Events that led to the collapse of the bretton woods system

With recent talks of currency wars and disagreement over policy of quantitative easing proposed by the U. S. Federal Reserve, leaders of 20 largest economies, known as G-20, will be meeting in Seoul on November 11-12th, 2010 to discuss issues related to the global economic recovery and building of a new framework, which can sustain more balanced global growth. Recently, some economists, political leaders, and media commentators argued in favor of a new international monetary regime capable of replacing existing Bretton Woods II system established in the early 1970s (Economist, 2010; Emsden, 2010). Some argue that new system should employ gold as a reference point for indicators such as inflation, deflation, and currency values (Zoellick, 2010). With this interest toward creation of a new monetary order, it is important to understand the main factors and events that led to the collapse of original Bretton Woods system as this will help to avoid past mistakes. Thus, the purpose of this paper is to provide a rather general overview of the key elements of the Bretton Woods system and to document the most important aspects that led to its demise.

Introduction

On August 15, 1971, in a televised address to the nation President Nixon announced that the United States was closing " gold window" and removing gold backing from the dollar. This meant that the foreign governments could no longer turn in dollars and convert them for gold. The announcement, aptly named Nixon Shock, has been made without prior consultation with the leaders of the other major capitalist nations. Thus the commitment by the U. S. to redeem international dollar holdings at the rate of $35 per ounce, which essentially had formed the backbone of the post-war international financial system set in place at the Bretton Woods conference in 1944, had been completely broken. Nixon’s unilateral decision dealt it a fatal blow and in fact ended the Bretton Woods system of international exchange (Cohen, 2002).

What are the factors that caused the collapse of the Bretton Woods System? To fully understand the decision made by the President Nixon and the importance of what followed it is necessary to consider the historical background of the Bretton Woods system as well as key design elements of this system.

Background

The Bretton Woods system refers to the international monetary system that existed from the end of World War II until the early 1970s. In 1944 leaders of major nations met in the Bretton Woods, New Hampshire in the U. S. to discuss plans and necessary actions that must be taken to help countries to rebuild their post-war economies. The conference resulted in the creation of a fully negotiated monetary regime intended to govern currency relations among sovereign states. Several important aspects should be noted (Suranovic, 2010).

First, the regime was based on the system of fixed exchange rates between currencies and the network of financial support for countries that could run into balance of payments difficulties. This was done to prevent hyperinflation and instability of international system. The memories of Great Depression, hyperinflation in Germany, and general economic instability in the world that lead to the installation of totalitarian regimes in many countries, were still fresh and vivid. So the system of fixed exchange rates was thought to prevent inflation and eliminate uncertainties in international transactions, thus promoting the expansion of international trade and investment. Generally, what came out of the conference was the ‘ pegged rate’ or ‘ adjustable peg’ currency mechanism, also known as the par value system. Members were obligated to declare a par value (a ‘ peg’) for national currency and could intervene in currency markets to limit exchange rate fluctuations within maximum margins (a ‘ band’) of one percent above or below parity. Nation had the right, whenever necessary and in accordance with agreed procedures, to change their par value to correct a ‘ fundamental disequilibrium’ in their balance of payments. A very important aspect of this mechanism is the question of the reserve currency and gold standard. Under the Bretton-Woods system, the United States had assumed the role of then main banker with dollar serving as a reserve currency. Foreign central banks could thus easily exchange dollars for gold. Originally, the exchange rate was set at $35 per ounce. National currencies of non-reserve members were fixed to the U. S. dollar or to gold. However, these nations did not have any obligations to exchange their own currencies for gold. Only the reserve country i. e. the U. S. had such obligation (Cohen, 2002; Suranovic, 2010).

Second, all national governments generally agreed that since exchange rates were pegged, governments must require some kind of assurance of an adequate supply of monetary reserves. What emerged was the International Monetary Fund (IMF), a new institution, which managed a fixed pool of funds consisting of national currencies and gold contributed by each member. Each nation was thus obligated to pay into the Fund a certain amount which included 25 percent of gold and 75 percent of national currency.

Furthermore, members were assigned a quota, which entitled them, when short of reserves, to borrow needed amounts of funds. The size of the quota reflected individual contribution and relative economic importance of each nation. The new mechanism was based on the series of binding legal obligations along with multilateral decision-making conducted by IMF, which had assumed very broad regulating responsibilities (Mikesell, 2000; Cohen, 2002).

Third, members were generally forbidden from engaging in any kind of discriminatory currency practices or exchange regulations. The idea was to prevent any recurrence of economic warfare between countries that had characterized the decade of the 1930s. Finally, all countries agreed that any type of currency troubles should be solved through an open forum that is through the IMF. This has established a formal protocol and set of procedures of inter-governmental consultation, which each nation was obligated to follow (Cohen, 2002; Mikesell, 2000).

Together these key aspects defined the essence of Bretton Woods system, a monetary system based on the fixed exchange rate supplemented by the system of adjustable pegs along with the pool of gold and a basket of national currencies.

The timeline of Bretton Woods system can be notionally divided into two distinctive periods. The first period is often called ‘ dollar shortage’, which lasted until about 1958 and the second one, the “ dollar glut” lasted until the collapse of the system. During the first period United States deliberately ran a balance of payment deficits to encourage an outflow of funds. This was done mainly to provide liquidity to other countries and help nations to overcome post-war financial distraught however geopolitical factors should not be excluded completely. Dollars were flowing to the Western Europe, Japan and other pro-American countries through a variety of different aid programs. During the dollar-shortage period, the United States emerged as the only nation in the world capable of supporting and sustaining a long-term economic recovery of international economy (Cohen, 2002).

The Collapse of the Bretton Woods

The situation, however, began to change shortly after 1958. The U. S. balance of trade plunged drastically causing a 3. 5 billion deficit in 1958. By the end of 1960 deficits become even larger. To many economic historians this marked a turning point. Instead of ‘ dollar shortage’ everyone talked about ‘ dollar glut’ as many foreign governments tried to get rid of excessive dollar accumulations (Cohen, 2002). But what did actually made the U. S. dollar so undesirable? One potential source of problem was caused by the so-called the Triffin dilemma. The phenomenon first described by the economist Robert Triffin posits that if the U. S. dollar serves as an international reserve currency, then the United States must be willing to run trade deficits to provide enough liquidity to the rest of the world to satisfy demand for foreign exchange reserves. So in order to avoid liquidity problems other nations had to rely on the United States, or more precisely on the deficits in the balance of payments of the United States, specifically on the current account. Triffin further argued that the reliance on the convertibility of dollar into gold represented an essential flaw of the Bretton Woods system. Indeed, by then end of 1960 the ‘ dollar overhang’ – a situation when the value of dollar denominated assets held by foreign central banks exceeded the total supply of gold in the U. S. – became quite obvious. The risk that the United States could simply run out of gold did not seem so inconceivable any more (Suranovic, 2010; Cohen, 2002). So to avoid potential speculation against dollar, the trade deficits would have to stop but that would create a liquidity problem. But how can the liquidity problem be solved? To solve it, the nation would have to accept current account deficit on the balance of payment. But that would lead back to the problem discussed above, namely to the depletion of gold reserves and the ability of the dollar to be converted into gold. Indeed, it is a true dilemma or rather the Triffin dilemma (Cohen, 2002; McKinnon, 2007).

Now, one potential solution to the dilemma could be devaluation of the dollar. This approach seemed easy in theory yet it was hard to implement since the U. S. dollar was not fixed to other national currencies. In fact, it was other way around. In addition, foreign governments argued that was not their fault, therefore they shouldn't worry about it (Suranovic, 2010).

Another possible solution to the Triffin dilemma was to devalue the dollar with respect to the gold. This was even harder to implement. The devaluation would have to be rather large otherwise the United States risked a depletion of gold reserves. But if implemented, this approach would not have solved fundamental conditions. Instead, it would have only reduced the exchange rate (Suranovic, 2010).

Another option open to the United States was to change its monetary policy and simply reduce the supply of dollars in circulation by cutting the current account deficit and raising interest rates in order to attract dollars back into the country. This however could lead to the economic recession since the growth of the money supply is limited. The government would have to finance the budget through higher taxes or cutting public spending or combination of both. In the end, both are politically unpopular measures (Suranovic, 2010).

As it can be seen, none of possible solutions actually resolves the problem, the dilemma still exists. Eventually, what the United States ended up doing was a adopting a series of smaller measures, rather defensive in nature, targeted primarily against speculative attacks on the dollar. These included a system of short-term credit swaps among central banks and providing much bigger authority to the IMF especially its lending ability (Cohen, 2002).

The Triffin dilemma was not the only source of strain. The other problem was the very nature and structure of the par value system itself. As mentioned earlier, foreign governments were allowed to correct a ‘ fundamental disequilibrium’. However, this was very hard to do since governments couldn’t even tell when such disequilibrium existed. So even though governments could change their exchange rates, the nature of the par value system inhibited the re-pegging of the rates, which made international payment equilibrium very hard to maintain. As one would expect, this inevitably leads to the rigidity of exchange rates and fears of the potential liquidity shortage, which in return only increases incentives for currency speculations (Cohen, 2002).

The relations between the United States and the European nations and Japan deserve special attention here. As mentioned before, each side blamed the other. The United States thought its partners could do much more by revaluing their currencies. The Europeans and Japanese expected the U. S. to take the first step in the tackling the deficits. Both parties thought that their interests were threatened by the other side. In the end, everyone argued that the opposite side created an asymmetry in the exchange rate regime favorable only to them. The debates over what side benefits more from existing condition masked a much deeper political problem. The political circles in the United States were coming to the realization that Europe and Japan could present a competitive problem to the commercial and business interest of the U. S. It was becoming very hard to reconcile protection of domestic interests on the one hand, with the assistance to foreign allies on the other hand. Conversely, Europe and Japan were becoming more and more concerned about America's privileged ability to finance its deficits. The " exorbitant privilege", a term coined by the France's president Charles De Gaulle sums up the essence of problem perceived by the foreign nations. Simply put, the United States could print any amount of extra dollars to cover deficits in balance of payment because dollar served as reserve currency. Such exclusive ability belonged only to the America. Other nations could not do that as they had to maintain the equilibrium in their balances of payments. The Europeans and Japanese could try to limit the America's ability by the demanding conversion of dollars into gold. However, as the ' dollar overhang' continued its growth, making the Triffin dilemma even more pronounced, foreign governments were becoming reluctant to pursue this path (Cohen, 2002; Suranovic, 2010).

As it can be seen, the Bretton Woods systems relied only on one simple but important assumption: the United States economic policies must have stabilizing effect for the whole system to work smoothly. As long as the U. S. behaves well, the system can work. Before 1965 this assumption generally held true and the Bretton Woods ran without major problems, mostly due to the corrective measures adopted earlier. During the second half of the 1960s, the U. S. behavior was becoming increasingly destabilizing. Increased government spending on social programs, unpopular war in Vietnam, and growing domestic inflation caused deficits to become larger exposing all hidden problems of the Bretton Woods system (Wills, 2005). However, no ameliorative measures were undertaken during this time. The problem was getting worse, thus undermining global confidence. It was becoming obvious that the pegged exchange rate system was not capable of handling growing deficits in the balance of payments. The speculative attacks were increasing and the dollar devaluation or major revaluation of European and Japanese currencies was imminent (Cohen, 2002).

The drama reached its peak, when the United States, the single most important member of the Bretton Woods system brought it to the end. Worried about an escalating disequilibrium in the balance of payment and growing national protectionism sentiments in the Congress, President Nixon decided to force new adjustments to exchange rates between the U. S., Europe and Japan. On 15 August 1971, the dollar could no longer be exchanged into gold. The U. S. also imposed a ten-percent tariff on all imports and introduced price and wage controls to inhibit inflation. This set of measures led to a new renegotiated agreement known as Smithsonian

Agreement but in the end, this agreement only temporarily extended the life of the system. In February of 1973, eighteen months after the “ Nixon shock”, currencies of all major industrial nations were set free as they established floating exchange rates. With its two key elements of system – par value and gold standard – terminated, the Bretton Woods system was officially gone. From now on, the exchange rate of the U. S. dollar and other major currencies was determined only by the market (McKinnon, 2007; Cohen, 2002; Suranovic, 2010).

Conclusion

The demise of the Bretton Woods system demonstrates the weakness of fixed exchange rate systems. Nations must give up certain degree of independence over their monetary policies thus ignoring domestic economic conditions, which are dominated by the international interests. It can be very hard and costly to do, requiring a lot of coordination at both national and international levels. The collapse of the Bretton Wood system also ushered in a new era: many restrictions were removed allowing capital move freely between nations. This essentially represented the beginning of the new stage characterized by the interconnectedness of global economy and increased role of international financial markets. The future of the new monetary system is not clear at this point. Recent financial crisis clearly indicates that new set of international monetary regulations is likely to be adopted in the near future. To what extend they will change international financial landscape remains to be seen.