary Transactions (OMT) announcement, and not the earlier IMF bailout packages, that stabilised sovereign bond yields in peripheral Europe. Their requirements could have been easily funded without

IMF intervention through amendment in their treaties that resolved the flaws in the monetary union through a closer fiscal and monetary union. The IMF again missed a trick here in not responding to the flawed union. It should have insisted on demarcating the lender of last resort responsibilities between itself and the ECB and possibly even amended its articles to accommodate the European Monetary Union (EMU). This would have freed up the G-20 resources for a massive recapitalisation of the World Bank to redirect global savings into upgrading infrastructure to sustain high growth in the stuttering new engines of growth of the global economy, the emerging markets. It is pertinent that the G-20 needed to raise only one-tenth of what it raised for the IMF to augment the World Bank's lending capacity by the same amount.<sup>3</sup> The G-20, however, enhanced the World Bank's resources only marginally, to enable it to ramp up its disbursements by about \$10 billion in the crisis year (2010). Net disbursements are now back to their pre-crisis lows.

The Bretton Woods institutions appear to be frozen in time most likely because they have been unable to adjust to the tectonic changes in the global economy over the last two decades. Table 1 illustrates how the governance structure of these institutions is out of sync with the current structure of the global economy. It still reflects the old post-war political economy configuration that has changed significantly since. What Table 1 does not show is the stranglehold of OECD countries over the top leadership of the Bretton Woods twins. As the failure of advanced countries to ratify even the modest shift<sup>4</sup> brokered by the G-20 in the voting share of the IMF agreed in 2010 indicates, over-represented shareholders seem reluctant, on the one hand, to cede voting share to emerging

**Table 1: BRICS – IMF Voting Share and Economic Size**

| Country      | IMF<br>Vote Share | Share of Global GDP |       |        |        |
|--------------|-------------------|---------------------|-------|--------|--------|
|              |                   | MER                 |       | PPP    |        |
|              |                   | 1993                | 2013  | 1993   | 2013   |
| Brazil       | 1.714             | 1.73                | 3.03  | 3.051  | 2.786  |
| Russia       | 2.306             | 0.73                | 2.86  | 3.714  | 2.938  |
| India        | 2.337             | 1.12                | 2.53  | 3.126  | 5.827  |
| China        | 3.806             | 2.43                | 12.41 | 4.77   | 15.398 |
| South Africa | 0.77              | 0.52                | 0.47  | 0.727  | 0.686  |
| BRICS Total  | 10.933            | 6.53                | 21.3  | 15.388 | 27.635 |

market economies. On the other hand, they are too fiscally stressed on account of ageing and declining trend growth to expand the resources of these institutions in a manner that would be meaningful for emerging market economies.

### Irrelevant on All Sides

To summarise, the Bretton Woods twins have become largely irrelevant today, for both developed and developing countries. The market has enthroned the us dollar as the international reserve currency (Sheel 2014), with little role for the IMF which has lost its role as the international lender of last resort to the us Federal Reserve and the us Treasury. Its crisis forecasting surveillance mechanism, with its reliance on complex econometric models that have little predictive value, has not proved to be very effective.<sup>5</sup> The IMF has effectively become a European Monetary Fund, and the World Bank a bank for small, poor economies. The G-20 has failed to resuscitate them to adjust to the winds of change in the global economy, perhaps because its governance structure still reflects the post-war world that has passed.

As the Bretton Woods twins unravel, the fast-growing emerging markets are endeavouring to put in place alternative institutions, such as the Chiang Mai initiative in east Asia (West 2014), the New Development Bank and the Contingency Reserve Arrangement of the BRICS. Whether these new institutions would be nimble enough to address their developmental needs, and whether the rising economic powers can achieve the geopolitical cooperation required to work collaboratively with each other in the manner the us and Europe did in the post second world war period, however, remain to be seen.

### NOTES

- 1 As a result the IMF methodology continues to evolve. See IMF (2013).
- 2 See IMF (2011). A number of other well-known economists held a similar view. Maurice Obstfeld and Kenneth Rogoff (2004).
- 3 Although the World Bank can leverage up to maximum debt equity ratio of only 1:1, considering the high credit-worthiness of its major shareholders only one-tenth of its capital needs to be paid up.
- 4 The G-20 orchestrated a shift in the share of BRICS in the voting share in the IMF at their third Summit at Pittsburgh in September 2009, following which the IMF agreed in 2010 to inter alia enhance the BRICS voting share from 10.933 presently to 14.139. This however falls far short of BRICS' share in the global economy at market

exchange rates (MER), and amounts to only about half their share at purchasing power parity (PPP).

- 5 IMF (2011). To be fair, the IMF has also learnt from the crisis and has moved to supplement its bilateral surveillance with multilateral surveillance through its new *Global Financial Stability Report*, the *Fiscal Monitor*, and the *G-20 Mutual Assessment Process* that it helps pilot. Multilateral surveillance could have arguably helped it to better appreciate the safe haven status of the dollar in the event of a global crisis. The enhanced surveillance however is still to be put to be tested in a real time crisis situation.

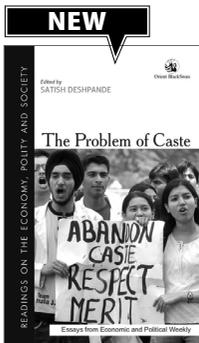
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# The Problem of Caste

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Caste is one of the oldest concerns of the social sciences in India that continues to be relevant even today.

The general perception about caste is that it was an outdated concept until it was revived by colonial policies and promoted by vested interests and electoral politics after independence. This hegemonic perception changed irrevocably in the 1990s after the controversial reservations for the Other Backward Classes recommended by the Mandal Commission, revealing it to be a belief of only a privileged upper caste minority – for the vast majority of Indians caste continued to be a crucial determinant of life opportunities.

This volume collects significant writings spanning seven decades, three generations and several disciplines, and discusses established perspectives in relation to emergent concerns, disciplinary responses ranging from sociology to law, the relationship between caste and class, the interplay between caste and politics, old and new challenges in law and policy, emergent research areas and post-Mandal innovations in caste studies.

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