The Legends of Bretton Woods

by Francis J. Gavin

Did the Bretton Woods monetary system really provide for economic stability and international cooperation over the quarter century following World War II? That is certainly the conventional wisdom among statesmen, foreign-policy analysts, and academics. The institutions and rules established by the 1944 agreements have been hailed as some of the most important economic and even political accomplishments of the cold war era. As a noted historian recently wrote, "Bretton Woods is the most revered name in international monetary history, perhaps in economic history."[1]

Assessing the performance of Bretton Woods is especially important now because of the widespread dissatisfaction with current monetary arrangements. Recent events, most notably the collapse of the Mexican peso and the steep decline of the dollar against the yen, have increased the concern for the fate of the dollar and the rules of the world monetary regime. Each unanticipated shift in exchange rates is talked about in grave tones, as if greater disaster will follow if the dollar is not stabilized and the system is not reformed. A failure to act, it is warned, could recreate the destructive conditions of the 1930s, a time marked by competitive devaluations, capital controls, and protectionism that in turn produced isolationism, autarky, and eventually war. W.L. Givens has likened the post–Bretton Woods record of dollar devaluation to a cocaine addiction and argued that "a massive deterioration of the dollar's value, particularly relative to the yen, has masked the problem of declining competitiveness and functioned as a habitual surrogate for both industrial policy and productivity improvement."[2] Diane Kunz predicted that "without a pronounced shift in

[1] Margaret Garritsen de Vries, "Bretton Woods Fifty Years Later: A View from the International Monetary Fund," in *The Bretton Woods–GATT System: Retrospect and Prospect after Fifty Years*, ed. Orin Kirshner (Armonk, N.Y.: M.E. Sharpe, 1996), p. 128.

[2] W.L. Givens, "Economic Cocaine: America's Exchange Rate Addiction," *Foreign Affairs*, July/Aug. 1995, p. 17.

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Washington's policy, the decline of the dollar could resurrect the ghosts of the 1930s."[3] And a conference of internationally renowned monetary economists faulted the world's governments for failing to emulate the leadership and cooperation demonstrated by the United States and Great Britain in 1944:

> In the last two decades international monetary relations have been characterized by latent instability, and more recently by severe tensions. Yet the issue of reforming the international monetary system does not appear on the agenda of the policymakers of the major countries involved.[4]

International monetary reform seems especially critical now because of the supposed primacy of economic factors over military considerations in the post–cold war world. This point is hardly debated any more. As a Clinton administration official was quoted as saying, "Everyone acknowledges that economics now plays a central role in foreign policy—that battle is over."[5] There is a widely held belief that peace can be assured only by building up international institutions and creating rules that promote global stability, cooperation, and interdependence. By this standard, current monetary arrangements seem grossly inadequate, a veritable "non-system" dominated by speculators and national authorities who pursue profit or narrow national interest at the cost of international stability. It is argued that current monetary relations are plagued by an exchange-rate volatility that wastes resources, creates acrimony, and promotes protectionism.

Many of these monetary reformers are nostalgic for the good old days of Bretton Woods. Kunz described Bretton Woods as the cornerstone of U.S. foreign economic policy, a crucial part of America's postwar domestic prosperity and ultimate success in the cold war: "Bretton Woods would have a significant bottom-line impact on the American economy."[6] The rules and institutions established at Bretton Woods, it is assumed, subordinated market speculation and national self-interest to the higher goal of international cooperation through a stable exchange-rate regime monitored and enforced by the rules of the International Monetary Fund (IMF). The authors of the plan wanted a system that would "avoid competitive devaluations among currencies; the fund would stabilize foreign-exchange rates, encourage the flow of productive capital among participating nations, help stabilize price levels, promote sound credit practices and reduce barriers to foreign trade."[7] That they succeeded—and thus laid a foundation for international growth, interdependence, and cooperation in the

[3] Diane B. Kunz, "The Fall of the Dollar Order: The World the United States is Losing," *Foreign Affairs*, July/Aug. 1995, p. 26.

[4] Peter B. Kenen, Francesco Papadia, and Fabrizio Saccomanni, eds., *The International Monetary System: Proceedings of a Conference Organized by the Banca d'Italia* (Cambridge: Cambridge University Press, 1994), introductory statement, p. 1.

[5] Anonymous source reported as "one of Mr. Clinton's top economic advisors," quoted in David E. Sanger, "Trade's Bottom Line: Business Over Politics," *New York Times*, July 30, 1995.

[6] Kunz, "The Fall of the Dollar Order," p. 23.

[7] Judy Shelton, "How to Save the Dollar," *Wall Street Journal*, July 15, 1994.

years following World War II—was a view oft repeated during the summer of 1994, in celebration of the fiftieth anniversary of the Bretton Woods conference.

That is why so many analysts want to re-establish a similar system. Judy Shelton, a senior research associate at the Hoover Institution, argues that international monetary reform is necessary to avoid a "global meltdown," and that reforms should be based on the successful elements of the Bretton Woods system:

> The next effort to build a new world monetary order should reflect an appreciation for what has worked well in the past. It should start with the same basic framework laid out in the old Bretton Woods approach: fixed exchange rates among national currencies anchored by a government commitment to redeem in gold.[8]

Last July, the Bretton Woods Commission, led by the former chairman of the Federal Reserve, Paul Volcker, announced an effort to encourage an economic supergovernment to coordinate exchange rates. According to the *New York Times:*

> A half century after the about to be victorious Allies of World War II put in place bold plans for a global financial system and two decades after that system was formally abandoned, a high profile group of economists, bankers, and diplomats is trying to put it back together again.[9]

Should the Bretton Woods monetary system be held in such high esteem, or are many of the standard beliefs about it simply incorrect? The answer, alas, is the latter. First, the Bretton Woods system was not driven by some grand idealistic purpose on the part of its founders, but by considerations of national interest. The British especially saw in the agreements a chance to immunize their planned social programs from international balance-of-payments pressures and to acquire generous amounts of American aid without political concessions. Secondly, the Bretton Woods agreements did not create financial stability, economic interdependence, and international cooperation. In fact, the plan to abolish exchange controls while at the same time establishing fixed exchange rates, full convertibility, free trade, and domestic autonomy was unworkable from the start. What emerged after the war was an ad hoc system plagued by non-convertibility, trade restrictions, and capital controls. These flaws were largely hidden through generous allotments of American aid. When the major European currencies were made convertible in late 1958, the system promptly began to break down. For the next ten years, monetary relations were marked by a chaos and instability that strained relations among the Western allies. Indeed, the internal contradictions of the Bretton Woods system virtually guaranteed contentious balance-of-payments issues that, absent an effective adjustment mechanism, could only be resolved politically. Whether or not

[8] Judy Shelton, *Money Meltdown: Restoring Order to the Global Currency System* (New York: Free Press, 1994), p. 289.

[9] Peter Passell, "Bretton Woods: A Policy Revisited," *New York Times*, July 21, 1994.

monetary relations and dollar policy should be reformed today is certainly debatable, but the history of postwar monetary relations does not provide a helpful vision of what any new system should look like.

The Bretton Woods Agreements

The Bretton Woods agreements of 1944 were the most ambitious and far-reaching monetary agreements among sovereign states in history. American and British financial officials, led by Harry Dexter White and John Maynard Keynes, hoped to set up a system that would maintain stable exchange rates, allow nations' currencies to be converted into an asset over which they had no issuing control, and provide an effective mechanism to adjust exchange rates in the event that a fundamental balance-of-payments disequilibrium did emerge. In the case of non-fundamental deficits that normally arose in international transactions, the deficit country would pay with a reserve asset (gold or a key currency convertible into gold) or seek short-term financing from the International Monetary Fund.[10]

This system differed greatly from a traditional gold standard, in which the domestic money supply, hence the domestic price level, was directly determined by the national gold stock. Under the gold standard, a balance-of-payments deficit would be paid for through the export of gold, resulting in a decrease in the domestic money base and a deflation of prices. The decreased purchasing power would lower that country's imports, and the increased international demand for that country's lower-priced goods would increase exports, naturally correcting the balance-of-payments deficit. Conversely, an influx of gold, by increasing the domestic monetary base and domestic prices, had the opposite effect of boosting imports and discouraging exports, thereby eliminating a payments surplus. According to standard market theory, any disequilibrium would be adjusted more or less automatically, eliminating the need for government interference. In reality, the gold standard worked as well as it did before World War I because capital flows from London, and to a lesser extent Paris, kept the system functioning smoothly.

White, and especially Keynes, believed that an adjustment process based on deflating the economy of a deficit country was draconian at a time when governments were promising full employment and generous social spending after the war. Decreasing the monetary base in a deficit country would lead to a fall in national income, unleashing unemployment and necessitating cuts in government spending. To avoid such a politically unacceptable system, the Bretton Woods regime allowed nations to import and export gold without penalty. Deficits were to be corrected through IMF assistance and small, discrete

[10] Much of this discussion is taken from two sources. See Richard Cooper, *The International Monetary System: Essays in World Economics* (Cambridge, Mass.: MIT Press, 1987); and Paul de Grauwe, *International Money: Post-War Trends and Theories* (Oxford: Clarendon Press, 1989).

changes in the exchange rate. Although the Bretton Woods agreements were hailed as the hallmark of international cooperation, in reality they provided national economic and political authorities an unprecedented amount of immunity from the pressures of the market. Macroeconomic decisions were the sole province of domestic governments, who were often quick to sacrifice measures that would bring about a payments equilibrium in order to achieve domestic goals.

Because it was generally believed that the existing gold stock was too small to sustain the growing demand for international liquidity, the Bretton Woods regime would be a two-tiered system whereby certain key currencies that were convertible into gold, such as the dollar and eventually sterling, could be used in lieu of gold to settle international transactions. It was believed that such a measure would conserve the use of gold and dramatically increase the amount of liquidity available to finance international transactions. International liquidity required that the economies of the key currency countries run payments deficits. But how large a deficit? Too little, and it was feared that liquidity would dry up and international transactions disappear; too large, and the resulting inflation would test the value of the key currency and set off a large-scale conversion into gold.

Should Bretton Woods be held in high esteem? The answer, alas, is no.

What were the larger motives of the founders of the plan? It has often been noted how remarkable it was that Keynes and White, despite the vastly different economic priorities of the countries they represented, were able to come up with such an extraordinary compromise.[11] Indeed, Keynes's original plan envisioned a "currency union" in which countries would have to pay a penalty on their *surplus* payments balances. Additionally, debtor nations would have unrestricted and virtually unlimited access to the resources of the clearing fund without having to seek international approval or make domestic adjustments to correct payments disequilibrium.[12] That plan had an enormous inflationary bias and would have allowed Britain to tap the immense resources of the United States without having to go through the arduous and embarrassing process of asking for direct aid.

Were White and Keynes driven, as Shelton has argued, "by a humanitarian desire to prevent the kind of financial stresses and economic dislocations that might lead to future wars"? Shelton nicely sums up the conventional wisdom:

[11] See John Ikenberry, "The Political Origins of Bretton Woods," in *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform*, ed. Michael Bordo and Barry Eichengreen (Chicago, Ill.: University of Chicago Press, 1993), pp. 155–82; and Richard Gardner, *Sterling-Dollar Diplomacy in Current Perspective: The Origins and Prospects of Our International Economic Order* (New York: Columbia University Press, 1980).

[12] For a description of Keynes's original monetary plans, see Donald Moggridge, ed., *The Collected Writings of John Maynard Keynes*, Vol. XXV, *Activities 1940–1944, Shaping the Post-War World: The Clearing Union* (Cambridge: Cambridge University Press, 1980).

> In short, Keynes and White were convinced that international economic cooperation would provide a new foundation of hope for a world all too prone to violence. 'If we can continue,' Keynes observed, 'this nightmare will be over. The brotherhood of man will have become more than a phrase.'[13]

Keynes's own writing calls this interpretation into doubt. Not only would his plan protect Britain's intended full-employment policies from balance-of-payments pressures, but it would also present a convenient and politically painless way to get money out of the United States in the guise of international reform:

> It would also be a mistake to invite of our own motion, direct financial assistance after the war from the United States to ourselves. Whether as a gift or a loan without interest or a gratuitous redistribution of gold reserves. The U.S. will consider that we have had our whack in the shape of lend-lease and a generous settlement of consideration. . . . We in particular, in a distressed and ruined continent, will not bear the guise of the most suitable claimant for a dole. . . . On the contrary. If we are to attract the interest and enthusiasm of the Americans, *we must come with an ambitious plan of an international complexion, suitable to serve the interests of others sides ourselves*. . . . It is not with our problems of ways and means that idealistic and internationally minded Americans will be particularly concerned.[14]

The Americans rejected the currency union plan as too radical, but the British came up with a substitute in the so-called scarce-currency clause, which permitted extensive capital controls and trade discrimination against major surplus countries. Both Keynes and R.F. Harrod, a Treasury official, suggested that the scarce-currency clause not be discussed in public for fear that the U.S. Congress might figure out its true implications. Harrod wrote, "In view of the need for 'good handling' the less public lucidity there is on this matter the better." And Keynes stated, "The monetary fund, in particular, has the great advantage that to the average Congressman it is extremely boring."[15]

The clause was included in the agreements, but the Americans interpreted it very narrowly, a fact that created much bitterness in Britain. In later years, the British government blamed many of its economic woes on the narrow interpretation of Article VII by the Americans:

> In particular, United States policy in the Fund has been directed . . . to making the 'scarce currency' clause a dead letter. We thought originally that this clause might give some real protection against a dollar shortage; indeed, Lord Keynes' conviction that this was so was one of the main factors which led His Majesty's Government and Parliament to accept the Loan Agreement. Once the clause comes into operation, it gives wide freedom for discriminatory exchange and trade controls against the scarce currency; and then there is real pressure on the country concerned to play its full part

[13] Shelton, *Money Meltdown*, p. 17.
[14] Moggridge, *The Collected Writings of John Maynard Keynes*, Vol. XXV, p. 42.
[15] Ibid., pp. 267, 445.

> in putting the scarcity right, e.g. by drastic action such as we want the United States to take to stimulate imports.[16]

The British had little to complain about, however, because the larger political goal of promoting European reconstruction and eventual union led the United States to permit extensive dollar discrimination while furnishing billions of dollars of aid.

The Flaws of the Bretton Woods Plan

In its final form, Bretton Woods was unworkable because it lacked an adequate adjustment mechanism. That guaranteed persistent payments imbalances, which threatened exchange-rate stability. Exchange-rate stability could be maintained only by providing ever increasing amounts of "liquidity," a process that created enormous political difficulties and ultimately undermined confidence in the system.

Why were the fixed exchange rates unstable? The plan, unlike a pure gold standard, affirmed the primacy of domestic economic goals, including the maintenance of full-employment economies, over strict balance-of-payments concerns. But exchange-rate stability can be sustained only when there is comparable price stability between countries. If prices change markedly because of inflation or deflation in a given domestic economy, then currency exchange rates must change accordingly or else their initial par rates will quickly be rendered meaningless. When exchange rates are not changed to reflect price changes, balance-of-payments disequilibriums emerge. Such a situation would be especially problematic if the initial par values were already out of line, which was often the case because nations had a large say in setting their own rates.

This payments disequilibrium was a constant source of financial instability in the postwar era. For example, if Britain's domestic economic goals produced a yearly inflation rate of 10 percent, and the United States pursued policies that resulted in 4 percent inflation, then the pound-to-dollar exchange rate would have to be adjusted to avoid a balance-of-payments disequilibrium. But that obviously contradicted the goal of exchange-rate stability, and there was no easy mechanism to adjust the exchange rate without creating havoc. The Bretton Woods system, despite its advertising, gave an unusual advantage to currency traders, who could easily discern what currencies were in need of revaluation and could simply put pressure on a vulnerable currency until its government exhausted its reserves and lost its will to defend the old exchange rate. Speculators made fortunes when sterling was devalued in 1949 and 1967. The only way to avoid such devaluations was to impose capital controls, which every major

[16] Memorandum by the president of the Board of Trade, *The Future of Multilateral International Economic Co-operation*, CP (49) 188, Sept. 12, 1949, Public Record Office, Kew, England, p. 4.

country, including the United States, had to install at some point during the Bretton Woods era in order to maintain its exchange rate.

A second flaw, less well recognized but equally serious, was the method of providing liquidity in the Bretton Woods system. Liquidity is simply another word used to describe reserve assets that are transferred from debtor countries to cover their payments gap. In order to offset a negative balance of payments and maintain a fixed exchange rate, nations have to supply some universally accepted asset over which they have no issuing control. Until 1914, that asset was gold. Because planners believed that there was not enough gold to supply world liquidity needs, key currencies, such as the dollar and sterling, would be used to supplement or replace gold to settle international transactions.

That brought up a larger question: how stable and cooperative would a system be that required the world's largest economy to run persistent balance-of-payments deficits? The dollar, fixed against gold at $35/ounce, had to do double duty under the Bretton Woods system: first, as a national currency; secondly, as an international reserve asset. But sooner or later, the amount of dollar liabilities held for this reserve purpose was bound to become larger than the value of the gold stock backing its value. At that point, holders of the reserve asset, in this case dollars, might question the ability of the reserve country to maintain the convertibility of its currency; they might start exchanging their dollars for gold until the American supply was exhausted. That would naturally worry the reserve country, which would take steps to limit the deficit and the loss of gold. But that, it was feared, would decrease the amount of liquidity in the whole global system, which could lead to deflation and a seizing up of international transactions.

In sum, Bretton Woods guaranteed failure. More and more liquidity was needed to maintain fixed exchange rates in the growing international economy. But because the worldwide gold stock was limited, most of the liquidity was supplied by the American payments deficit. As this deficit increased, doubts arose everywhere as to the ratio of dollars to the gold backing them up. This confidence problem was known as the "Triffin dilemma" after the economist, Robert Triffin, who first pointed it out in 1960.

Nevertheless, the dilemma remained largely misunderstood during the 1960s. Instead of improving the adjustment mechanism to correct the payments imbalances, economists and policymakers focused on finding ways to provide more liquidity. But that only masked and exacerbated the original problem—the differential inflation rates that produced large imbalances among countries in a fixed-rate regime. Since it was difficult to adjust exchange rates, and most governments refused to alter domestic priorities for balance-of-payments purposes, leaders clamored for liquidity to finance balance-of-payments deficits. But it was rarely pointed out that such liquidity would be unnecessary if there were an efficient, effective, and automatic process for adjusting imbalances, as provided for by a gold standard or—the opposite extreme—a flexible exchange-rate system.

Instead, all manner of stopgaps were invented to fudge the structural contradiction in the currency system: swap agreements, a gold pool, Roosa bonds, increased authority for the IMF, and the Special Drawing Rights (SDR). These innovative institutions, regimes, and rules fostered an illusion of international cooperation but in fact allowed a dysfunctional system to limp along through ever more elaborate suppression of the workings of the market.

Managing Disequilibrium: Monetary Relations, 1946–1968

The Bretton Woods blueprint for exchange-rate stability, hard convertibility, and international cooperation through the International Monetary Fund soon proved untenable. In 1947, buoyed by an enormous stabilization loan given by the United States after the cessation of Lend-Lease, the British attempted to make sterling convertible into gold and dollars, as stipulated by the Bretton Woods agreements. That first real test of the agreements proved a dismal failure. There was an immediate run on the pound, and within months Britain ran down the loan. Convertibility was suspended, and no other major currency would attempt anything approaching hard convertibility until the end of 1958. That failure convinced the United States to provide direct aid to Britain and Western Europe through the Marshall Plan. It also persuaded the Americans to accept widespread trade discrimination and monetary controls aimed at the dollar and dollar goods, in clear violation of the terms of Bretton Woods. Some of the monetary restrictions were lifted in 1958, but much of the trade discrimination against U.S. goods continues to this day.

The pretense of exchange-rate stability was abandoned shortly thereafter when Britain undertook a massive devaluation of sterling in order to make its exports more competitive and to write down wartime debts. The British did not seek the approval of the IMF or any of their major non-Commonwealth trading partners except for the United States. The 1949 devaluation outraged the nations of Western Europe and threatened to undo the tentative movement toward European trade and monetary integration. The lesson learned by other nations was that there was no punishment for a unilateral devaluation. If one of the countries that helped design the Bretton Woods system flouted its rules, how could other nations be expected to go along? Other devaluations soon followed.

Where was the International Monetary Fund, which was supposed to be the source of liquidity for temporary payments imbalances and the enforcer of international monetary rules? In actuality, the IMF was emasculated in the 1940s and 1950s, with little authority or voice in international economics. Liquidity was supplied to the world by direct U.S. aid, through programs like the Marshall Plan, Harry S Truman's "Point Four" program, and the Military Assistance Program. In fact, signatories of the Marshall Plan were strictly *forbidden* from using the IMF to correct payments imbalances. The Marshall Plan actually created a monetary system for Western Europe—the European Payments Union—that provided for extremely limited intra-European convertibility and allowed significant discrimination against dollar transactions (discrimination that had been forbidden except under extreme circumstances in Bretton Woods). It was only much later, and for largely political reasons, that the IMF became a player in world monetary relations.

Only in December 1958 did the major Western European economies establish current-account convertibility. Some argue that this marked the true beginning of the Bretton Woods system. It was also the beginning of the massive U.S. payments imbalances that were to plague the system until its collapse. The American deficit was first identified as a cause for concern towards the end of 1958, when U.S. secretary of the treasury Robert Anderson became alarmed at its growing size. An American deficit was not news; deficits had been run throughout the 1950s. It was the size of the deficit, and the fact that excess dollars were being turned in for gold instead of being held as reserves, that concerned Anderson. He worried that the amount of dollars held abroad would soon be larger than the value of the gold stock promised to back those dollars. That would make the dollar vulnerable to a speculative attack in the event of a political or economic crisis, and a run on the dollar would surely undermine confidence in the whole monetary system at a critical moment in the cold war.

No measures could fix the fundamental problems of Bretton Woods.

The Eisenhower administration debated various policies to reduce the deficit until the matter came to a head during the summer and fall of 1960. The price of gold on the London free market increased to over $40 an ounce, providing an enormous incentive for anyone abroad holding dollars to buy gold from the U.S. Treasury at $35 an ounce, then sell it in London for a substantial profit. But by 1960 there was not enough U.S. gold to cover these overseas dollars. America's promise to sell gold at a fixed price, a promise that was the foundation of all international monetary rules, thus became a magic money machine for overseas holders of dollar liabilities. The reasons that gold had been bid up included the tensions over Berlin, the burgeoning American payments deficit, and the fear of loose monetary and fiscal policies under a Kennedy presidency. But instead of recognizing the flaws in the system, American policymakers wrongly blamed the market. After 1960, the United States introduced measures to protect the dollar, and the system it upheld, from future attack. Capital controls, at first mild and "voluntary" but eventually quite obtrusive, were introduced. Restrictions on tourism were initiated. As noted, various stopgaps were instituted in Western countries to restrict and control currency and gold markets. That the world's largest and apparently healthiest economy had to take such steps seemed strange, but the gold guarantee and fixed exchange rates could be maintained only by increasingly complex controls. What was perhaps most alarming was the impact that these monetary matters had on U.S. foreign policy and relations with NATO.

By any measure, the United States during the 1960s possessed overwhelming economic strength, commanding a larger share of the world's wealth than any modern nation in history. That wealth was convincingly exhibited by the American ability to dispense billions of dollars in aid to its allies and station hundreds of thousands of troops in foreign countries. Yet the United States's whole foreign policy—including the global containment of communism—was absurdly endangered by movements in the price of gold in London. After the gold crisis of 1960, it seemed logical to policymakers to blame the U.S. payments imbalance and shortage of gold on two factors: speculators operating in a free market and American overseas commitments. After all, the United States still consistently maintained a sizable current-account surplus (positive balance of trade) throughout this period.

So a fierce debate raged within the Eisenhower, Kennedy, and Johnson administrations over the impact that vital U.S. foreign-policy commitments were having on the balance of payments and price of gold. Dwight D. Eisenhower and his top aides feared that unless U.S. commitments were reduced, the payments balance would deteriorate, the gold outflow would worsen, and the international monetary system would be destroyed. The resulting economic collapse might well fracture the NATO alliance and hand the Soviet Union a victory in the cold war without a shot being fired. Of course, that never happened, and it is arguable whether it could have happened. But the important point is the fact that concerns over the dollar and the international monetary system had a major impact on foreign-policy decisions.

All three administrations met the crisis with policies that antagonized alliance relations. Although American troop reductions in Europe were never fully carried out, mere discussion of the issue damaged confidence in the U.S. commitment to defend Western Europe. Ultimately, West Germany, Japan, and others "agreed" to offset the full balance-of-payments cost of the American troops. The president of the Bundesbank also promised to hold American dollars and not turn them in for gold. Both the offset agreement and the gold guarantee created great tensions in the American-German relationship. Attempts to get Charles de Gaulle's France to cooperate on monetary matters failed miserably, worsening an already strained alliance.

Neither these nor any other measures could repair the fundamental problems of the Bretton Woods system. Throughout the 1960s, policymakers and outside observers produced dozens of plans to reform the international monetary system but reached no consensus. The task became urgent when Britain, in the face of massive speculation on the currency markets, was forced to devalue sterling again in November 1967. Johnson administration officials feared that speculators would attack the dollar next. The payments deficit, which had been brought under control in 1965, ballooned during the next two years, primarily because of the cost of the Vietnam War.

The Johnson administration announced a program on January 1, 1968, that included border taxes and export subsidies, steep travel taxes, increased offset payments from allies, limits on overseas lending by American banks, and mandatory controls on capital investment abroad. The program had enormous political costs, especially in an election year. Overseas, especially in continental Europe, the plan provoked an outcry. The Atlantic Alliance, strained to the breaking point in 1966 and 1967 by internal crises, was pressured further by the administration's plan. Worse still, the plan reversed a cardinal tenet of postwar American foreign economic policy: to promote open markets and free trade around the world.

The American public found it hard to understand how U.S. policymakers had gotten the nation into such a mess. Milton Friedman, in a widely read *Newsweek* column, condemned Johnson's program:

> How low we have fallen! The United States, the land of the free, prohibits its businessmen from investing abroad and requests its citizens not to show their faces or open their pocketbooks in foreign ports. The United States, the wealthiest nation in the world, announces that its foreign policy will no longer be determined by its national interest and its international commitments but by the need to reduce government spending abroad by $500 million.[17]

To compound matters, the harsh balance-of-payments program was completely ineffective. By March 1968, the Johnson administration was forced to call an emergency meeting of the world's finance ministers, and finally to ask the British government to close its gold market. Under enormous political pressure from the United States, it was agreed that a two-tiered gold market would be established: a private market in which the price of gold would be determined by supply and demand, and an intergovernmental market where the price would remain $35 an ounce. Of course, the finance ministers had also to agree not to buy or sell gold on the open market. That meant the United States could exert enormous political pressure on world bankers to hold their dollars without fear of being overwhelmed by the private market. When the Nixon administration subsequently ended convertibility altogether in 1971, then abandoned fixed exchange rates in 1973, it was almost an anti-climax. The Bretton Woods system was already dead—a victim of its own contradictions. What replaced it—the term is illustrative—was the current system of sometimes free, sometimes managed exchange rates called the "dirty float."

Gold, Dollars, and Power

Imagine the public reaction if the global leaders of a particular industry colluded to suppress the workings of the free market and arbitrarily fix the price of their goods. People would be outraged, and the corporate heads would be charged with conspiracy and restraint of trade. Why then should an international monetary system that arbitrarily fixed prices and repressed its market mechanism be hailed as a highpoint of international cooperation? While there are important differences, it seems odd to honor a system that was so inherently unstable. It seems even odder that so many people look to this system as a model for future monetary reform.

Although the Bretton Woods system has been subject to a certain amount of criticism within the highly technical world of international monetary economics, most historians and political scientists (and many economists) hold

[17] Milton Friedman, "The Price of the Dollar," in *Dollars and Deficits: Inflation, Monetary Policy and the Balance of Payments* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1968), p. 240. Originally published in *Newsweek*, Jan. 29, 1968.

an idealized view of the system.[18] Even those economists who have criticized the system have failed to understand that economic issues were inextricably linked with political considerations. And few have questioned the idea that the controversial authors of the Bretton Woods plan were driven by anything but the most idealistic purposes.

That brings up an important question: why did American policymakers go to such great lengths to preserve a deeply flawed monetary system? Did the political benefits outweigh the costs of the Bretton Woods system? And why was there such a fear of abandoning fixed exchange rates for a more flexible exchange-rate system that had a market-driven adjustment mechanism?

There were certainly disadvantages for the United States in the system. As the reserve currency country, the United States was to a certain extent trapped by the system in ways other countries were not. From 1958 on, there was a constant fear that the ratio of dollar liabilities to American gold would increase to a level that might cause a loss of foreign confidence in the dollar and a run to the Treasury Department's gold window. A mass conversion to gold would force the United States to suspend convertibility, which would wipe out the dollar's value as a reserve and transaction currency. The ensuing competition among central banks for scarce gold could subject the international economy to paralyzing deflation. The resulting collapse of liquidity could freeze world trade and investment, but ending the American payments deficit could have an equally disastrous impact on the international economy. While in hindsight this fear derived from a misunderstanding of the liquidity issue, it was real in the minds of American statesmen.[19]

U.S. policymakers had to worry constantly about the payments deficit and felt they had to sacrifice important domestic-policy goals and even foreign-policy imperatives in order to maintain the dollar's value. It angered them that much of the deficit was caused by expenditures made to defend Europe and Asia from the Soviet Union. And what seemed particularly outrageous was the fact that the United States could be pressured for political reasons by the countries in the system, the most obvious example being Charles de Gaulle's policy of converting dollars into gold, even when it made little economic sense to do so.

So why did the United States not abandon the system sooner? One important factor was the intellectual influence of the conventional wisdom about the history of monetary relations between the wars. It was a widely held belief that the economic collapse of the 1930s was due to a failure of international monetary cooperation. Most postwar economists and policymakers believed that speculation-driven capital flight had ruined the gold standard and destroyed international liquidity. The collapse of the rules of the game unleashed a vicious competition, whereby countries pursued beggar-thy-neighbor policies of com-

[18] For a non-specialist who was an exception to this rule, see Henry Hazlitt, *From Bretton Woods to World Inflation: A Study of Causes and Consequences* (Chicago, Ill.: Regnery Gateway, 1984).

[19] See Brendan Brown, *The Flight of International Capital: A Contemporary History* (London: Biddles, Ltd., 1987), pp. 1–15.

petitive devaluations and trade restrictions. To most, the enemy was a free market "out of control." What these policymakers failed to realize is that competitive devaluations and beggar-thy-neighbor actions were caused by *government* policy, not the workings of the market. The free market was made the scapegoat for disastrous political decisions. In the postwar world, by contrast, the market would be tamed and national interest replaced with international cooperation based on enlightened rules and institutions. And few economists seemed to understand how chaotic and inefficient the Bretton Woods system actually was, since massive American aid and intervention tended to obscure its failings. The only voice calling for free exchange rates during the 1950s was Milton Friedman's, but his ideas were completely ignored until the 1960s, when other economists finally started to doubt the wisdom of the Bretton Woods system.[20] Hence, a deeply flawed intellectual framework guided postwar planners in most Western countries, especially the United States, and still commands disciples even today.

Few economists understood how chaotic the Bretton Woods system was.

Another and perhaps more important reason why the United States stuck so long with a bad system was the fact that international disequilibrium *benefited* the United States in many ways. Because the dollar was an international currency held for reserve and intervention purposes, the United States received the benefits of seigniorage. That is, the fact that foreign central banks held dollars in reserve enabled American consumers to purchase foreign goods and services without having to give anything other than a promise to pay in return. It was like automatic credit. That arrangement could be maintained as long as the dollar was "as good as gold," when holding dollars in the form of short-term, interest-bearing securities was probably preferable to buying gold, which earned no interest income and had high transaction costs.

Most important, the Bretton Woods system also served a larger purpose in terms of American political and strategic goals: it fostered an image of Western unity and cooperation during the cold war. One of the foremost goals of American foreign policy in the postwar world was the rebuilding and eventual unification of Western Europe. The Bretton Woods monetary system could not function without massive government intervention and transnational collaboration. Between 1958 and 1968, when the Bretton Woods system was supposedly at its height, a whole series of agreements, regimes, rules, and institutions had to be invented—a revivified IMF, swap agreements, the gold pool, the group of ten, the Organization for Economic Cooperation and Development, the General Arrangements to Borrow, SDR, the Kennedy Round of GATT negotiations, the Working Party Three, and the Basle club—without which the whole system would have collapsed. The appearance of such unity and cooperation within the West was an important part of cold war strategy. And in fact, the

[20] See Milton Friedman, "The Case for Flexible Exchange Rates," in *Essays in Positive Economics* (Chicago, Ill.: University of Chicago Press, 1953), pp. 157–203.

system guaranteed that Western Europe (and Japan) had a stake in what the United States did, and vice-versa, because the reserve currency at the heart of the system was the dollar, a dollar whose convertibility into gold at a fixed price was considered fundamental to the prosperity of the Western economies.

Where Do We Go from Here?

To be sure, monetary relations have been turbulent since 1968, when the private and public gold markets were separated and the fiction of Bretton Woods came to an end. The bright hopes that floating exchange rates would create perfect equilibrium and stability have been to some extent disappointed. Many have claimed that there have been "overshoots" and wide fluctuations, which have misallocated resources. But constant intervention by these same central bankers has been responsible for many of the problems of the post–Bretton Woods period. It has been this intervention, this "managed" or "dirty" floating, that has prevented a truly flexible exchange-rate regime from coming into existence. Still, disappointment with the results of the managed float has made many misty-eyed for the days of Bretton Woods, or even the traditional gold standard. But regardless of the virtues of the nineteenth-century system, it is quite impossible today to imagine that national governments would relinquish their autonomy and accept the risk of severe deflation that comes with a "hard" gold standard.[21] So that leaves 1) a return to Bretton Woods, or 2) an even freer market that discourages central-bank intervention altogether.

The latter is unquestionably the way to go. For all the criticism, the post–Bretton Woods period has witnessed an unparalleled explosion of international trade and financial transactions. Indeed, real per capita growth in the United States was higher during the floating exchange-rate period of 1974–1989 (2.1 percent per year) than it was during the Bretton Woods period of 1946–1970 (2.0 percent per year) or even the gold-standard period of 1881–1913 (1.8 percent per year).[22] Moreover, the recent growth has spread broadly to regions like the Pacific Rim and South America. Growth during the Bretton Woods period was concentrated in Western Europe and Japan, areas that were the largest beneficiaries of American aid and trade favoritism. The more recent growth may have much to do with the drastic reduction in exchange and capital controls that has come about during the post–Bretton Woods era. Emerging economies can now tap a vast reservoir of private capital, and they have a much greater incentive to remain credit worthy than in the past. Today, private investment dwarfs international aid programs, which were, in any case, often driven more by politics than economic logic.

[21] Barry Eichengreen, *International Monetary Arrangements for the 21st Century* (Washington, D.C.: Brookings Institution, 1994), pp. 41–47, comments by Toyoo Gyohten, p. 146. See also Marcello De Cecco, *The International Gold Standard: Money and Empire* (London: Francis Pinter, 1984).

[22] See Bordo and Eichengreen, eds., *A Retrospective on the Bretton Woods System*, p. 8.

Is exchange-rate volatility really the fault of the post–Bretton Woods non-system? As a recent publication pointed out, that is the equivalent of a drunk driver blaming unsafe roads for his accident.[23] Since 1973, the economic policies of the United States and other developed nations have often been contradictory. In the 1980s, a mixture of loose fiscal policy and tight monetary policy created massive swings in capital flows, which produced substantial exchange-rate volatility. Happily, under the current non-system, the market is free to punish profligate and irresponsible governments. And given the performance of government financiers and central bankers during the twentieth century, is that really such a bad thing?

[23] The analogy is attributed to Rudiger Dornbusch, quoted in "Why Currencies Overshoot," in *Economics: Ten Modern Classics* (New York: The Economist Newspaper Group, 1991).