

Advantage and disadvantage of bretton woods system



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Most of the countries tried to reestablish the gold standard after World War I, but it had been totally collapsed during the Great Depression in 1930s. Some economists said comply with the gold standard had prohibited monetary authorities from increasing the money supply rapidly enough to recover the economies. Therefore, the representatives of most of the world's leading nations met at Bretton Woods, New Hampshire, in 1944 to create a new international monetary system. The representatives had decided to link the world currencies to the dollar since the United States accounted for over half of the world's manufacturing capacity and held most of the world's gold during that time. At the final, they agreed should be convertible into gold at \$35 per ounce.

What is Bretton Woods System? The Bretton Woods system is often refer to the international monetary regime that prevailed from the end of World War II until 1971. The origin of the name is from the site of the 1944 conference that had created the International Monetary Fund (IMF) and World Bank. According to the history, the Bretton Woods system was the 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.

The International Monetary Fund was officially established on 27th December 1945, when the 29 nations who had participated in the conference of Bretton Woods signed the Articles of Agreement. It commenced its financial operations on 1st March 1947. The IMF is an international organization, which consists of 183 member countries nowadays. The objectives of the IMF are to promote international monetary cooperation by establishing a global monitoring agency that supervises, consults, and collaborates on monetary problems. It facilitates world trade expansion and thereby contributes to the promotion and maintenance of high levels of employment and real income. Furthermore, the IMF ensures exchange rate stability to avoid competitive exchange depreciation. It eliminates foreign exchange restrictions and assists in creating systems of payment for multilateral trade. Moreover, member countries with disequilibrium in their balance of payments are provided with the opportunity to correct their problems by making the financial resources of the IMF available for them.

On the other hand, World Bank is the most significant source of financial aid for developing nations in the world. It provides approximately \$16 billion of loans to its client countries per year. It utilizes its financial resources, highly trained staff, and extensive knowledge base to help each developing country to move towards the path of stable, sustainable, and equitable growth in the order to fight against poverty. Its goals are to eliminate the worst forms of poverty and to improve living standards. It supports the restructuring process of economies and provides capital for productive investments.

Furthermore, it encourages foreign direct investment by making guarantees or accepting partnerships with investors. The World Bank's aims are to keep

payments in developing countries balanced and to foster international trade. It is active in more than 100 developing economies. It forms assistance strategies by cooperating with government agencies, non-governmental institutions and private enterprises. It offers financial services, analytical, advisory, and capacity building.

The conference that gave birth to the Bretton Woods System was organized in the American resort village of Bretton Woods, New Hampshire. It 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 44 allied nations, plus one neutral government — Argentina, the conference discussion was dominated by two rival plans developed — Harry Dexter White of the U. S. Treasury and John Maynard Keynes of Britain respectively. 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.

Although the gaps between the White and Keynes plans seemed enormous during that time, 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 International Monetary Fund.

There were four points being stand out which are listed as below:

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.

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 loath 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 <https://assignbuster.com/advantage-and-disadvantage-of-bretton-woods-system/>

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.

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.

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.

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In the postwar era, the Fund itself would provide such a forum – in fact, an achievement of truly historic proportions. Even more path breaking 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.

With these four points, the definition of the Bretton Woods system is 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 as stated as below:

Regulatory – administering the rules governing currency values and convertibility,

Financial – supplying supplementary liquidity

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.

Under the Bretton Woods system, central banks of countries other than the United States had to perform the task of maintaining fixed exchange rates
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between their currencies and the dollar by intervening in foreign exchange markets. If a country's currency was too high relative to the dollar, its central bank would sell its currency in exchange for dollars in order to reduce the value of its currency. Conversely, if the value of a country's money was too low, the country would buy its own currency in order to raise the price.

The Bretton Woods system had been lasted until 1971. The inflation in the United States and a growing American trade deficit of that time were depreciating the value of the dollar. Americans urged both Germany and Japan which had favorable payments balances to appreciate their currencies. But those nations were reluctant to do so, since raising the value of their currencies would raise the prices for their goods and hurt their exports. Finally, the United States abandoned the fixed value of the dollar and allowed it to "float", that is to fluctuate against other currencies. This caused the dollar fell dramatically. World leaders sought to revive the Bretton Woods system with the so-called Smithsonian Agreement in 1971, but failed. By 1973, the United States and other nations agreed to allow exchange rates to float.

Economists named the resulting system as "managed float regime", which means that even though exchange rates for most currencies float, central banks still can intervene to prevent sharp changes. As in 1971, countries with large trade surpluses often sell their own currencies in an effort to prevent them from appreciating and prevent them from hurting exports. Conversely, countries with large trade deficits often buy their own currencies in order to prevent depreciation, which could increase domestic prices. But there are limits to what can be accomplished through intervention, especially <https://assignbuster.com/advantage-and-disadvantage-of-bretton-woods-system/>

for countries with large trade deficits. Eventually, a country that intervenes to support its currency may deplete its international reserves, making it unable to continue buttressing the currency and potentially leaving it unable to meet its international obligations.

2. 5. 2 Advantage and Disadvantage of Bretton Woods System

The benefits of the Bretton Woods system were a significant expansion of international trade and investment as well as a notable macroeconomic performance: the rate of inflation was lower on average for every industrialized country except Japan than during the period of floating exchange rates that followed, the real per capita income growth was higher than in any monetary regime since 1879 and the interest rates were low and stable. It has to be noted that leading economists nowadays argue “ whether macroeconomic performance stability was responsible for the successes of Bretton Woods, or the controversy.”

Under the gold exchange standard, a country has to resort to the classical medicine of deflating the domestic economy when faced with chronic BP deficits. Before World War II, European nations often used this policy, in particular the Great Britain. Even though few currencies were convertible into gold, policy makers thought that currencies should be backed by gold and willingly adopted deflationary policies after World War I. Deflationary policy is not the only option when faced with BP deficits. Devaluation is accepted in Bretton Woods. The adjustable peg was viewed as a vast improvement over the gold exchange standard with fixed parity. Currencies were convertible into gold, but unlike the gold exchange standard, countries

had the ability to change par values. For this reason, Keynes described the Bretton Woods system as “ the exact opposite of the gold standard.”

On the contrary, weaknesses of the system were capital movement restrictions throughout the Bretton Woods years (governments needed to limit capital flows in order to have a certain extent of control) as well as the fact that parities were only adjusted after speculative and financial crises. Another negative aspect was the pressure Bretton Woods put on the United States, which was not willing to supply the amount of gold the rest of the world demanded, because the gold reserves declined and eroded the confidence in the dollar.

In the post-World War II scenario, countries devastated by the war needed enormous resources for reconstruction. Imports went up and their deficits were financed by drawing down their reserves. At that time, the US dollar was the main component in the currency reserves of the rest of the world, and those reserves had been expanding as a consequence of the US running a continued balance of payments deficit; other countries were willing to hold those dollars as a reserve asset because they were committed to maintain convertibility between their currency and the dollar.

The problem was that if the short-run dollar liabilities of the US continued to increase in relation to its holdings of gold, then the belief in the credibility of the US commitment to convert dollars into gold at the fixed price would be eroded. The central banks would thus have an overwhelming incentive to convert the existing dollar holdings into gold, and that would, in turn, force the US to give up its commitment. This was the Triffin Dilemma after Robert

Triffin, the main critic of the Bretton Woods system. Triffin suggested that the IMF should be turned into a 'deposit bank' for central banks and a new 'reserve asset' be created under the control of the IMF. In 1967, gold was displaced by creating the Special Drawing Rights (SDRs), also known as 'paper gold', in the IMF with the intention of increasing the stock of international reserves. Originally defined in terms of gold, with 35 SDRs being equal to one ounce of gold (the dollar-gold rate of the Bretton Woods system), it has been redefined several times since 1974. At present, it is calculated daily as the weighted sum of the values in dollars of four currencies (euro, dollar, Japanese yen, and pound sterling) of the five countries (France, Germany, Japan, the UK and the US). It derives its strength from IMF members being willing to use it as a reserve currency and use it as a means of payment between central banks to exchange for national currencies. The original installments of SDRs were distributed to member countries according to their quota in the Fund (the quota was broadly related to the country's economic importance as indicated by the value of its international trade).

Structural problem also exist in this system. Over time the world economy grew and needed more liquidity, which meant that US had to maintain increasing trade deficits. But the US was not able to devalue the dollar. The dollar was the numeraire of the system, i. e., it was the standard to which every other currency was pegged. Accordingly, the U. S. did not have the power to set the exchange rate between the dollar and any other currency. Changing the value of dollar in terms of gold has no real effect, because the values of other currencies were pegged to the dollar. This problem would not

have existed if most of other currencies were pegged to gold. However, none of these currencies were pegged to gold because they were not convertible into gold with the limited supply of gold.

The breakdown of the Bretton Woods system was preceded by many events, such as the devaluation of the pound in 1967, flight from dollars to gold in 1968 leading to the creation of a two-tiered gold market (with the official rate at \$35 per ounce and the private rate market determined) and finally in August 1971, the British demand that US guarantee the gold value of its dollar holdings. This led to the US decision to give up the link between the dollar and gold.

2. 5. 3 Crisis of Bretton Woods System

The enduring imbalances of payments between the Western industrialized countries in the 1960s and 1970s had weakened the Bretton Woods System. The main problem was that one national currency which is the U. S. dollar had to be an international reserve currency at the same time. This made the national monetary and fiscal policy of the United States free from external economic pressures, while seriously affecting those external economies. The U. S. was forced to run deficits in their balance of payments in order to ensure international liquidity which had been caused world inflation. In the 1960s, there was a run of very inflationary policy which limited the convertibility of the U. S. dollar since the reserves were insufficient to meet the demand for their currency. Yet, the other member countries were not willing to accept the high inflation rates that the par value system would have caused and “ the dollar ended up being weak and unwanted, just as

predicted by Gresham's law: Bad money drives out good money." The Bretton Woods System had collapsed. Another fundamental problem was the delayed adjustment of the parities to changes in the economic environment of the countries. It was always a great political risk for a government to adjust the parity and " each change in the par value of a major currency tended to become a crisis for the whole system." This led to a lack of trust and destabilizing speculations.

End of Bretton Woods System dissolved between 1968 and 1973. In August 1971, U. S. President Richard Nixon announced the " temporary" suspension of the dollar's convertibility into gold. While the dollar had struggled throughout most of the 1960s within the parity established at Bretton Woods, this crisis showed the symptom of the breakdown of the system. An attempt to reestablish the fixed exchange rates failed, and by March 1973 the major currencies began to float against each other. In March of 1973, the par value system was abandoned and the member countries agreed on permitting different kinds of ways for determining the exchange value of a nation's money. Since the collapse of the Bretton Woods System, IMF members have been free to choose any form of exchange arrangement they wish except pegging their currency to gold: allowing the currency to float freely, pegging it to another currency or a basket of currencies, adopting the currency of another country, participating in a currency bloc, or forming part of a monetary union.

Many feared that the collapse of the Bretton Woods system would bring the period of rapid growth to an end. In fact, the transition to floating exchange rates was relatively smooth and it was certainly timely: flexible exchange

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rates made it easier for economies to adjust to more expensive oil, when the price suddenly started going up in October of 1973. Floating rates have facilitated adjustments to external shocks ever since. The IMF responded to the challenges created by the oil price shocks of the 1970s by adapting its lending instruments. To help oil importers deal with anticipated current account deficits and inflation in the face of higher oil prices, it set up the first of two oil facilities.

From the mid-1970s, the IMF sought to respond to the balance of payments difficulties confronting many of the world's poorest countries by providing concessional financing through what were known as the Trust Fund. In March of 1986, the IMF created a new concessional loan program called the Structural Adjustment Facility. The SAF was succeeded by the Enhanced Structural Adjustment Facility in December of 1987.

As a conclusion, the Bretton Woods System of 1944 with its fixed exchange rates does not exist anymore today. Its institutions and procedures had to adjust to market forces to survive but still its goals are as valid today as they have been in the past. Today many large developed countries allow their currencies to float freely, which means that only supply and demand at the market determine what it is worth. Some nations try to influence this process by buying and selling their own currency. Another method is to peg the value of the money to one of the main currencies.

What are the implications of the Bretton Woods experience for future international monetary relations? The most important implication is that simply stabilizing exchange rates is not sufficient to automatically deliver the

benefits trumpeted by the proponents of such an initiative. It is crucial that national economic policies, for instant, budget deficits, and economic outcomes, for instant, inflation, converge to a certain extent before countries decide to fix exchange rates. However, a short term divergence of policies is not detrimental for the functioning of such a system; it is rather a credible commitment to fixed exchange rates that ensures its stability. It can be concluded that ambitious international monetary reforms like the Bretton Woods System can only work if they are integrated into wider economic and political convergence. With this fact in mind it is easy to understand how far the world with its various countries and living standards, policies, and economies is from a “ new system of Bretton Woods”, that can overcome its previous weaknesses.