

The causes of the collapse of the bretton woods system

[Finance](#)



When U. S. President Richard Nixon formally ended the backing of U. S. currency by the gold standard system in 1971, the noble attempts of the Bretton Woods delegates finally ended. . This paper will examine the causes of the death of the Bretton Woods System: Some have blamed it on the changing situation of the international economic system; others blamed it on the failure of the System itself. We will explore the Bretton Woods System, its ideals and contradictions, in an attempt to discern what indeed went wrong.

Fixing the exchange rate between the U. S. dollar and other currencies was doomed to failure because of various principles of macroeconomics which will be analyzed herein. However, in spite of its failures, the Bretton Woods System played a crucial role in the economic development of Europe and Japan in the decades immediately after World War II.

Its original purpose was the economic rehabilitation of Europe and Japan, and in this, the Bretton Woods System was indeed successful. The collapse of the Bretton Woods System in 1971 could be traced to a number of reasons. The most important of these was the increasing trade imbalance of the U. S. economy. The Cold War between the United States and the USSR drained the U. S. Treasury, leading to deficit spending, and a surge in imports.

In particular, the Vietnam War became a veritable black hole of runaway spending. Furthermore, the rehabilitated economies of Europe and Japan soon made up for lost ground, and caught up to the United States' economy. The U. S. economy, booming throughout the Fifties and Sixties, finally reached the point of deficit in the early 1970s. At this time, the U. S. started to experience massive cash outflow to the rest of the world.

This was certainly instrumental in the collapse of the Bretton Woods System, but not the only reason. A second reason for the end of the Bretton Woods System was the lack of autonomy to maintain its workings. As the U. S. currency came to a crisis in the early 1970s, the System collapsed. The International Monetary Fund (IMF), the authority to control the currency exchange rate, had no power to stop the System from collapsing, and the System subsequently spiraled out of control.

The powerlessness of the IMF was due to the lack of autonomy of the U. S. currency dominance based on the gold standard. In this paper, we will show that these reasons were the main causes of the end of the Bretton Woods System, by analyzing the economic data and considering the economists' and historians' arguments. The origin of the Bretton Woods System will be explored to clarify the theory behind the System. Additionally, we will review the world economy of the 1950s, when the Bretton Woods System was working effectively, and compare it to the world economy of the 1960s, when the System began to lose effectiveness.

The comparison is necessary to answer to the question why the Bretton Woods System became ineffective although it was functional at the beginning. This paper will also analyze the structure of the International Monetary Fund, to see how that too was instrumental in bringing the Bretton Woods System to its close. It is important to understand how the IMF had been trying to standardize the currency until 1973, the year in which the world transferred to the exchange currency system from a pegged exchange rates system.

The United Nations Monetary and Financial Conference, better known as the Bretton Woods Conference, was a meeting among 730 delegates representing the 45 Allied nations of the Second World War. The conference was held at the Mount Washington Hotel in Bretton Woods, New Hampshire. The conference followed the conclusion of the Second World War and convened from July 1 to July 22, 1945. The purpose of the delegates at this Conference was to establish a new global economic order following the trauma of the war, not simply a re-hash of the world economic system of the 1930s.

Most economists agreed that that system had not been efficient during the period between world wars. Depression hit the United States in 1929, and recession gripped the world economy in the thirties. While some nations let their currencies float, others set a policy of pegging their currency to gold or other currency. This system had outbreaks of "competitive devaluation". In order to keep their reserve at a high level, governments introduced exchange control, restricted the use of foreign currency and imposed higher tariffs barriers to limit the volume of imports.

World trade declined because of these restrictions, and the world faced very slow economic recovery in the 1930s. Delegates at the Bretton Woods Conference worked to revamp these short-sighted, restrictive policies. They felt the need to establish economic institutions which would transform the world economy into a well-oiled machine, one which promoted international trade for all countries..

The delegates created three major structures: the International Monetary Fund (IMF); the International Bank for Reconstruction and Development (IBRD)
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or the World Bank; and the International Trade Organization (ITO). However, in 1950, the U. S. Congress nixed the formation of the ITO, and it never got off the ground. In place of the ITO, a treaty was agreed upon by most of the world economic powers and the rest of the world.

The treaty was commonly known as the General Agreement on Tariffs and Trade (GATT), which took over the ITO ideology. The other two institutions, IMF and the World Bank, were to take responsibility of being the bi-pillar system of the Post-Second World War global economy. The purpose of the World Bank was to promote development, and that of the International Monetary Fund was to maintain order in the international monetary system.

The delegates of the Bretton Woods Conference based the new global economic structure on a code of what they felt to be economic fairness. This code related to a global regime of fixed but adjustable exchange rates. This system of adjustable rates was designed to implement equity on a world economic scale. The adjustable fixed rate provided exchange rate stability in the short run, just like the gold standard system. At the same time, it also allowed the possibility to adjust the exchange rate when a national balance of payment is in a crucial state of disequilibrium.

However, the weakness of this adjustable exchange system was that it lacked the stability, the certainty of the gold standard and the flexibility of the flexed exchange rate regime. Despite the demerits of this currency exchange mechanism, the Bretton Woods System worked fairly well in the 1950s and early 1960s. The adjustable-fixed exchange was successful in increasing international trade and supporting the recovery of the economy in Europe and Japan.

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The system resulted in the per rate system, under which currencies of the member countries were fixed within 1% of the value of the U. S. dollar, which was pegged to the value of gold. With this system, the IMF was successful between 1946 and 1966, although it had its kinks. The Bretton Woods delegates hastened the integration of the world economy, but they could not so easily achieve a smooth currency exchange system, because the destruction of the Second World War was too massive to recover without unilateral action such as discarding the pegged exchange rate system. Some nations set up their own restrictions on trade and currency exchange so that the IMF could not get those countries into the world currency system.

Moreover, the ruined European nations requested massive funding from the IMF until 1950. In spite of IMF mistakes, the global economy progressed after 1951. The Fund successfully spread its economic activities to all members, not just to the fund users. However, after 1966, the world economy changed substantially once again. The problems inherent in the Bretton Woods System started to be exposed gradually in the mid-1960s. Richard N. Cooper, in his book *The International Monetary System*, listed the features of the Bretton Woods System as well its contradictions..

The first characteristic of the system was that member countries of the Bretton Woods System would determine their own domestic economic policies. This permitted autonomy of domestic economies, enabling nations to pursue their own internal economic objectives, such as assuring low inflation or achieving the “ natural” unemployment rate. The second feature of the Bretton Woods System, according to Cooper, was that the U. S.

currency be pegged to gold. The third feature was that other nations adopted the adjustable-exchange rates system.

Cooper argues that these three features of the Bretton Woods System contradicted each other:: Countries could not frame their national economic policies independently and still maintain fixed exchange rates and currency convertibility except by luck and coincidence. That potential conflict was recognized by the Bretton Woods architects... Cooper suggests that to fix these contradictions, the creators of the system, the delegates, added two elements. One was the establishment of the IMF, and the other was altering exchange rates under the condition that a nation comes to a severe economic imbalance.

According to Cooper, the Bretton Woods System architects assumed that new gold production coming into monetary reserves would be an ample supply to fuel adequate growth. The US dollar, they further assumed, would be able to provide for the required liquidity to keep the exchange rate at the fixed level. However, until the 1970s, growth in the global gold demand had been increasing faster than new gold production. World monetary reserves outside the United States increased by \$54 billion, a 4.5 per cent per annum growth rate.

United States gold reserves departed to other countries to the tune of \$9 billion, while only \$4 billion came from new gold production. Foreign exchange, which was overwhelmingly in dollars as the medium of choice, supplied \$30 billion of the growth in reserves. Additionally, the IMF started, in 1970, to provide Special Drawing Rights (SDRs), which is the new type of international reserve assets generally called "paper dollars". U. S. gold
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reserves declined dramatically during this period because its stock of gold had gone to much of the rest of the world.

The reasons for this exodus of American capital were complicated and controversial. Military expenditures involved with the Cold War and the Vietnam War predominate. As the result of heightened expenditures, the United States tried to increase its money supply regardless of being able to back it up with gold reserves. The rest of the world accumulated these lost U. S. reserves until the beginning of the 1970s, which caused uncertainty in the value of the US dollar itself. The second reason for the exodus of U. S. capital was that the European and Japanese economies had caught up to the United States' economy.

Due to the increased economic clout of revived nations, the United States began suffering from the trade deficit. European nations and Japan were taking advantage of the underestimated price of their currency, enabling them to increase the volume of their exports. The United States suffered because of the high price of the dollar relative to other currencies. After accumulation of the wealth, European countries and Japan embarked on converting reserve surpluses into dollar reserves. They practiced this policy because of the interest that could be earned on U. S. dollars.

Moreover, if it ever became necessary the U. S. dollar could be converted to gold. These were miscalculations of the International Monetary Fund creators.. In these ways, the Bretton Woods economic structure was undermined, as the nominal price and real value of U. S. currency came into conflict. In 1970, in order to restore the system, the IMF introduced a new international reserve asset. Special Drawing Rights (SDRs) were expected to <https://assignbuster.com/the-causes-of-the-collapse-of-the-bretton-woods-system/>

supplement the other components of global reserves, i. e. U. S. dollars and gold. The need for liquidity in the international monetary system was the reason for the creation of SDRs.

In 1970, when the SDRs were first allocated, the United States had the largest share, totaling about \$867 million, followed by the United Kingdom, at \$410 million. According to Acheson, “ A problem... is the prospect of conflict over the amount of SDRs to be created. ” The development of the new asset system was eventually unsuccessful. Richard Harper argues that the failure of IMF came from a fundamental problem within the system itself. The problem, he says, is that a fixed exchange-rate system requires national governments to arrange their monetary policy in problematic ways.

If, for instance, one nation has continuously higher inflation rate than others', it cannot compete in the world market, and its citizens would be buying more expensive imported products, leading to trade deficits. Therefore, the government has to be adjusting to its trading partners all the time. Harper goes on to say that under the pre-1914 gold standard system, there would no such problem because the inflation rate would spill over to the countries around it and achieve a convergence. By contrast, under the par value system, the mechanism of self-converging is missing.

Harper summarizes his thoughts about monetary cooperation between nations: Lack of co-ordination of monetary policies and, in particular, the implementation of inappropriate policies by any individual member, resulted in the countries in question facing runs on their currency when there was perceived to be an imbalance between their internal monetary policies and external exchange rates. He argues that this systematic flaw was closely
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related to the ultimate obsolescence of the Bretton Woods System. Instability of the System came to a head, and it collapsed, like a house of cards.

The real signal of its death was in 1971, when U. S. officials declared suspending the convertibility between dollars and gold, making other nations' currency float. The fixed exchange rates between U. S. dollars and other world currencies disappeared, and the Bretton Woods System went the way of the dinosaurs—extinction. After its collapse, on March 19, 1973, the central banks of the world economic powers gave up their commitment to stabilize exchange rates between their currencies and the dollar.

After suspending the convertibility from dollars to gold, the fixed exchange rates between U. S. currency and others began to disappear, even though many nations insisted on keeping the pegged exchange rates of the Bretton Woods System. Riccardo says: It now seems clear that the really essential characteristic of Bretton Woods was not the maintenance of parity but the convertibility of the dollar... After March 1973, the central banks rapidly discovered that it was simply not possible to abandon exchange rates to market forces completely. In this way, the Bretton Woods System lost its key component—convertibility from dollars to gold—in 1971, then an ancillary key component—adjustable-fixed exchange rates in 1973.

Henceforth, currency valuations were determined according to market fluctuations. The IMF lost the function of setting exchange rates.. Conclusion The Bretton Woods System came to an end in 1973, almost three decades after the Conference. The System contained contradictions and flaws since its foundation in 1945. Some economists argue that the system's defects <https://assignbuster.com/the-causes-of-the-collapse-of-the-bretton-woods-system/>

were negligible, and that the problem lay in the changing world economy, not the Bretton Woods System itself. However, it is undeniable that the mechanisms of the Bretton Woods System were not flexible enough to adjust to a changing world economy.

Adaptability is the key to survivability, and in this sense, the Bretton Woods System was doomed to failure. The revivals of European nations and Japan were predictable, given the scope of international policy to revive these moribund economies. More than thirty years have passed since the collapse of the Bretton Woods System. Some economists say that Bretton Woods II is emerging in the world today.. The fact that China pegs its currency to the US dollar seems similar to the situation at the Bretton Woods Conference of yesteryear.

Because of the fixed exchange rate system between the Chinese Renminbi and the U. S. dollar, the United States suffers a huge trade deficit with China today. . Matthias Kaelberer argues that Bretton Woods II would be different from the classic one, for the Bretton Woods System from 1944 to 1973 was agreed upon by its members, while the emerging system of today comes from Chinese de facto unilateral behavior pegging its currency to the U. S. currency. However, he also emphasizes that, no matter what their origin, reviewing the classic Bretton Woods System will be helpful and important to predict the consequences of the Chinese-American fixed exchange rates relationship.

The Bretton Woods Conference helped ease the world's economy through a tumultuous period after the Second World War. Although the economic solutions they espoused seem anachronistic today, we should also thank the <https://assignbuster.com/the-causes-of-the-collapse-of-the-bretton-woods-system/>

architects for playing a vital role in restoring some semblance of equilibrium to a world in tatters.

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