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ON THE RELATIONSHIP BETWEEN BRETTON WOODS AND THE FINANCIAL MARKETS

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Abstract

With the crisis of 1929 began a process that characterized both the financial system and the real economy. In this context, a key role was played by the Bretton Woods Conference. During this event, many decisions were taken and many important international institutions were born. However, the financial market played, also, an important role: it was tempting for capital to move freely.
With this work, we want to show how, instead, thanks to the diffusion of the euro-dollars, what was previously stated was not there. Granger and Toda-Yamamoto test, in fact, show how even in the Bretton Woods time the finance capitals continued their expansion.

Keywords: Bretton Woods, Capital Movement, Financial Market, Granger
JEL Classification: F22,F42, F44;

Introduction

At the end of the Second World War the economically stronger countries - the USA and the United Kingdom- began to lay the foundations for the birth of a new system of international relations. It had to regulate the international economic and political life, ensuring a lasting balance of powers, avoiding new conflicts. The idea was to create institutions operating in the economic and financial sphere so as to guarantee monetary stability and the growth of international trade. To this end, the Bretton Woods Conference was organized where, in 1944, Keynes and White brought their proposals to stabilize the international monetary system. Among the various problems that were faced, there was also that relating to capital movements. It was decided to support control over the international capital movements. In order to send money abroad, citizens and companies of all the states had to give communication to their Central Bank, obviously through their bank of trust, and the Central Bank authorized the transfer. Also receiving money from abroad required passage through the Central Bank.

In this system, therefore, central banks played a fundamental role: they saw all the flows of money with foreign countries, and every day they calculated the exchange rate between the currencies based on these data. To avoid excessive inflation or the sudden impossibility of paying debts abroad, they set aside reserves (in dollars or gold) for the money they printed.

Governments could intervene to limit or encourage international capital movements, imposing or removing protectionist measures.
The restrictions on international financial flows, in other words, would have allowed "regulated" changes in exchange rates in situations of persistent imbalance. In theory, policymakers would have been able to change exchange rates deliberately, without the pressure of intense speculative attacks. However, the reasons for choosing to limit capital movements may also be others. In analyzing the limitations imposed on the financial system by the agreements of Bretton Woods is important to note that, in the immediate post-war

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period, the system world financial did not have a good reputation either in the United States or in many other industrialized countries: the financial market was responsible for the great depression. In this context, we find the choices of Keynes and White to introduce controls on capital flows. It is interesting to note that such policy would seem contrary to US interests, more creditors to the world. In fact, the United States would not need to adopt such controls, which were allowed, but not obligatory; furthermore, at that time the great American economic interests were directed to the free movement of goods and not so much to the capital. Therefore, the decision to limit the role of finance was a pain to reconcile the market with political and social needs, reaching so the so-called "embedded liberalism compromise" that sees, in fact, the
market (embedded) in the system of political and social relations.

However, although this approach initially worked well, Bretton Woods' success in restoring international trade, over the years, made it increasingly difficult for policymakers to avoid a rapid resurgence of the financial market, even speculative with the diffusion of the euro-dollar market.

1. The economic context

After the 1929 crisis and the great depression that followed, the international economic system was brought about by the outbreak of the Second World War. The finance sector, however, reacted differently than the first great war. In particular, in the Old Continent, the financial markets recorded the best results. For example, the London Stock Exchange, above, performed the gold from 1939 until 1948 and had even greater returns than those in the United States of America (fig.1).

Fig. 1 Equity returns pre-post World War II

Source: Global data Service

However, this phase of growth in equity indices was not likely to last. In fact, with the end of the second great conflict, the international economic system came out profoundly damaged. The finances of the European states were practically collapsing: heavy imbalances in the balance of payments to the USA; high inflationary levels due to countries' expansive monetary policy decisions to finance military spending; production equipment destroyed. In this context, therefore, a recovery would have been possible when economic policy choices had been taken away from those post-World War I and which had created, at an international level,

the segmentation of the economic system into closed national entities. In fact, since this was considered one of the causes of the war just ended, the foundations were laid to rebuild a world economy open by anchoring the exchanges to a system of payments stable and lasting over time. Therefore, from the 1st to the 22nd day of July 1944, forty-four nations gathered in the city of Bretton Woods to give life to what will become, in reality, a complex process of reorganizing the world monetary institutions as a response, precisely, to the disappointing experience of the first post-war period. The start of this "new world order", however, was not easy since it was born on the basis of a compromise between the United States of America and England that led to rejecting the Keynes plan for the US White plane.

The American goal was to tackle the problem of supporting the reconstruction and development of post-conflict through the recovery of the balance of payments balances and at the same time, the increase in international trade. To do these goals, a new monetary structure was needed which would have incorporated the advantages of a certain exchange flexibility without, however, the disadvantages of their unlimited flexibility (A. Marzano, 2006). Therefore, the Bretton Woods agreements gave rise to a flexible but adjustable exchange rate regime, based on certain parities established between different currencies. A system of exchange and payments which, however, was based on a double commitment: the United States had to guarantee the convertibility of the dollar in gold at a pre-established rate and the other countries would undertake to declare the parity of their currency against the dollar with an oscillation not higher than 1 percent above and below parity; the International Monetary Fund, born of the agreements of 1944, would have instead committed itself to favoring the financing of those countries that presented excessive balance of payments balances.

2. Debt and finance hidden in the Bretton Woods choices

Although, in general, the experience and results of the Bretton Woods Agreements are to be considered positive in terms of exchange rate stability and economic growth, the lack of an international unit of account, as though by Keynes in the bancor, made Bretton Woods is a monetary system, in fact, without a currency. Unquestionably canceling the role played by gold up to that time and anchoring, instead, a national currency to the precious metal, in fact, we wanted to attribute to a currency a task until then never attributed.

In other words, an essential defect was generated: the coin was conceived as a credit title deriving from the indirect value of the gold reserve and not as a purely conventional title. The theoretical implication of this assumption is that the opening of a credit stops at the bilateral level since the same credit if denominated in the currency of a country, can be used by the creditor only for the purchase of the assets of that country (M. Amato, L. Fantacci 2014). Obviously, this limit was exceeded - in part - by the possibility for a country in deficit to be able to buy the necessary currencies to pay the creditor country from the International Monetary Fund thus allowing the opening towards a multilateral credit

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relationship. The foundations of the International Monetary Fund according to which it generates money through an operation to sell the foreign currency of a member country in exchange for the national currency, will be an essential limitation of the monetary system put in place: the creation of a debt. Therefore, although the preference towards the International Monetary Fund compared to the Keynes Clearing Union passed precisely from the need to avoid the emergence of a debt position, the effects were the same and even more cumbersome. In fact, for a country in deficit the purchase of currency at the Fund involved the consequences of a real loan: one had to commit to the repurchase of one's own currency at the IMF since the excessive presence of currency at the Fund it determines a burden as the quantity increases;
each purchase transaction involved a commission. Thus, the obtaining of foreign currency in exchange for national currency committed the country in the deficit of repayment of the loan. The balance payments deficits must, therefore, have been temporary as the debt position had to be filled as soon as possible. This repayment, which could take place through payments in foreign currency, would be the prerequisite for the countries in excess of being able to become the real international currency instead of the Fund itself. The reason lies in the fact that a country registered a demand for its own, as it presented a surplus, it would have found itself in a position of advantage as an international seigniorage. These characteristics were defined in the United States of America, the choice of the White piano appeared to be the answer of the strong position in the United States within the Bretton Woods Conference.

The history will confirm everything. In fact, the US had led the world to use the dollar as an international currency despite the fact that, on an official level, the mention of the US currency will only appear in the final version of the agreement. However, the reasons behind the choice of the White plan cannot be limited to the sole search for a dominant position that the United States demanded, not wanting to be on the same level as all other countries. In fact, other logic indirectly or directly favored the renunciation of an international unit of account *(the banchor*) with the non-acceptance of the English plan. They can be traced back to the need to avoid that the movements of capital - in the presence of an international unit of account - could become, as White himself stated, completely useless. In other words, although it insisted on a limitation of capital movements, the Bretton Woods Conference went in the direction so desired by the Wall Street financial communities. In fact, since the US yielded a lot of money to the world, they retained the power of money creation. Thus, the marriage between debt and finance was consolidated, which witnessed, therefore, the enormous liquidity of dollars.

3. The false limitation of capital movements

In the Bretton Woods Conference, the world had not forgotten, at least apparently, the 1929 crisis. In this context, according to White, was taken the decision to “stem” short-term movements and all portfolio investments. However, this limitation lasted until the early 1960s when, more or less legally, most economic operators around the world began to exploit the weaknesses of the international

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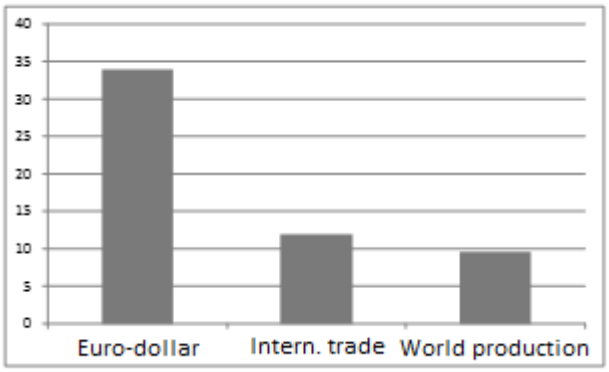
monetary system that had been created. Among these, the main was that of the so-called Eurodollars which were deposited in the short term denominated in dollars at banks whose headquarters were located outside the US territory. These financial assets presented a weak regulation compared to strict banking regulation. This allowed the Eurodollars a remarkable growth that fed, international trade and the first flows of foreign direct investment (M.Obstfeld and A.M. Taylor, 1997).

The euro-dollar market had the characteristic of being free of regulations, since the euro-banks that received dollars in deposit used them to finance, through international interconnections, companies or financial operators. In other words, the euro-dollar banks offset the financial market regulated by Bretton Woods constituting a first type of deregulation. Therefore, they offered high-interest rates on deposits unlike traditional banks that operated on national markets, given the lower costs incurred thanks to computerization. This situation generated two disruptive effects on the international money market: on the one hand, they attracted huge short-term liquidity, on the other, the growing demand for Eurodollars diminished the risk perceived by investors. The result was that in just ten years, growth in Eurodollar capital exchanges surpassed those of international trade and world production (fig.2).

Fig.2 Eurodollar market growth, 1964-72



Source: our analysis on tab.1. Battilossi, *The eurodollar Market, 2009*

Although, according to Amato and Fantacci (2009), some authors have empirically demonstrated how on a global scale the multiplication of Eurodollars has not been really meaningful, we convey with those who see in the Eurodollar market a case of optimal allocation of resources, they have guaranteed certainty in an intermediary system that moved from the financial markets to the banking system. If history teaches that the goal and the purpose of the birth of finance was to provide liquidity, during Bretton Woods with financial markets tightened by hypothetical laces and laces, Euro-dollar banks took on the task of a vehicle for investment and savings, especially in the short term.

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We can affirm that the stringent choices imposed by the Agreements on the financial market have come shyly less in the same choice as the White plan. It will be, however, with the 1958 convertibility declaration that finance, indirectly, will begin to regain strength and vigor by developing beyond the rules imposed by the Treaty. The main and undisputed protagonist was the Eurodollar market, whose relevance will be such as to contribute substantially to the collapse of the Bretton Woods System itself. In other words, the de jure limitation of capital movements will clash with the de facto liberalization that will help to bring down a weak born system.

4. Capital movements and Euro-Dollar market: empirical analysis

-Results

Now we want to check how during the Bretton Woods period the euro-dollar market was the lubricant for capital movements. To carry out this analysis we will follow the approach according to which the investments-saving co-movement are compatible with capital mobility (Obstfeld 1986; Engel and Kletzer 1989; Backus 1992; Baxter and Crucini 1993). The dataset for this study is 1950-1972 utilizing BEA' dataset for capital movements, OECD Monetary and Financial Statistics data for Euro-Dollar market. All variables were considered as logarithmic.

In order to explain the impact of the Euro-dollar market on capital movement during Bretton Woods period we will use the Granger Causality test with Toda Yamamoto approach.

Tab1. Summary Statistics

Variables	Mean±SD	Minimum	Maximum	IQR	10 Trim	Pseudo SD
l.Euro-Dollar	0,245±1,153	1,08	4,19	1,05	0,63	1,186
l.Capital-mov	1,416±1,245	2,04	7,14	1,92	1,89	1,206

In Table 1 we have the summary statistics for the overall sample. In this analysis we can see as the Mean value of all variables is positive. We can also see that, for each variable, the 10-Trim values are near to the mean and the standard deviation to the pseudo-standard deviation, the inter-quartile range shows the absence of outliers in the observed sample.

Tab.2 Granger-Toda-Yamamoto Test

dep/ind	Euro-Dollar	Capital-mov
l.Euro-Dollar	1	2,05
l.Capital-mov	1,84***	1

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**P<0.01

In Table 2, instead, we performed Toda-Yamamoto test. These results, in fact, to show the effect of the test exists only in one sense: the growth of the euro-dollar phenomenon has caused, in the period considered, the movements of capital. In other words, they have assisted the false rigidity thought of Bretton Woods on the financial markets.

5. Conclusion

Many agreements were made at the Bretton Woods conference. They gave life to a system of rules and procedures aimed at regulating international monetary policy. The objective was to govern future economic and financial relations, in order to prevent the return to the situation that gave rise to the Second World War. According to the economic literature, among the causes of the war there were also widespread protectionist practices, exchange rate devaluations for competitive reasons and the lack of cooperation between countries on monetary policies. To these causes, although this thought may represent a marginal effect, we can also add "the memory of the crisis of '29". Therefore, together with the numerous decisions, during the Bretton Woods constitution, attempts were made to limit capital movements. However, speculators and the financial market overcame capital restrictions by borrowing directly abroad and using the euro-dollar market. In our work, therefore, we have verified how the euro-dollar market has caused the continuous growth of capital movements and the results of the causality test have confirmed this event.

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