Do We Need a New Bretton Woods?

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Balance Sheet for Bretton Woods

In discussing strengths and weaknesses of the Bretton Woods system, three things have to be kept in mind. First, although the dates of its existence run from 1944 to 1971, in fact it became operative only from 1959, when the European currencies became fully convertible, and its ultimate breakdown in 1971 was foreseeable in 1968, when gold was demonetized by the establishment of the two-tier gold market. Second, if good times coincided with the dates of Bretton Woods, it does not follow that credit for the good times belongs to Bretton Woods. Institutions other than the international monetary system made important contributions to favorable economic conditions. Third, even if one believed that it was desirable to restore a Bretton Woods system free of its weaknesses, it would not fit today's world. With these caveats in mind, I list the strengths and weaknesses of the system.

Strengths

Three strengths stand out:

1. Macroeconomic performance was notable. The rate of inflation was lower on average and for every industrialized country except Japan than during the subsequent period of floating exchange rates until the early 1990s. In addition, inflation variability and inflation persistence were lower than under the subsequent float. Low and stable nominal interest rates also characterized Bretton Woods. Finally, real per capita income growth was higher than in any monetary regime since 1879, but it was more variable than during the subsequent float.

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2. The degree of exchange rate stability compared favorably with volatility of preceding and subsequent periods.
3. Unprecedented expansion of international trade and of investment occurred during the Bretton Woods years.

The record of Bretton Woods in providing good nominal results accords with the view that, to the extent that the regime offered convertibility of money issues into gold, it was a stable nominal anchor. It is less plausible to link real output stability to superior nominal performance under Bretton Woods. What evidence there is about supply shocks suggests they were not serious during that period; hence output stability was a windfall effect of an externality. The stability of the exchange rate regime cannot account for either trade flows or the level of investment, channels that might have been the sources of economic growth. Trade liberalization, moreover, occurred under institutions independent of Bretton Woods, such as the Marshall Plan and GATT. So it is questionable whether the prosperity of the member countries was attributable to the Bretton Woods framework.

Weaknesses

Four weaknesses are notable:

1. Governments restricted international capital movements throughout the Bretton Woods years. Controls limited international capital flows.
2. Bretton Woods was designed to operate as an adjustable peg system of exchange rates. In a system of fixed rates, adjustments in parity are needed from time to time as economic policies between two countries diverge. It is difficult to know how much to adjust, but pressures build up and speculators force adjustment. Governments could not forever resist market forces. But the European countries and the United States were unwilling to allow their exchange rates to adjust.
3. In the end parities were adjusted, but usually after mounting speculative and financial crises. Devaluation was resisted as an admission of a failure of government policies leading to defeat in coming elections. France would not devalue because it wanted a U.S. devaluation to underscore U.S. economic mismanagement. Increasing capital mobility made the pegged exchange rates unworkable. Speculation against a fixed parity could not be averted by organizing rescue packages or raising interest rates.
4. Under Bretton Woods only the United States was required to convert its domestic currency into gold.

The rule did not work. In the early 1960s, the United States was not willing to supply gold that the rest of the world demanded because it feared that confidence in the dollar would erode as its gold reserves declined. In the late 1960s, the rule did not deter U.S. pursuit of an inflationary policy. The priority for the United States in the final analysis was its domestic economic objectives, not its obligations as the center country of the international monetary system. So the system of pegged exchange rates collapsed, when the United States abandoned its commitment on August 15, 1971, to buy and sell gold at $35 an ounce.

Is There a Role for the IMF in a New Bretton Woods System?

In October 1993 a meeting of the so-called Bretton Woods Commission, chaired by Paul Volcker, consisting of former central bankers, finance ministers, and well-known economists, met to propose a system of foreign exchange rates that should not be left to the markets to determine. The commission's report in July 1994 advocated that the monetary authorities of the United States, Germany, and Japan establish a system of policy coordination to avoid excessive exchange rate misalignments and volatility. In time, the report concluded, the system could yield flexible exchange rate bands within which exchange rates could move without mandating coordinated intervention. The IMF and the World Bank would be assigned the responsibility to monitor and manage the world's currencies so they would fluctuate within narrow bounds of fundamental real equilibrium exchange rates. Thus, "market excesses" would not occur. The recommendations of the Bretton Woods Commission have not materialized.

A new Bretton Woods system presumably would be a monetary regime with three large geographical zones in which use of the dollar, the yen, and the euro would predominate. The rest of the world would either peg domestic currencies to one of the three or else give them up in favor of one of the triumvirate. The triumvirate currencies would float freely against one another.

Gold would not be a reserve asset in the new system, for reasons I explain in what follows. One of the triumvirate currencies, possibly the dollar, would be the dominant international medium of exchange, and the dominant vehicle currency for interbank clearing of spot and forward transactions in the private foreign exchange market. That currency would also be used for official intervention. The invoice currency for primary commodity trading could be any one of the triumvirate currencies. There might be rules for intervention in the foreign exchange rate market to maintain some desired behavior of bilateral rates.

What would be the functions of the IMF in the new international monetary system? Under the first Bretton Woods, international capital markets did not function freely. Exchange controls limited private capital movements, and private portfolio adjustments could not finance current account deficits. The IMF was then needed to finance current account deficits. Since the demise of the first Bretton Woods system, capital mobility among the three major geographical zones has become virtually unrestricted, and governments and private corporations can borrow or lend foreign currencies at any term to maturity. The provision of liquidity by a new international agency, the IMF, which was a central concern for establishing the Bretton Woods system, no longer is required. There is no need for the IMF to provide loans to emerging market countries and economies in transition to finance current account deficits or to assist adjustment in the case of financial crises. Capital markets can serve both public and private borrowers in those countries on a commercial basis.

What would there be left for the IMF to do? It could harmonize activities of national regulators. It could continue its surveillance of financial policy of member governments. It could operate as a research institution, publishing studies and statistical information.

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What would be the object of reform? For the Bretton Woods Commission, the reform would end market fluctuations of foreign exchange rates and substitute management of their movements by central banks or finance ministers. This vision of reform is not possible. Central banks and finance ministers are not endowed with the wisdom to know what are the correct values of bilateral foreign exchanges.

For some, the reform would be a return to the gold standard, domestic currencies convertible into gold, and fixed exchange rates among national currencies. This reform vision is also not possible. This is the lesson of the post-Bretton Woods years, when governments set aside the simple rule to maintain a fixed price for gold. Country after country instead opted for full employment and economic growth. They rejected the restraints that the operation of a fixed exchange rate imposed on the pursuit of these widely supported national objectives. In the United States, where the share of international trade was a minor factor in aggregate national income, the view prevailed that the domestic economy should not be hostage to the balance of payments. Maintenance of the price of gold was not an objective of the Employment Act of 1946.

The growth of government itself has destroyed the viability of a gold standard. A real gold standard was feasible in a world in which government spent 10 percent of national income, as in Britain and the United States pre-World War I. It is not feasible in a world in which governments spend half or more of national income. Why is this so? A country that adopts a gold standard and observes the convertibility rule at times will be compelled to implement contractionary monetary policy. A balance of payments deficit will lead to a loss of gold reserves. A loss of gold reserves will enforce a reduction in domestic money supply. That reduction will impose price reductions and employment losses. The government share of national income is unaffected by the contraction in money, but the private sector bears its brunt. The government will not be constrained, as the private sector is, to lay off workers and cut the price of its services. When government's share is half of national income, the burden on the private sector is magnified. That is why the appeal of the gold standard has declined as the leviathan government has grown.

A new Bretton Woods system is not needed so long as independent central banks worldwide set as their primary goal an inflation-free economy, as indeed is the case in the advanced industrialized countries.

Reference

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