Overview of the bretton woods system economics essay

An idea for a framework to stabilize world's financial system came after the Second World War. The biggest global economies wanted to recover from war and maintain financial stability in order to avoid another great depression. Therefore, in July 1944, delegates from 44 countries met in Bretton Woods USA. The result of that meeting was establishing the International Monetary Fund, World Bank (The International Bank for Reconstruction and Development) and also a stable international monetary system as an effective method to promote free international trade.

The system was supposed to bring stability by keeping exchange rates between currencies fixed. This would be achieved by ' pegging' each currency to a reserve currency. At the request of the US and also because of the reason that it was a dominant economic and military power, the US Dollar was made the reserve currency. From the bottom of the chain, each currency was ' pegged' to the US Dollar and 1% variation on each side was allowed. US Dollar was pegged to Gold at $35 per ounce. The US government committed to exchange dollars for gold at that rate, which along with the strength and credibility of the US economy made the dollar as good as gold. This eliminated the problem which was faced by the Gold Standard System since printing money was much cheaper than finding and mining limited gold resources.

Fixed exchange rates were supposed to encourage and stabilize world trade. The International Monetary Fund consisted of a fixed pool of national currencies and gold. Its aim was to manage individual trade deficits so that no deflationary pressures for any currency would arise. If a country experienced a current account deficit and was short of reserves it could borrow from the IMF. Should a fundamental economic disequilibrium arise in any country it was allowed to adjust its currency value by 10%. Such action would be carried out by the IMF through an international agreement.

The World Bank (The International Bank for Reconstruction and Development) was mainly supposed to speed up the recovery of world’s economy after the war. It had a capitalization of $10 billion and was supposed to loan this money in order to achieve its goal.

After the war, US were running huge balance of payments surpluses. Since the dollar became the reserve currency there arouse an immense need for it to flow out of the US economy. This had to be done since the world economy suffered from a tremendous dollar shortage. Policymakers alerted the natural state of things and created US balance of payments deficits. This was carried out through the creation of credit facilities and grants to the recovering Europe.

In general Bretton Woods attempted to create stability by making the US utilize the dollar-gold peg to trade with developing countries for a profit and then using this profit to fund European and Japanese recovery. These economies, growing on the inflow of US dollars, would then sell their products to the US and then buy from the developing countries. This triangular trade system reinforced US as the main country responsible for financial stability.

Bretton Woods achieved its aim of promoting world trade and encouraging the post-war recovery.

Collapse of the system

Bretton Wood system was a good short run solution for the international monetary system. However, in the long run it was programmed to collapse based on many weaknesses that the system consisted of.

A major weakness of the Bretton Woods system was the dependence of the United States’ ability to maintain a balanced ratio between its outstanding liabilities and gold stock. If the United States’ outstanding liabilities exceed its gold stock, it would lead to the fear of the depreciation of the dollar value and thus affect the reverse values of those countries that fixed its exchange rate with the dollar. On the other hand, if U. S. deficits were eliminated, the world would be deprived of its major source of reserve growth, with depressing effects on world trade and economic activity. (Robert, p32). In 1953, U. S. gold reserves exceeded foreign liabilities by three-fold. But dollarization of the world economy proceeded apace and the liability/gold ratio became equal by 1964 as the United States inflated its money supply and exported dollars overseas. By the time President Nixon took office in 1969, debt attributed to the Vietnam War effort reversed the monetary position of the United States. By 1970, foreign liabilities were five times greater than gold reserves. By 1960 the Bretton Woods fixed exchange rate system came under pressure when gold traded above its official dollar peg of $35 an ounce on the London gold market.

A second weakness of the Bretton Woods system was the balance of payments adjustment process. When an individual country encountered deficits, the problem was dealt with on an individual basis by providing credit, usually through the Fund, rather than reviewing if the balance of payments policies and the aims of individual countries were compatible with each other and with a stable international monetary system. (Robert, p32).

A third weakness, which was the failure of the system to cope with large unequilibrating capital flows. Both France and Britain had experienced major speculative outflows in the 1950’s; furthermore, it was becoming evident that interest rate differentials could induce sizable movements of capital. The Fund’s Articles had assumed that controls would suppress such flows but in the reality, it is not possible for most of countries to control capital flows without controlling all international transactions. Leads and lags in commercial payments had already shown up as a potent disequilibrate force.

However, as the U. S. external deficits increases, the demand on dollar started to exceed the U. S. gold stock, and thus it ultimately undermined the ability of the U. S. to maintain the exchange rate between the dollar and gold at the rate of $35 per ounce. For instance, in 1960, the value of U. S. gold stocks at the official parity of $17. 8 billion fell short of the $18. 7 billion of outstanding liquid foreign dollar claims. To avoid changing the dollar parity, many different measures were implemented to overcome the shortage of dollar. For instance, in 1967, the IMF created a facility called “ special reserve drawing right” (SDRs) in the Fund to provide an alternative to the dollar in countries’ reserves. The SDRs were implemented to create accounting entries in the IMF accounts to settle payments imbalances between members. Furthermore, the IMF also introduced new methods of calculating the U. S. balance of payments on the basis of liquidity balances.

Despite all these efforts to safeguard the system, the gap between international claims on dollar and U. S gold stock continued to widen. For instance, U. S. gold stocks by 1971 had fallen to just over $10 billion against outstanding claims of more than $60 billion. Since, the dollar was tremendously overvalued in comparison to gold, in 1971 gold was allowed to float. Nevertheless by then the international community lost its faith in the US ability to control its balance of payments deficits and as the gold appreciated more and more countries withdrew from the fixed exchange rate agreement. Ultimately in 1973 the Bretton Woods market collapsed and a floating exchange rate regime was implemented.

Reasoning on the discussion of the introduction of the new version of the system

Discussion is common on the proposal to reintroduce a new version of Bretton Woods System. Bretton woods System is perceived by many to have achieved its intended mandate after its formation in1944 (Bordo & Eichengreen, 1993). It was formed to address Europeans countries' economic problems brought about by World War II which was nearing its end. It met its stipulated objectives of fixing currency parities by choosing US dollar as the reserve currency. Agreement mechanism of Bretton woods of 1944 led to the realization of monetary stability and reconstruction of economy after the war.

Explosion of financial crises since 1997 in different parts of the world has led to fresh calls for reintroduction of Bretton woods System commonly termed as Bretton woods II. Recent crises such as fall of financial markets lay off of industries, trade deficits and hyperinflation of energy prices many argue may not reoccur if only Bretton woods System were reintroduced.

In Lyndon LaRouche's call for reintroduction of Bretton woods System, he states that there are five important steps that need to be taken in order to prevent future reoccurrence of similar crises that have been realized in the recent past (Witzsche, 2003). First, he said there is need to adopt a global system like Bretton Woods System to recover world trade. Next, governments must not try to save derivatives markets from collapsing but should instead protect the people, important trade in science services and hard commodities and produce enterprises. He further asserts that the president of the United States of America should join other governments in putting to an end the existing monetary and financial system and instead embrace a new system. In addition, in order for growth and recovery of economy to be realized, there is need to protect governments' debts and credits at all cost and also the production and distribution of essential goods and services should not be discontinued at all.

Bretton Woods System reintroduction has received support across the globe with American economist LaRouche's economic policy on Bretton Woods II drawing support from tally, Common wealth of Virginia, European parliament Kentucky of representatives and house of representative of Albania. They are unanimous in asserting that reintroduction of a new monetary system would do away with the current hazardous mechanism and thus stabilize currency values. New Bretton woods System has also received support from leading politicians like French president, Britain's prime minister and Italian president, terming it a global justice movement to address the problem of capital flow (Patomaki, 2001). Proponents of the system say there is need for a new economic system since the current one has failed.

Obstacles to the introduction of Bretton Wood system

Despite the success of Bretton woods System formed in 1944, there is fear that that a new Bretton Woods might not succeed. Those who oppose the system argue that it will not be easy to choose the currency that can withstand financial strain. First coming up with the currency that will be the backing currency of world's currencies among the world's leading currencies may not be possible as many superpowers would want to exert their authority in the world trade. United State's dollar was chosen to be the sole backing currencies when Bretton Woods System was formed. However, due to increase in financial strain the system collapsed in 1971. There is fear that such an occurrence might happen again as there is no surety which currency can survive the storm of inflation and financial strain to avert collapse of the new Bretton woods System.

According to Matai (2008) American was and is still the pillar of financial system in the globe and economic crisis affecting such government will trickle down to other nations raising fear that such system may not survive global crises. It is for this reason that many leaders are calling for Bretton Woods System reintroduction so that America's financial crisis might not affect other nations. But the next choice of currency reserve is a challenge as Euro for example is just a decade old and cannot be trusted as the American dollar. This means therefore it might not be easy on the side of US to let go the control it has on the reserve currency (Haberler, 1953).

The public is not aware about the effectiveness of the Bretton woods System and therefore it is likely to lack public support. This can seriously affect the success of the Bretton woods System greatly because for people to use the new currency and exchange rate it must have the support of the people. There is need for dissemination of information about the new system but even if the public has the information it does not mean they will embrace the system. The system also faces a challenge of finding a balance of coping with the complexity the global economy and the ability to mitigate any global economic crises (Boughton & Lateef, 1995).

Conclusion

In conclusion many view the system as a major solution to the current economic crisis but fear also reign is some quarters whether the system will not fail as the former Bretton Woods System. It therefore calls for caution and sobriety and appropriate measures that can prevent reoccurrence of such costly failures.