Bretton Woods System

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The Bretton Woods system is commonly understood to refer to the international monetary regime that prevailed from the end of World War II until the early 1970s. Taking its name from the site of the 1944 conference that created the *International Monetary Fund (IMF) and *World Bank, the Bretton Woods system was history's first example of a fully negotiated monetary order intended to govern currency relations among sovereign states. In principle, the regime was designed to combine binding legal obligations with multilateral decision-making conducted through an international organization, the IMF, endowed with limited supranational authority. In practice the initial scheme, as well as its subsequent development and ultimate demise, were directly dependent on the preferences and policies of its most powerful member, the United States.

Design of the Bretton Woods system

The conference that gave birth to the system, held in the Amrican resort village of Bretton Woods, New Hampshire, was the culmination of some two and a half years of planning for postwar monetary reconstruction by the Treasuries of the United Kingdom and the United States. Although attended by all forty four allied nations, plus one neutral government (Argentina), conference discussion was dominated by two rival plans developed, respectively, by Harry Dexter White of the U.S. Treasury and by *John Maynard Keynes of Britain. The compromise that ultimately emerged was much closer to White's plan than to that of Keynes, reflecting the overwhelming *power of the United States as World War II was drawing to a close.

Athough, at the time, gaps between the White and Keynes plans seemed enormous - especially with respect to the issue of future access to international *liquidity - in retrospect it is their similarities rather than their differences that appear most striking. In fact, there was much common ground among all the participating governments at Bretton Woods. All agreed that the monetary chaos of the interwar period had yielded several valuable lessons. All were determined to avoid repeating what they perceived to be the errors of the past. Their consensus of judgment was reflected directly in the Articles of Agreement of the IMF.

Four points in particular stand out. First, negotiators generally agreed that as far as they were concerned, the interwar period had conclusively demonstrated the fundamental disadvantages of unrestrained flexibility of *exchange rates. The floating rates of the 1930s were seen as having discouraged trade and investment and to have encouraged destabilizing speculation and competitive depreciations. Yet in an era of more activist economic policy, governments were at the same time reluctant to return to permanently fixed rates on the model of the classical *gold standard of the nineteenth century. Policy-makers understandably wished to retain the right to revise currency values on occasion as circumstances warranted. Hence a compromise was sought between the polar alternatives of either freely floating or irrevocably fixed rates - some arrangement that might gain the advantages of both without suffering the disadvantages of either.

What emerged was the 'pegged rate' or 'adjustable peg' currency regime, also known as the par value system. Members were obligated to declare a par value (a 'peg') for their national money and to intervene in currency markets to limit exchange rate fluctuations within maximum margins (a 'band') one per cent above or below parity; but they also retained the right, whenever necessary and in accordance with agreed procedures, to alter their par value to correct a 'fundamental disequilibrium' in their *balance of payments. Regrettably the notion of fundamental disequilibrium, though key to the operation of the par value system, was never spelled out in any detail - a notorious omission that would eventually come back to haunt the regime in later years.

Second, all governments generally agreed that if exchange rates were not to float freely, states would also require assurance of an adequate supply of monetary reserves. Negotiators did not think it necessary to alter in any fundamental way the *gold exchange standard that had been inherited from the interwar years. International liquidity would still consist primarily of national stocks of gold or currencies convertible, directly or indirectly, into gold ('gold exchange'). The United States, in particular, was loth to alter either the central role of the dollar or the value of its gold reserves, which at the time amounted to three quarters of all central bank gold in the world. Negotiators, did concur, however, on the desirability of some supplementary source of liquidity for deficit countries. The big question was whether that source should, as proposed by Keynes, be akin to a world central bank able to create new reserves at will (which Keynes thought might be called *bancor); or a more limited borrowing mechanism, as preferred by White.

What emerged largely reflected U.S. preferences: a system of subscriptions and quotas embedded in the IMF, which itself was to be no more than a fixed pool of national currencies and gold subscribed by each country. Members were assigned quotas, roughly reflecting each state's relative economic importance, and were obligated to pay into the Fund a subscription of equal amount. The subscription was to be paid 25 per cent in gold or currency convertible into gold (effectively the dollar, which was the only currency then still directly gold convertible for central banks) and 75 per cent in the member's own money. Each member was then entitled, when short of reserves, to borrow needed foreign currency in amounts determined by the size of its quota.

A third point on which all governments agreed was that it was necessary to avoid recurrence of the kind of economic warfare that had characterized the decade of the 1930s. Some binding framework of rules was needed to ensure that states would remove existing *exchange controls limiting *currency convertibility and return to a system of free multilateral payments. Hence members were in principle forbidden to engage in discriminatory currency practices or exchange regulation, with only two practical exceptions. First, convertibility obligations were extended to current international transactions only. Governments were to refrain from regulating purchases and sales of currency for trade in goods or services. But they were not obligated to refrain from regulation of capital-account transactions. Indeed, they were formally encouraged to make use of *capital controls to maintain external balance in the face of potentially destabilizing 'hot money' flows. Second, convertibility obligations could be deferred if a member so chose during a postwar 'transitional period.' Members deferring their convertibility obligations were known as Article XIV countries; members accepting them had so-called Article VIII status. One of the responsibilities assigned to the IMF was to oversee this legal code governing currency convertibility.

Finally, negotiators agreed that there was a need for an institutional forum for international cooperation on monetary matters. Currency troubles in the interwar years, it was felt, had been greatly exacerbated by the absence of any established procedure or machinery for inter-governmental consultation. In the postwar era, the Fund itself would provide such a forum - in fact, an achievement of truly historic proportions. Never before had international monetary cooperation been attempted on a permanent institutional basis. Even more pathbreaking was the decision to allocate voting rights among governments not on a one-state, one-vote basis but rather in proportion to quotas. With one-third of all IMF quotas at the outset, the United States assured itself an effective veto over future decision-making.

Together these four points defined the Bretton Woods system - a monetary regime joining an essentially unchanged gold exchange standard, supplemented only by a centralized pool of gold and national currencies, with an entirely new exchange rate system of adjustable pegs. At the center of the regime was to be the IMF, which was expected to perform three important functions: regulatory (administering the rules governing currency values and convertibility), financial (supplying supplementary liquidity), and consultative (providing a forum for cooperation among governments). Structurally, the regime combined a respect for the traditional principle of national *sovereignty - especially, of course, that of the United States - with a new commitment to collective responsibility for management of monetary relations, expressed both in mutually agreed rules and in the powers of the Fund.

<u>The implicit bargain</u>

Negotiators at Bretton Woods betrayed a remarkable optimism regarding prospects for monetary stability after the war's end. Underlying their choice of exchange rate system, for example, seemed a clear expectation that beyond the postwar transitional period (itself expected to be brief) payments imbalances would not be excessive or require sacrifice of domestic stability for the sake of external equilibrium. The pegged rate regime was manifestly biased against frequent changes of currency values, since states had to demonstrate the existence of a fundamental disequilibrium before they could alter their par values; yet governments were left with few other instruments, other than capital controls, to deal with payments disturbances. Negotiators evidently felt that major future threats to stability were more likely to come from private speculation than from basic price or income developments. They also presumably believed that the IMF's centralized pool of liquidity, though limited, would suffice to cope with any financing problems that might emerge.

As matters turned out, their optimism proved utterly Panglossian. Monetary relations after the war were anything but stable, the transitional period anything but brief, the Fund's initial resources anything but sufficient to cope with emerging payments difficulties. Hence after a short burst of activity during its first two years, IMF lending shrank to an extremely small scale for over a decade. Instead, the burden was shifted to the one actor at the time with the financial and economic resources needed to shoulder responsibility for global monetary stabilization - namely, the United States.

Fortunately, for reasons of its own, the United States was not only able but willing to take on that responsibility, in effect assuming the role of global monetary hegemon: money manager of the world. *American hegemony was exercised principally in three ways. First, a relatively open market was maintained for imports of foreign goods. Second, a generous flow of long-term loans and grants was initiated, first through the *Marshall Plan and other related aid programs, then through the reopened New York capital market. Third, a liberal lending policy was eventually established for provision of shorter term funds in time of crisis. Since the reserves of most countries were near exhaustion and the Fund's pool of liquidity was manifestly inadequate, the rest of the world was more than willing to accumulate dollars. Given the scarcity of central bank gold outside the United States and limited prospects for new gold production, America became the residual source of global liquidity growth through the deficits in its own balance of payments. Other governments with payments surpluses stabilized their exchange rates by buying dollars. The United States pledged convertibility of its dollars into gold at a fixed price, thus making the greenback a near perfect substitute for gold.

Though multilateral in formal design, therefore, the Bretton Woods system in practice quickly became synonymous with a hegemonic monetary regime centered on the dollar, much in the same manner as the classical gold standard of the nineteenth century had come to be centered on Britain's pound sterling. For gold exchange standard, many said, read dollar exchange standard.

Like the British in the nineteenth century, the United States did not actively seek global monetary leadership. Indeed, during the interwar period the responsibilities of hegemony had been deliberately evaded. On the other hand, unlike the British, once the Americans found themselves in the role, they soon came to welcome it, for reasons that were a mixture of altruism and self-interest. Being money manager of the world fit in well with America's newfound leadership role in the *Cold War with the Soviet Union. U.S. policy-makers perceived a need to promote the economic recovery of important allies in Europe and Japan, as well as to maintain a sizable and potent military establishment overseas. All this cost money. The privilege of financing deficits with its own currency ('liability financing') meant that America was effectively freed from external payments constraints to spend as freely as its leaders thought necessary to promote objectives believed to be in the national interest. The United States could issue the world's principal reserve currency in amounts presumed to be consistent with its own priorities - not necessarily those of foreign dollar holders.

Foreign dollar holders, for their part, conceded this policy autonomy to the United States because it also directly contributed to their own economic rehabilitation. America accepted the necessity, for example, of preferential trade and payments arrangements in Europe, despite their inherent discrimination against U.S. exports; likewise, America accepted the necessity of granting Japanese exporters access to the U.S. market at a time when most other countries remained closed to goods labeled 'Made in Japan.' In effect, an implicit bargain was struck. America's allies acquiesced in a hegemonic system that accorded the United States special privileges to act abroad unilaterally to promote U.S. or collective interests. The United States, in turn, condoned its allies' use of the system to promote their own prosperity, even if this happened to come largely at the short term expense of the United States. The subsequent evolution of the Bretton Woods system may be read as the history of that implicit bargain. The system's eventual breakdown in the early 1970s may be read as the bargain's final collapse.

<u>From dollar shortage to dollar glut</u>

The chronology of the Bretton Woods system can be divided into two periods: the period of *'dollar shortage," lasting roughly until 1958; and the period of 'dollar glut,' covering the remaining decade and a half.

The period of the dollar shortage was the heyday of America's monetary hegemony. The term 'dollar shortage,' universally used at the time, was simply a shorthand expression for the fact that only the United States was then capable of assuring some degree of global monetary stability; only the United States could help other governments avoid a mutually destructive scramble for gold by promoting an outflow of dollars instead. Dollar deficits began in 1950, following a round of devaluations of European currencies, at American insistence, in 1949. In ensuing years, shortfalls in the U.S. balance of payments (as conventionally measured) averaged roughly $1.5 billion a year. But for these deficits, other governments would have been compelled by their reserve shortages to resort to competitive devaluations or domestic deflation to keep their payments in equilibrium; they would certainly not have been able to make as much progress as they did toward dismantling wartime exchange controls and trade barriers. Persistent dollar deficits thus actually served to avoid destabilizing policy conflict. The period up to 1958 was rightly called one of 'beneficial disequilibrium.'

After 1958, however, America's persistent deficits began to take on a different coloration. Following a brief surplus in 1957, owing to special circumstances, the U.S. balance of payments plunged to a $3.5 billion gap in 1958 and to even larger deficits in 1959 and 1960. This was the turning point. Instead of talking about a dollar shortage, observers began to speak of a dollar glut. In 1958 Europe's currencies returned to convertibility. Subsequently, the former eagerness of European governments to obtain dollar reserves was transformed into what seemed an equally fervent desire to avoid excess dollar accumulations. Before 1958, less than 10 per cent of America's deficits had been financed by calls on the U.S. gold stock (the rest being financed with dollars). During the next decade, almost two thirds of America's cumulative deficit was transferred in the form of gold, mostly to Europe. Bretton Woods was clearly coming under strain.

<u>The Triffin dilemma</u>

One source of strain, inherent in the structure of the postwar gold exchange standard, was first illuminated by economist Robert Triffin in his influential 1960 book <u>Gold and the Dollar Crisis</u>. A gold exchange standard, Triffin argued, is fundamentally flawed by its reliance on the pledge of convertibility of some national currency, such as the dollar, into gold. The Bretton Woods system had come to rely on U.S. deficits to avert a world liquidity shortage. But already by the time Triffin wrote, America's *'dollar overhang' was growing larger than its gold stock. The resulting erosion of America's net reserve position was bound in time to undermine confidence in the dollar's continued covertibility. In effect, therefore, states found themselves caught on the horns of a dilemma - what came to be known as the *Triffin dilemma. To forestall speculation against the dollar, U.S. deficits would have to cease. But this would confront the system with a liquidity problem. To forestall the liquidity problem, U.S. deficits would have to continue. But this would confront the system with a confidence problem. Governments could not have their cake and eat it too.

Not that governments were unwilling to try. By the mid-1960s, negotiations were begun to establish a substitute source of liquidity growth in order to reduce systemic reliance on dollar deficits, culminating in agreement to create the *Special Drawing Right (SDR), an entirely new type of international reserve asset. Governments hoped that with SDRs in place, any future threat of world liquidity shortage could be successfully averted. On the other hand, they were totally unprepared for the opposite threat - a reserve surfeit - which is in fact what eventually emerged in the late 1960s. Earlier in the decade a variety of defensive measures were initiated in an effort to contain mounting speculative pressures against the dollar. These included a network of reciprocal short-term credit facilities (*swaps) among central banks as well as enlarged lending authority for the IMF. But in the end none proved sufficient to avert a decisive loss of confidence in the dollar.

<u>Exchange-rate rigidity</u>

A second source of strain was inherent in the structure of the par value system: the ambiguity of the key notion of fundamental disequilibrium. How could governments be expected to change their exchange rates if they could not even tell when a fundamental disequilibrium existed? And if they were inhibited from repegging rates, then how would international payments equilibrium be maintained? In practice, governments began to go to enormous lengths to avoid the "defeat" of an altered par value. The resulting rigidity of exchange rates not only aggravated fears of a potential world liquidity shortage. It also created irresistible incentives for speculative currency shifts, greatly adding to the global confidence problem as well.

The heaviest weight on exchange rates at the time was of course the dollar glut - more accurately, the persistent payments imbalance between the United States and the surplus countries of Europe and Japan. Each side blamed the other for the disequilibrium. America felt its erstwhile allies could do more to reduce their surpluses by inflating or revaluing their currencies; the Europeans and Japanese, conversely, contended that it was the responsibility of the United States, with the world's biggest deficit, to take the first steps to correct the situation. Both sides felt discriminated against. The surplus countries argued that America's privilege of liability financing deficits created an asymmetry in the regime favorable to the United States. None of them, after all, enjoyed such a degree of policy autonomy. America, on the other hand, believed that use of the dollar by other governments as their principal intervention medium to support par values created an asymmetry more favorable to Europe and Japan, since it left the United States itself with no effective control over its own exchange rate. America controlled only the price of its currency in terms of gold; it had no direct means to influence the rates at which other countries bought or sold dollars.

<u>The bargain comes unstuck</u>

In fact, the debate over asymmetries masked a deeper political conflict. The postwar bargain was coming unstuck. In the United States, concern was growing about the competitive commercial threat from Europe and Japan. The cost of subordinating domestic interests to help strengthen foreign allies was becoming ever more intolerable. Conversely, concern was growing in Europe and Japan about America's use of its privilege of liability financing - the 'exorbitant privilege,' as France's Charles de Gaulle called it. The Europeans and Japanese had just one major weapon they could use to curb America's policy autonomy: their right to demand conversion of accumulated dollar balances into gold. But as the dollar overhang continued to grow, making the Triffin dilemma ever more acute, it was a weapon most governments became increasingly reluctant to deploy.

At bottom, the Bretton Woods system rested on one simple assumption - that economic policy in the United States would be stabilizing. The absence of an effective external discipline on U.S. policy could not threaten the regime so long as that assumption held, as it generally did prior to 1965. During the first half of the 1960s, America's foreign deficit actually shrank as a result of a variety of corrective measures adopted at home. After 1965, however, U.S. behavior became increasingly destabilizing, mostly as a result of increased government spending on social programs at home and an escalating war in Vietnam. America's economy began to overheat and inflation began to gain momentum, causing deficits to widen once again. Yet Washington pointedly declined to undertake any new ameliorative actions under a calculated policy of *'benign neglect.' With governments elsewhere committed to defending their pegged rates by buying the growing surfeit of dollars, a huge reserve base was created for global monetary expansion. Inflation everywhere began to accelerate, exposing all the latent problems of Bretton Woods. The pegged rate system was incapable of coping with widening payments imbalances, and the confidence problem was worsening as speculators were encouraged to bet on devaluation of the dollar or revaluations of the currencies of Europe or Japan.

Ultimately it was the United States, still the leading member of the system, that brought the drama to its denouement. Concerned about America's rapidly deteriorating payments situation, as well as rising protectionist sentiment in the U.S. Congress, President Richard Nixon was determined to force the Europeans and Japanese to accept a mutual adjustment of exchange rates. The U.S. might lack effective control over the dollar exchange rate under the prevailing rule of the game. But it did still have the power, alone among governments, to unilaterally change the rules themselves should U.S. policy-makers see fit. Accordingly, on 15 August 1971, the convertibility of the dollar into gold was suspended, freeing the greenback to find its own level in currency markets. Eighteen months later, in February 1973, after new waves of speculation against a realigned structure of par values negotiated in late 1971 -- the so-called *Smithsonian Agreement -- the monies of all the industrial countries were set free to float independently. With these decisions, both the par value system and the gold exchange standard, the two central elements of the postwar monetary regime, were effectively terminated. The Bretton Woods system passed into history.

Significance for international political economy

For students of international political economy, the significance of the Bretton Woods system lies primarily in the inspiration it gave to the later development of formal *regime theory. International regimes, which act as a sort of governance mechanism among sovereign states, are conventionally defined as sets of implicit or explicit principles, norms, rules and decision-making procedures around which actors' expectations converge in a given issue area. The Bretton Woods system was an especially well articulated regime, formally negotiated and concretely embodied in a multilateral organization, the IMF. The circumstances of the system's birth and life cycle offered scholars invaluable material for assessing the relative importance of diverse variables in promoting or inhibiting economic cooperation among governments.

Most obviously, Bretton Woods provided evidence of the key role of power in shaping the design and evolution of international regimes, giving rise to so-called *hegemonic stability theory. The dominance of the United States in the negotiations at the wartime conference seemed to confirm the vital importance of hegemonic leadership in the initial formation of international regimes; even more critically, America's assumption of responsibility for stabilization after the war appeared to affirm the subsequent and continuing need for hegemony in order to preserve economic order. Conversely, the malign effect of less disciplined use of power could be seen in the destabilizing impact of America's benign neglect of its balance of payments toward the end of the Bretton Woods era.

Less obviously, Bretton Woods also provided evidence of the lasting effectiveness of regimes themselves even after shifts in the distribution of inter-state power associated with their origins or early operation. Though the managerial role of the United States in the postwar period was eventually undermined by the emergence of economic and political rivals, leading ultimately to the spectacular breakdown of both the gold exchange standard and par value system in the early 1970s, monetary relations did not collapse in chaos as they had in similar circumstances during the 1930s. Rather a significant degree of cooperation was preserved under the auspices of the IMF, which continued to perform its assigned regulatory, financial, and consultative functions; the regime's underlying principles and norms continued to exercise influence over the behavior of national governments. That demonstration of the possibility of durability in a social order at the international level, seemingly at variance with the predictions of hegemonic stability theory, may well be the most significant of all the Bretton Woods system's germinal implications for IPE theory.

Further reading

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