[draft – please do not quote]

Back to which Bretton Woods?
Liquidity and clearing as alternative principles for reforming international finance

Massimo Amato
Luca Fantacci

(Bocconi University, Milano)

Abstract

In the face of the current crisis, there is growing demand for regulation, often invoked in terms of a "return to Bretton Woods".
The Bretton Woods conference of 1944 was indeed the last explicit attempt to define a rule for international settlements. In fact, post-World War II currency negotiations gave place to a confrontation between two alternative visions of the international financial system. The two plans presented at Bretton Woods embody two alternative principles: the first aims at producing international *liquidity* on the basis of a reserve currency (White's Plan for an International Stabilization Fund), the second aims at providing a pure means and measure for the multilateral *clearing* of current accounts in the form of a currency unit (Keynes's plan for an International Clearing Union).
The former has undoubtedly prevailed. However, it is questionable whether it is the most appropriate way to manage global imbalances.
Indeed, the principle eventually embodied in the Bretton Woods system, and persisting even after its demise, tends to identify money with a reserve asset, making possible, and even necessary, the accumulation of global imbalances, despite original intentions to reabsorb them. On the contrary, the principle which inspired the alternative plan was intended to deprive money of the character of a reserve asset, thus making it the rule for international exchanges, rather than an object of regulation among others.
This paper outlines the two principles both in historical perspective and in the perspective of future reforms, particularly in relation to the recent proposal by the governor of the People's Bank of China.

massimo.amato@unibocconi.it
luca.fantacci@unibocconi.it

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I.

The most direct and compelling motive for a "return to Bretton Woods" comes not from a need of historical erudition, but from the present state of the economy. The current crisis, and the persistence of global imbalances *despite* the shock represented by the crisis, has raised the issue of the reform of the international financial system. Not only a certain number of scholars, but also many journalists, economic advisors and policymakers have advocated "a new Bretton Woods" to assert the necessity of new rules. Too few, however, remember that the Bretton Woods Conference, besides defining the norms and designing the institutions that were to rule international finance, was also characterized by the deliberate intention of establishing that peculiar norm and institution which is international money.

This fact deserves, for at least four reasons, far more attention than it normally receives:

1. money is the first economic norm and institution: without a money providing a common measure, there is no condition for trade or finance; and the way money is designed deeply affects the structure of economic relations and the operation of all other norms and institutions;
2. the monetary system that was established in 1944 collapsed in 1971, and has not been replaced;
3. the lack of an international money is one of the major factors of current global imbalances;
4. the institution of an international money is not something that happens by itself: Bretton Woods was the only instance in history in which it was deliberately accomplished by an international conference, and it required then a great deal of thinking and negotiating; the question that the organizers of this conference quite appropriately raise is whether we now have "the necessary insight and ideas" to solve the problems that despite those efforts have reemerged.

Reforming institutions is a matter both of thought and of policy. It demands that researchers and politicians share a common concern, even as they recognize their respective competences and goals. This conference has been promoted as a scientific reply to the political stance raised by the G-20. Among those countries, several have raised in particular the issue of reforming the international monetary system. The most explicit analysis and proposal on this front has come, perhaps, from the governor of the People's Bank of China, Zhou Xiaochuan, in a speech published last March on the official site of the Bank, just before the G-20 summit in April 2009.[1]

The document goes straight to the point:

> The outbreak of the current crisis and its spillover in the world have confronted us with a long-existing but still unanswered question, i.e., what kind of international reserve

[1] Zhou Xiaochuan, "Reform the International Monetary System", People's Bank of China, 23 March 2009 (http://www.pbc.gov.cn/).

> currency do we need to secure global financial stability and facilitate world economic growth, which was one of the purposes for establishing the IMF?

Before looking into the details of the proposal, it is possible to infer the two main characteristics of the new money advocated by Mr. Zhou from the expression he uses to designate it. He speaks of an "international reserve currency". The new money is thus characterized by two qualifications that may seem rather obvious, but should not be taken for granted. The new currency, whatever form it may take, is intended by Mr. Zhou to be:

1. an *international* currency, and .
2. a *reserve* currency.

The first characteristic is strongly emphasized by Mr. Zhou. The idea is that *international* economic relations require *international money*, and that a real international money cannot and should not also be a national money. The use of a national money as an international money gives rise to an impasse that Mr. Zhou describes, appropriately evoking the Triffin dilemma:

> Issuing countries of reserve currencies are constantly confronted with the dilemma between achieving their domestic monetary policy goals and meeting other countries' demand for reserve currencies. On the one hand, the monetary authorities cannot simply focus on domestic goals without carrying out their international responsibilities; on the other hand, they cannot pursue different domestic and international objectives at the same time. They may either fail to adequately meet the demand of a growing global economy for liquidity as they try to ease inflation pressures at home, or create excess liquidity in the global markets by overly stimulating domestic demand. The Triffin Dilemma, i.e., the issuing countries of reserve currencies cannot maintain the value of the reserve currencies while providing liquidity to the world, still exists.

It is significant that text presents the problem from the point of view of the country that issues the currency used as an international reserve asset. This may well be intended not only as a concession to the balance of payment problems of the US, but also to suggest that China, as a rising economic power, does not intend to replace the US in the uncomfortable position of having to provide a new international reserve asset with its own currency. It is as if Mr. Zhou were saying that China is totally unwilling to enter, in the 21st century, in the same mess that has already troubled the economies of UK in the 19th and of US in the 20th century.

On the other hand, the second characteristic seems to be taken for granted by Mr. Zhou. In fact, as a solution to global imbalances and as a way out of the Triffin dilemma, he suggests the establishment of an international *reserve* currency:

> The desirable goal of reforming the international monetary system, therefore, is to create an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies.

It is at this point that Mr. Zhou recalls the historical precedent of Bretton Woods:

> Back in the 1940s, Keynes had already proposed to introduce an international currency unit named "Bancor", based on the value of 30 representative commodities. Unfortunately, the proposal was not accepted. The collapse of the Bretton Woods system, which was based on the White approach, indicates that the Keynesian approach may have been more farsighted.

This recollection has the merit of reminding us that at Bretton Woods there was not only one plan, but two radically different plans, based on two radically different principles, moreover suggesting that the plan adopted was perhaps the wrong one. This is why "Back to Bretton Woods" cannot be simply a slogan, calling for a revival: it requires to reopen a discussion in view of a decision. The question is, then: "Back to which Bretton Woods?"

Mr. Zhou seems to have no doubts in proposing a return to Keynes's plan. In principle we subscribe to this point of view, and yet we must be sure to understand what Keynes really proposed.

In Mr. Zhou's reconstruction, Bancor seems to be confused with the tabular standard that Keynes had outlined in the Treatise on Money in 1930. In fact, Bancor is not a basket of commodities, but a pure unit of account. Quite appropriately, Mr. Zhou refers to it as a "currency unit". However, as we shall argue, a currency unit is not the same thing as a reserve currency, but is in fact incompatible with it. Throughout this paper we will try to show that reserve currency and currency unit are mutually exclusive, both logically and historically. It is important therefore to distinguish between the two, in order to understand which one we need to avoid the accumulation of global imbalances, allowing both goods to be traded and debts to be paid.

Indeed, to provide a means to allow global trade and to absorb global imbalances was also the explicit goal of the American plan for Bretton Woods and of the agreement that was eventually signed, as expressed in Article 1. Now Mr. Zhou suggests that Keynes's plan might have been more appropriate and effective to reach those same goals. Yet he fails to explain why. Our main argument is that Keynes's plan would have been better exactly because the money that it would have established, Bancor, was not a *reserve currency*, but a *currency unit*. Mr. Zhou uses two different expressions, yet without asking whether they are in fact compatible.

This is precisely what we will enquire, by going back to Bretton Woods or rather back to the theoretical elaborations and the political discussions that prepared the conference. However we can anticipate here a definition of both kinds of currencies, in order to suggest the relevance of the distinction.

Whether it is national or international, a reserve currency is a *store of value*: this means that, even if it is intended as a means of payment for the settlement of international debts, it is always possible for a country *not* to spend it and to accumulate it indefinitely, thus building up the global imbalances that it would be intended to reabsorb.

Instead, a currency unit is an *instrument for the denomination of debts*. It is therefore impossible by definition to own it or even more to accumulate it. It is intended exclusively to measure the value of actual goods and services and to facilitate their exchange, but it is not itself a commodity. In this sense, it allows imbalances to be created in order to facilitate trade, but it requires and allows those imbalances to be duly reabsorbed. It is not part of the wealth neither of a specific nation nor of the international community as a whole.

This is why we agree with Mr. Zhou when he suggests that Keynes's plan might have been "more farsighted". In fact, Bancor was not conceived only as an international currency as distinct from a national currency. It was also conceived as a currency unit as opposed to a reserve currency.

In this sense, the story of Bretton Woods, with respect to the goals that it was supposed to achieve, is the story of a failure: it is the story of how, instead of an international

currency unit, a national reserve currency was eventually established as international money.
In the next sections we shall enquire how this happened (II), what the implications were for the possibility of global imbalances (III), and what possible remedies this story suggests (IV).

II.

In the diplomatic run-up towards Bretton Woods, the establishment of an international currency unit appeared to be, at least at a certain stage, a common concern of both the parties involved. Both the British and the American proposals had, at least in certain drafts, provisions concerning the adoption of an international unit of account: Bancor in the Clearing Union and Unitas in the Stabilization Fund. It appears somewhat paradoxical that the adoption of an international unit of account should be discarded already in the course of the Anglo-American negotiations that lead to the publication, in April 1944, of the Joint Statement that eventually provided the working draft for the Bretton Woods conference. If both the British and the U.S. representatives agreed on the opportunity of introducing an international unit of account, why did they discard this hypothesis in the course of their bilateral talks, even before submitting it to the other 42 delegations summoned at Bretton Woods?[2]
A possible answer may perhaps be sought for in the different roles assigned to the international unit of account in the two schemes. As Horsefield has pointed out: "for Keynes this would have been a true medium of exchange […] for White it was no more than a standard of value".[3] This is usually understood as a further confirmation of Keynes's alleged inflationary spur, as opposed to sound principles of orthodox finance. According to this interpretation, the Keynes plan provided for the creation ex nihilo of a new international medium of exchange, whereas the White plan remained soundly anchored to the available quantity of the old international medium of exchange, i.e. gold.
It is true that the introduction of an international unit of account was essential to the Proposal for an International Clearing Union, from the very first version, sketched out by Keynes in 1941, while, on the contrary, it was purely accessory to the White Plan. The first Draft Proposal of the latter (dated April 1942), had no provision at all for an international currency. In fact, it was followed by a commentary which included a very sceptical section on "A new international currency".[4] The adoption of an international currency is described by White as:
a) *useless*, if it were to be introduced merely as a *unit of account* to supplement national currencies, since this would not reduce calculations in foreign trade nor exchange rates instability;

[2] Some of these delegations at Bretton Woods did advance proposals for the adoption of an international unit of account. They however lacked the force to contrast a position, which was clearly not just the result of forgetfulness. The sponsors of the Fund did not just lack good reasons to introduce an international unit of account: they apparently had good reasons to refuse it.
[3] J. K. Horsefield (ed.), *The International Monetary Fund, 1945-1965 : twenty years of international monetary cooperation*, vol. I. Chronicle, IMF, Washington 1969, p. 64.
[4] H. D. White, *Preliminary Draft Proposal for a United Nations Stabilization Fund and a Bank for Reconstruction and Development of the United and Associated Nations*, April 1942, Part III, reprinted in Horsefield, *The International Monetary Fund*, vol. III. Documents, pp. 78-82.

b) *impracticable*, if it were to be introduced as a medium of exchange to *substitute* national currencies, since this would imply a renunciation of monetary sovereignty;
c) *worthwhile*, if it were to be introduced as a medium of exchange to *complement* existing national and international currency.

This last point deserves closer consideration, since it appears as a substantial concession towards the essence of the Clearing Union Proposal. As White explicitly states, it would have allowed to reabsorb global imbalances inherited from the war, in the form of a concentration of gold in the US:

> it may be worthwhile giving the Bank note-issuing powers—based on some gold reserve—solely in order to make the world's monetary gold stock do more work, and at the same time help correct the maldistribution of gold.[5]

This was, indeed, the main purpose of the Clearing Union. It was in view of attaining this goal that, according to Keynes, an international currency was needed. And even this was promptly recognised by White:

> if the Bank were to be established and given the authority to issue notes [or, as we shall see, to provide overdraft facilities, in the logic of the Clearing Union], what unit should it be? It would be preferable to adopt a new unit. The adoption of a new international unit of currency of account [sic] would probably meet with little opposition, whereas an attempt to use any one of the existing currencies, such as dollars, sterling or francs for that purpose would be opposed on the grounds that it would seem to give the country possessing that currency some slight advantage in publicity or trade.[6]

Showing perhaps little intellectual honesty, White accused the Clearing Union of proposing (b), which was clearly to be refused, whereas it was in fact proposing (c), which he himself recognised as desirable. And, showing little practical consistency, after having praised (c) in 1942, he pursued (a) in the later drafts.[7]

Unitas was introduced as the "Monetary Unit of the Fund", in a separate section under this title, only in the third draft (dated December 11). Unitas was to have a fixed gold equivalent of 137 $^{1}/_{7}$ grams of fine gold, corresponding to a dollar equivalent of $10.[8] The choice of a gold equivalent corresponding to a round dollar equivalent suggests that the second equivalent was considered more important than the first: Unitas was just another way of saying $10. This is perhaps the reason why "the significance of the Unitas in the Stabilization Fund was a source of some perplexity to the United Kindgdom".[9] As Phillips observed, it was merely a unit of measure, except in the clause providing for deposits of gold, where it became "a warehouse receipt for gold" – a clause which disappeared in the subsequent versions of June 26 and July 10, being substituted by the provision for gold convertibility of national currencies at par.[10]

What is the reason for introducing a monetary unit which is in fact nothing else than another name for gold? Perhaps it was only smoke in the eyes for the British, while U.S. officials remained fundamentally critical against the introduction of an international currency. They feared the possible inflationary effects of an accumulation of balances,

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5 *Ibidem*, p. 79.
6 *Ibidem*, pp. 81-2.
7 This was done, as we shall suggest, only to be able to easier show the uselessness and to abandon the idea of a new international money altogether, in favour of surreptitiously promoting the dollar as an international currency.
8 Horsefield, *The International Monetary Fund*, vol. I, p. 41.
9 *Ibidem*.
10 *Ibidem*.

and they believed that there would be strong opposition against the use of government funds to purchase an international currency (different from gold), in view of sterilising its effects.[11]

At a meeting with U.S. representatives in Washington in February 1944, Keynes proposed modifications to the Fund, in view of making Unitas more similar to Bancor. The objections of U.S. officials revealed their opposition to the adoption of an international money as such: in their view, the British, "unable to secure the redistribution of real gold, proposed to create a substitute out of thin air".[12]

By this time, U.S. representatives appear to have already abandoned even the idea of an international money. It was the British who insisted on the adoption of Unitas, in view of introducing and preserving the distinction between national and international money. The British feared that entrusting the Fund with members' currencies could threaten the autonomy of national monetary policy. On the contrary, White considered the adoption of an international unit of account, over which the U.S. would have no control, as a surrender of monetary sovereignty (thus implicitly suggesting that American monetary sovereignty would suffer no limitation).[13]

The issue remained unsettled throughout February and March. British officials regarded it as a matter of so fundamental importance that it ought to be deferred to the decision of the Ministers.[14] This, in turn, would have required a comprehensive revision of the problems arising from Clause VII of the Lend-Lease arrangement, and hence an attention that Ministers could not afford, under the war events of Spring 1944.[15] The American government pressed for reaching an agreement, until Britain accepted the version without Unitas, which was published on April 21.

The publication of the Joint Statement in London on the following day was introduced by an *Explanatory Note by United Kingdom Experts*,[16] in which the functioning of the Fund was related to that of the Clearing Union, and it was shown that "these two arrangements represent alternative technical setups, capable of performing precisely the same functions".[17]

Even if this declaration may well have been inspired by political prudence, in the attempt to reach a mediation, it is nonetheless true that the Joint Statement was still consistent with the main objectives of the Clearing Union. The fact that Britain eventually accepted to do without an international unit of account does not mean that they were willing to renounce their main goals: the autonomy of national economic policy, and the possibility of reconciling the goals of domestic economy and the needs of foreign trade. The points on which British delegates insisted at Atlantic City seem to confirm this, being primarily aimed at preserving the right of members to modify their

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[11] *Ibidem*.

[12] Quoted in Horsefield, *The International Monetary Fund*, vol. I, p. 65.

[13] *Ibidem*, with reference to H. D. White, *Some Notes on the Articles of Agreement of the International Monetary Fund*, May 1946 (Princeton papers, Box 10, File 27).

[14] This makes it all the more surprising that it should be settled, between Atlantic City and Bretton Woods, without even being discussed by the delegates, and reinforces Van Dormael's hypothesis, according to which the issue was passed under silence because it was too important to be left open to discussion (A. Van Dormael, *Bretton Woods: birth of a monetary system*, Macmillan, London 1978, pp. 200-203).

[15] Horsefield, *The International Monetary Fund*, vol. I, p. 65.

[16] Reprinted in Horsefield, *The International Monetary Fund*, vol. III, pp. 128-31.

[17] *Ibidem*, p. 129.

exchange rates as they may consider necessary or advisable in view of domestic balance.[18]
Between the Joint Statement and the Articles of Agreement, another sea change occurred in this very crucial aspect of the international monetary system: from gold as the only standard of value to a gold-dollar standard, in other terms from an international to a national reserve currency.[19]
The change was accomplished in two steps. Both surprisingly quiet, apparently straightforward, without discussion, and without trace in the proceedings of the Conference.[20]
The first step was probably made on the train trip towards Bretton Woods, by the members of the U.S. delegation that were responsible for preparing the draft to be submitted at the Conference. The addition of a reference to "gold-convertible currencies" (i.e., in 1944, only the dollar) to the article defining the "common denominator" for international exchanges was presented as a joint U.S. & U.K amendment to the draft, among other amendments proposed by other delegations that had had the opportunity to see the draft beforehand. It is however quite puzzling that, after having agreed on a common plan at their previous meeting, they should have also agreed to change it. It is comprehensible that the plan could be accompanied by amendments proposed by either the U.S. or the U.K. on specific points of divergence. But a joint amendment to a joint statement sounds like nonsense. It is easy to imagine that the British officials would have never backed it. In fact, they had already explicitly opposed any reference to "gold-convertible" currencies.
The second step consisted in the outright substitution of "the U.S. dollar" to "gold-convertible currencies" (thus excluding any other currency that should gain convertibility thereafter). This second step was taken presumably during the last days of the Conference, at night, by a special committee. Again, without discussion.
As Moggridge reports: "despite the delay in finishing the Conference, there were still not complete copies of the Articles of Agreement ready when the delegates signed them at the end".[21] This is confirmed by Keynes himself, in a memorandum on the International Monetary Fund dated 29 December 1944:

> We, all of us, had to sign, of course, before we had had a chance of reading through a clean and consecutive copy of the document. All we had seen of it was the dotted line. Our only excuse was the knowledge that our hosts had made final arrangements to throw us out of the hotel, unhouselled, disappointed, unanealed, within a few hours.[22]

Why this hasty outcome? Why was an existing national currency eventually preferred to a new international unit of account? In order to answer, it is necessary to consider in detail the consequences of the two options for international economic relations. This is the object of the next session.

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[18] Horsefield, *The International Monetary Fund*, vol. I, p. 82-3.

[19] The problems experienced several decades before with a "limping bimetallism" could have contributed to dissuade from adopting a double standard.

[20] *Bretton Woods: looking to the future. Conference proceedings*, Washington DC, July 20-22, Bretton Woods Committee, Washington 1994.

[21] D. Moggridge (ed.), *The Collected Writings of John Maynard Keynes, Vol. XXVI. Activities 1941-1946. Shaping the post-war world: Bretton Woods and reparations*, Macmillan, London, 1989, p. 96.

[22] J. M. Keynes, "The International Monetary Fund", memorandum of 29 December 1944, in *Collected Writings, Vol. XXVI*, p. 149.

III.

What were the consequences of adopting a national reserve currency rather than an international currency unit? Let us analyze the functioning of the two plans, paying particular attention to the way in which each of them deals with the common declared goal of allowing the imbalances implied by the physiological operation of international trade, but in view of their reabsorption.

Keynes's proposal for the post-war international monetary regime envisaged the establishment of an International Clearing Union. Each country would hold an account with the Clearing Union. The accounts would be denominated in an international unit of account called Bancor. The equivalence between Bancor and the currency of each country would be set at a certain par. The initial balance of each account would be set to zero Bancor. All international settlements would have to be made by transfers of a corresponding amount of Bancor, from the account of the importing country to the account of the exporting country. Each country would be granted an overdraft facility, i.e. the possibility of spending Bancor that it had not yet earned, thus recording a negative balance with the Clearing Union. A country with a negative balance would be called a deficit country; a country with a positive balance would be called a surplus country. Each country would be granted the possibility of accumulating a (negative or positive) balance up to the level of its quota equal to its relative weight in international trade.

Within the system thus designed, international money would be created every time a deficit country used the overdraft facilities provided by the Clearing Union to pay for its imports towards a surplus country. Money creation would thus take the form of an increase in the positive Bancor balance of the surplus country with the Union. Symmetrically, a *destruction* of international money, and hence a reabsorption of the temporary imbalances, would occur whenever a payment would take place in the opposite direction, from a surplus country to a deficit country, reducing the positive balance of the former and the negative balance of the latter. Every other type of payment, from a deficit country to another deficit country or from a surplus country to another surplus country, would only involve a transfer of negative or positive balances, without affecting the overall volume of money outstanding.

Hence, in any given moment, the total amount of international money would be equal to the aggregate trade imbalances within the Union (i.e. to total deficits = total surpluses). Money creation would thus be closely tied to trade, with the purpose of providing financial breathing room for trade deficits. Within such a system, it is not the availability of money that allows trade, but rather trade that gives rise to the money required.

Until now, we have only considered the mechanisms for the creation of money. It is not surprising, therefore, that they should appear inflationary, as indeed they were accused to be by the critics of the Keynes plan. Of course, if this had been the entire plan, those critics would have been right. But we still have to look at the rest of the picture.

In fact, the Clearing Union was not intended to encourage *systematic* deficits, but only deficits of a *temporary* nature. Accordingly, to avoid the accumulation of permanent deficits, the Keynes plan included not only limits but also interests to be paid on negative Bancor balances. Such interests were intended to serve as an inducement, for deficit countries, to converge towards a balanced trade.

However, the facilities provided by the Clearing Union were intended to serve the interests of both surplus and deficit countries, since they would have allowed the former to sell just as they would have allowed the latter to buy, goods that could not have been exchanged without the existence of the Union. Hence, not only deficit countries, but also surplus countries were required to collaborate in re-establishing the balance of the system.

Accordingly, to avoid the accumulation of permanent surpluses and the ensuing stagnation of excess money, the Keynes plan included also limits and fees to be paid on positive Bancor balances. Such fees were intended to serve as an inducement for surplus countries, to contribute to the convergence towards a balanced trade, and were designed to perform as a sort of drain for excess money (i.e. imbalances) within the Union.

On the basis of common sense, the fact of imposing on creditor countries the same obligations of debtor countries may appear arbitrary and unjust. However, this common sense is not an innate wisdom responding to a natural justice, but it stems from a peculiar conception of money, which in turn is tied to the historical embodiment of monetary institutions in the form of a reserve asset, i.e. of *liquidity*.

In fact, the obligation of the creditor is perfectly justified in a system where the balance is defined in terms of *clearing* (i.e. accounts equal to zero): since surplus and deficit countries are all out of balance, the burden of correcting the imbalances should be distributed symmetrically between them.

This is precisely the intention that inspires Keynes in designing this peculiar feature of the Clearing Union:

> a country finding itself in a creditor position *against the rest of the world as a whole* should enter into an obligation to dispose of this credit balance and not to allow it meanwhile to exercise a contractionist pressure against the world economy and, by repercussion, against the economy of the creditor country itself. This would give us, and all others, the great assistance of multilateral clearing.[23]

The credits do not arise from having spontaneously lent a money, which could have been used for any other purpose, or even not used at all, i.e. a reserve currency; they arise from having carried out a trade transaction that only the existence of the Clearing Union has made possible thanks to the existence of a currency unit. Hence, there is no reason to remunerate those credits.

In fact, the credit required by international trade is not made available by surplus countries, but by the existence of the Clearing Union itself. Keynes himself described the properties of his plan in the following terms:

> The peculiar merit of the Clearing Union as a means of remedying a chronic shortage of international money is that it operates through the velocity, rather than through the volume, of circulation.[24]

The amount of money becomes irrelevant in the sense that the functioning of the Clearing Union and its capacity of supplying an adequate money for international transactions does not depend on the initial endowment of means of payments (e.g. in the form of gold reserves or of reserve assets in general).

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[23] J. M. Keynes, "Proposals for an International Clearing Union", 18 November 1941, in *Collected Writings, Vol. XXV. Activities 1941-1946. Shaping the post-war world: the Clearing Union*, p. 47; italics by the author.

[24] 'The Objective of International Price Stability', *The Economic Journal*, Vol. 53, No. 210/211, Jun. - Sep., 1943, p. 185; reprinted in *Collected Writings, Vol. XXVI*, p. 31.

Keynes is not unaware of the current relations of power, reflected in the endowments of gold reserves and credits at the end of the war. The U.S. are the owners of over 80% of all global monetary gold: hence they have a legitimate interest that this gold accumulated under the old monetary law is not simply wiped out by the new. For this reason, Keynes envisages the possibility of converting the old money into the new, by depositing in the Clearing Union gold and receiving an equivalent credit balance in Bancor. However, in order to ensure the enforcement of the new rule, he also establishes that such a conversion should be irreversible. In other terms, gold should be convertible into Bancor, but Bancor should not be convertible into gold. The only shift that makes any sense is from the old to the new, and not vice-versa.
Hence, without disregarding the status quo, and the given distribution of power, Keynes aims at inaugurating a new monetary order where distribution of power responds to different rules as in the past.

By contrast, the plan approved at Bretton Woods depended from the outset on the collection of a predefined quantity of money in an International Monetary Fund. It did not create an international currency, but merely gave the possibility of swapping the national currencies deposited in the Fund in order to perform international settlements. The basket of gold and currencies collected in the Fund provided thus a sort of reservoir for international reserve assets, in the form of national currencies that could be exchanged one for the other within given limits.
Each country subscribed to a certain quota of the Fund, depositing the corresponding amount in the Fund, 25% in gold and 75% in its own currency. Each country was thus entitled to purchase from the Fund the currency of another country, for the purpose of effecting a payment towards that country. The amount of its own currency in the Fund increased accordingly. Deficit (and surplus) countries were therefore characterized by the fact of holding more than (or less than) 75% of their own quota in their own currency with the Fund.
However, the conditions for deficit and surplus countries in the Fund, unlike those in the Clearing Union, were strongly asymmetrical: a deficit country was obliged to repurchase its own currency from the Fund and was subject to a cost for the operation, which was structured, therefore, as a ‘hidden loan’; instead, a surplus country was not subject to any obligation or to any cost, and hence had no incentive to restore a balanced trade nor to reabsorb previously accumulated imbalances. On the contrary, there is an incentive to maintain surplus balances, in order to earn a rent.
The provisions of the Articles of Agreement to deal with persistent and widening surpluses were contained in the so-called ‘scarce currency clause’ (article VII). It is often stated that creditor countries were not adequately involved in the adjustment of post-war imbalances because this clause was never fully enforced. In fact, it was perhaps the most important and effective clause of the whole Agreement. The real problem was that the application of this clause implied a suspension of the rest of the Agreement. According to its provisions, if the currency of a country became scarce (because of a persistent trade surplus of that country that induces all other countries to demand its currency) the Fund may borrow or purchase the scarce currency and allow the other members to impose protectionist measures. All these provisions amounted to a perpetuation of international imbalances and to an organization of global trade which contrasted sharply with the purposes of the Agreement and with the instruments originally designed to accomplish them.

Moreover, the scarcity of a currency (namely the U.S. dollar) was not only possible, but probable. Indeed, the total resources of the Fund were set at such a low level, that it had no chance of meeting the requirements of international trade. Hence, from the very beginning, post-war international settlements had to rely on an alternative reserve asset, in the form of the national currency of the greatest surplus country, namely the U.S. dollar.

Perhaps at this point we have all the elements to explain why the reference to gold in the Articles of Agreement was inevitably by-passed by the reference to the dollar: gold reserves were insufficient to manage the imbalances required by the expansion of global trade and post-war reconstruction.

The shortfalls of the articles of agreement of Bretton Woods paved the way to a creation of international reserve assets, which occurred not within but without the framework of the Fund, and without any restriction or link to the trade of actual goods, mainly through the development of the euro-dollar market. Unlike the Clearing Union based on Bancor as a currency unit, the prevailing system based on the dollar as a reserve currency had no built-in mechanism designed to ensure both the circulation and drainage of international money. In other terms, despite their common goals, the latter was not capable of reabsorbing global imbalances, but rather allowed its currency to be indefinitely hoarded as a reserve asset by foreign central banks.

This perspective may help understand post-war disequilibria not as the result of deviations from the rules of the game, but as an inevitable concomitant of its operation. In particular, the intrinsic problems of a reserve currency system, as they have appeared since its inception, may give account of apparent paradoxes, namely why it was possible to pass from a dollar shortage to a dollar glut, i.e. from a lack of international reserve assets to an excess of international reserve assets and hence from a net creditor position to a net debtor position of the U.S.; and why, vice versa, the current crisis has detonated in the form of a sudden shift from a superabundance of international money to a sudden draught of international capital movements.

Moreover, the fact of having seen the limits inherent in a reserve currency may help understand the current political and scientific impasse in the face of growing global imbalances. When international money is conceived and implemented as a quantity of reserve assets, there seems to be always too little or too much of it and never an adequate measure. The reasons for this difficulty are manifold:

1. it is difficult to estimate in advance how much international reserve currency is needed, especially when the need is not clearly defined;
2. it is difficult, once the requirements have been estimated, to adjust the actual amount accordingly, or to define the rules of its creation, so as to accommodate the fluctuations in its requirements;
3. the same quantity may result either insufficient or excessive according to its actual use in circulation.

On the other hand, the fact of having appreciated the virtues of the clearing mechanism based on an international currency union may help us to imagine a way out of the structural flaws of the present system, and not merely a way of containing its most dramatic effects. This allows us to reconsider more in detail the constructive part of Mr. Zhou's proposal, with a better understanding of its actual scope and limits.

IV.

The proposal advanced by Mr. Zhou is to enhance the use of Special Drawing Rights as an international reserve asset:

> The SDR has the features and potential to act as a super-sovereign reserve currency. Moreover, an increase in SDR allocation would help the Fund address its resources problem and the difficulties in the voice and representation reform.

To this end, Mr. Zhou recommends to:

> Actively promote the use of the SDR in international trade, commodities pricing, investment and corporate book-keeping [and to] create financial assets denominated in the SDR to increase its appeal.

The strengthening of the role of the SDR in international economic relations requires, moreover, a redefinition of the governance of its issuing process and of the balance between the countries and currencies supporting it. This is why Mr. Zhou further suggests that:

> The basket of currencies forming the basis for SDR valuation should be expanded to include currencies of all major economies.

The first part of the proposal was already endorsed by the G-20 in April 2009 and has recently been implemented. With a general SDR allocation taking effect on August 28 and a special allocation on September 9, 2009, the amount of SDRs has increased almost tenfold, from SDR 21.4 billion to SDR 204.1 billion.
The use of SDRs as a reserve asset can certainly serve to substitute part of the conspicuous reserves in dollars held throughout the world and particularly in Asia. It may therefore allow to ease the bilateral tensions between China and the U.S.
However, despite the extraordinary increase, total SDR allocations are still dramatically insufficient to reabsorb the global imbalances accumulated in over sixty years of dollar standard. Despite having increased by a factor of ten, they are still ten times lower than the overall foreign exchange reserves of China alone, and fifteen times lower than the foreign indebtedness of the US.
Moreover, and more seriously, it is far from clear that even an expanded use of SDRs as a reserve asset would avoid the accumulation of *further imbalances*. In fact, unlike the provisions of the Clearing Union, the IMF rules do not impose on countries that accumulate SDRs in excess of their original allocation any kind of charge or constraint; on the contrary, if a member's SDR holdings rise above its allocation, it earns interest on the excess.
In addition, if the volume of SDRs should increase, there would also be an increasing concern to assure their acceptability. To avoid an inflation of SDRs it would be necessary, as the Chinese proposal suggests, to increase their use, not only as a means of payment for the actual trade of goods and services, but also to denominate financial assets. In any case, it would be essential to assure their constant convertibility into *equally appealing* national currencies. In other terms, it would be necessary to assure the liquidity of both the SDRs and of the currencies that are included in the basket and that represent de facto the ultimate form of international liquidity, as long as SDRs are conceived as a basket of national currencies.
It is for this reason that the Chinese request to include the yuan in the SDR-basket have been challenged by the counter-request to assure full convertibility of the yuan on

foreign exchange markets.[25] But this would amount to requiring the yuan to increasingly assume the function of an international currency, which is exactly what the Chinese proposal intends to prevent, with a view to avoiding the substitution of current international imbalances with new international imbalances.

A way out of this dilemma could be to transform the SDR from reserve asset to currency unit. To make SDR the ultimate means of denomination and payment of international debts, i.e. the international money. To establish, accordingly, a one-way convertibility, from national currencies into SDRs, but not from SDR to national currencies. To introduce symmetric charges on SDR balances above and below original allocations. To link new issues of SDRs to international transactions or to purchase of primary goods as real reserve asset by the IMF or by another international organization.

In any case, the primary objective of a sound monetary regime should be to define the rules not only of money creation, but also of its circulation and destruction, in order to ensure that the imbalances are always reabsorbed. In order to achieve this objective, as we have tried to show in this paper, two crucial features are required:

- not only the distinction between international money and national currencies,
- but also the existence of a pure international unit of account, that cannot by definition serve as a reserve asset.

At Bretton Woods, the conjunction of these two features allowed Keynes to design an international financial system in which the interests of each single country are not set at variance with those of other countries and with the well-being of international trade as a whole. This plan was rejected in favour of a system that was supposed to serve the same goals while in fact its operation has led in the diametrically opposite direction. The oft-invoked new Bretton Woods should perhaps not merely repropose the Keynes plan, but it ought to reinterpret its main principles according to the present economic and political situation of the world.

Massimo Amato
Luca Fantacci

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[25] Cfr. D. Marsh and A. Seaman, "China's love-hate relationship with the dollar", *Financial Times*, 9 September 2009.