Financial exit: time for a new Bretton Woods conference amid the Ukraine war?

***Ousmène Jacques Mandeng** examines the need for a new financial order as integration is unlikely to hold up amid the Ukraine war. Despite important network advantages emerging from the Bretton Woods integration policies, Western control of the international financial system caused overdependence on the US dollar and subsequent liability chains impairing needed flexibility. Looking forward, financial decentralisation and peer-to-peer relations may be more effective to reduce dependency between international institutions and their clients.*

The Ukraine war seems set to trigger a reorganisation of international economic and financial relations. New alliances are being revealed that may be incompatible with existing ones. Different economic spheres are highly likely to emerge amid significant political and ideological divergence. This new world may no longer rest on the premise of a single financial system and the ever-closer economic and financial integration from the Bretton Woods system and its successor arrangements. A new financial order is needed.

The financial sanctions against Russia, a necessary and welcome measure, will serve as a reminder for many that the international financial system has largely remained under the immediate control of Western countries. Despite Western countries representing about half of world output, their currencies are used nearly exclusively in international financial transactions. So any international transfer or exchange of financial assets, goods and services rests on financial market infrastructures and entities governed by Western countries. The fundamental asymmetry between the real and the financial spheres has been a source of tension and disequilibrium. The system may not be reformable enough.

During World War II, the U.S. convened a conference at Bretton Woods, New Hampshire, starting on 1 July 1944. 44 Allied countries discussed a “currency plan” and established the International Monetary Fund (IMF). It laid the foundation for today’s international financial system. Taking place only 6 weeks after operation Overlord (D-Day), it ensured a new financial order was in place to support a speedy post-war recovery.

The Bretton Woods conference stipulated that every country wanted to participate in a single world economy. While the IMF had originally been planned with a size of US$8 billion, a prescient U.S. envisaged it could grow to US$10 billion “once the enemy countries joined.” Germany and Japan did so in 1952. China and the Soviet Union were also at Bretton Woods. Specifically, the People’s Republic of China was seated in 1980 and Russia joined in 1992. By that time, most countries had become members of the IMF.

The IMF established fixed exchange rates to advance financial and economic integration. All currencies were pegged to the dollar while the dollar was pegged to gold at US$35 an ounce. This meant that all countries had to pursue economic and financial policies consistent with maintaining a fixed exchange rate. The system also stipulated that economic policies of one country should not excessively adversely affect the economy of another. As such it required policy coordination but also reinforced important and desired interdependencies among countries. National currencies, rather than a neutral medium like gold, became the basis for international exchange.

As the system developed, it relied on a reduced number of currencies used in international financial transactions – predominantly the dollar. Important advantages came with the system’s positive network effects, but it also led to a disproportional dependence on U.S. economic and financial policies and institutions. Bretton Woods institutionalised the dollar as the world currency. While the system changed with the suspension of the dollar peg to gold in 1971 and the adoption of floating exchange rates for the main currencies, centralisation advanced further and became entrenched. The IMF has lost its influence in managing the system and struggled to accommodate an increasingly diverse membership.

The reliance of the financial system on a small set of currencies caused considerable dependencies on a narrow set of financial assets and market infrastructures. While the system enabled effective integration then, it complicated disintegration. As payments relations are often indirect, ejecting one country or institution may lead to a collapse of entire payment and liability chains. As such all other institutions and their clients are affected, rather than just the institution and their clients in question.

The system therefore implies high costs for both leaving and remaining countries. It also risks procrastinating willing leavers and makes remainers reluctant to expel no longer wanted participants. It may thus unduly prolong unproductive financial relationships and thereby impair the effectiveness of remaining ones. It also risks creating incentives for obstructive behaviour. This system seems increasingly inconsistent, particularly with the realities of the new world.

A system of variable geometry may now be more effective. While a new simple division of the world economy may seem possible and tempting, a more flexible arrangement should be sought. Countries will be ejected or seek exit as they may no longer want permanent relations with a given grouping. Rather than partition though, decentralisation should be the new anchor for international financial relations.

Such new international financial system would have to fundamentally rest on peer-to-peer relations and loose coupling to reduce dependencies to the least extent practicable. It should give rise to incentives to join without causing unwarranted pains for leavers and remainers. The new system must use multiple currencies to support financial decentralisation. There would also be room for neutral or supranational currencies to complement national currencies.

The Bretton Woods system was most visionary and has brought unparalleled advantages. But its fundamental premise of ever-closer international integration for all countries may simply no longer hold. There is a new urgency to act as existing arrangements risk become increasingly ineffective in accommodating economic and financial divergence. While the Ukraine war is in full force, there is no excuse to delay planning a new international financial system more aligned with a permanently decentralised world. This would signal preparedness and willingness to accommodate the new order.

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Notes:

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