

# Bretton Woods System, 1945-1973

## Lecture outline

- Three Pillars of Bretton Woods
  1. Trade (ITO⇒GATT)
  2. Fixed exchange rate system (IMF)
  3. Recovery and Development (IBRD aka “World Bank”)
- Pillar 1: Trade Liberalization via the GATT
  - Origins and antecedents
  - Theoretical underpinnings
  - Successes and failures
- Pillar 2: Exchange rate stability and the IMF
  - Origins of regime and the nature of the BIG COMPROMISE
  - Comparison to classical gold standard
  - Successes and failures; abrupt end of regime in 1971

# Pillar 1: GATT and the Int'l Trade Order

- Origins of the GATT
  - Intended int'l institution - International Trade Organization (ITO) - not ratified by U.S. Congress
  - GATT born out of the ashes in 1948; Ad hoc and informal institution.
  - Subsumed in 1995 by World Trade Organization (Table 1)
- Theoretical Underpinnings of the GATT
  - Reciprocity and delegation
    - As with RTAA, executives of nations trade tariff “concessions”
    - Reciprocity rooted in domestic politics; generates support for free trade
  - GATT is multilateral instead of bilateral, like RTAA
    - more efficient than RTAA. A forum for concluding 1000s of bargains among dozens of countries
  - Nondiscrimination via MFN (most-favored-nation) clause.
    - MFN generalizes benefits of any bilateral bargain to all GATT members

# GATT and the Int'l Trade Order (cont)

- Successes
  - 48 year history involving 8 “rounds” or negotiations covering progressively larger volumes of trade (Table 2)
    - Tariffs on manufactured goods drop from around 40% to less than 4%
    - Growth of world trade outpaces world economic growth
  - GATT very robust. Succeeds despite Cold War, Vietnam, many wars of independence, de-colonization, creation of EC, etc
- Failures
  - Agriculture exempted. Haunts us today.
  - Exceptions for EC and other customs unions
  - Exemptions for developing countries

# Pillar 2: Exchange rate stability and the IMF

- Origins: 1944 conference in Bretton Woods, NH
  - Key players: Harry D. White (U.S.) and J.M Keynes (G.B.).
  - Both agreed that stable exchange rates are a good thing because they promote trade and investment
  - But both also saw that new domestic political realities (concern for employment) meant that a return to permanently fixed rates was impossible
- **BIG COMPROMISE**
  - Fixed but adjustable regime, with capital controls
    - If nation faced “fundamental disequilibria” in BOP, it could devalue, under the auspices of the IMF
    - If nation faced a temporary BOP deficit, IMF would be available to supplement its foreign reserves
  - Capital controls (restrictions on access to foreign exchange) allowed nations to pursue domestic goals without compromising exchange rate commitments (Figure 3)

# What was new about this regime?

- Similarities to the Gold Standard
  - Pegged exchange rates (to facilitate recovery of trade)
  - Gold the ultimate numeraire (dollar pegged to gold at \$35 per ounce)
- Differences with the Gold Standard
  - Only U.S. pegged to gold; all others pegged to the U.S. dollar
  - Contained explicit provisions for changing exchange rates
  - Allowed restrictions on short-term capital movements encouraged – Int'l capital mobility was not an integral part of the system
  - Provided coordinated oversight of national policies via a new international organization - the IMF

# Textbook version of Bretton Woods

- Low inflation credibility
  - With the dollar pegged to gold, there was a stable nominal anchor. Commitment to convert dollars to gold compelled the U.S. to follow policies of price stability. Because other countries were linked to the dollar, they too followed policies of price stability
- Built-in flexibility
  - Adjustable exchange rates meant that persistent BOP imbalances could be avoided
- Capital controls would facilitate the simultaneous pursuit of domestic (employment) and external (exchange rate) objectives (Figure 3)

## Reality of the Bretton Woods System

- Adjustable pegs was almost never adjusted
- IMF monitoring was ineffectual (when nations adjusted exchange rates, they did not follow the rules)
- Inflation was a persistent problem, beginning in the 1960s (with the US was the biggest offender)
- Bretton Woods collapsed abruptly in 1971 – Nixon breaks the link between dollar and gold

# History of Bretton Woods Exchange Rate System

- **Key role for the U.S. Dollar**
  - U.S. dollar pegged to gold, and other currencies pegged to the dollar. Formed a “gold-exchange” standard with the dollar serving as the reserve currency
  - Status of the dollar made the system dependent on US macroeconomic policy--system stability required price stability (low inflation) in the US
- **U.S. as a stabilizing force, 1945-58**
  - U.S. trade surpluses lead to a “dollar shortage” in the rest of world
  - Solved by U.S. foreign aid programs (Marshall Plan), and overseas military expenditures (Korean War). These transfers allowed other nations to finance their BOP deficits (Figure 4)
  - The IMF’s resources were insufficient. Foreign aid helped smooth payments problems in the early Bretton Woods era



# What caused the breakdown of Bretton Woods?

- Rising capital mobility
  - Markets inevitably recover from WWII
  - Domestic financial deregulation made it harder to stop capital flows at the border
    - E.g., the rise of Eurodollar market, in which dollar denominated assets were traded in Europe
  - The combined effect was to heighten the conflict between domestic and external goals
- Lack of Monetary Discipline in the U.S.
  - US money supply and budget deficit grew, reflecting Great Society and Vietnam War pressures
  - Fundamental unwillingness to cut spending and/or reduce inflation (Figure 5)

## U.S. Options in the 1960s

- Monetary and fiscal restraint
  - Ruled out by the conflict with other goals (full employment, US foreign policy objectives)
- Devaluation of the dollar
  - Ruled out by credibility concerns. Other currencies were pegged to the dollar. So if the US devalued once, the fear was that it would do so repeatedly. The response would be a run on US gold as dollar reserves were liquidated, leading the system to come crashing down.
- Take the dollar off gold (end BW)
  - Preferred option of US policymakers given that they were fundamentally opposed to cutting spending, raising taxes, and raising interest rates.

## **Table 1: Differences between GATT and WTO**

- GATT was ad hoc and provisional
  - General Agreement was never ratified by members, nor did it provide for the creation of an int'l organization.
- WTO and its agreements are permanent
  - As an int'l organization, WTO has a sound legal basis because members have ratified it, and the agreements themselves describe how the WTO is to function.
- GATT dealt with trade in goods. WTO covers services and intellectual property as well.
- WTO dispute settlement is faster, more automatic than GATT's. Its rulings cannot be blocked.

## Table 2: GATT Rounds

Name	Dates	Objective
Geneva	1947	<ul style="list-style-type: none"> <li>• adoption of GATT</li> </ul>
Annecey, France	1949	<ul style="list-style-type: none"> <li>• tariff reduction</li> </ul>
Torquay, England	1951	<ul style="list-style-type: none"> <li>• tariff reduction</li> </ul>
Geneva	1956	<ul style="list-style-type: none"> <li>• tariff reduction</li> </ul>
Geneva ("Dillon")	1960-62	<ul style="list-style-type: none"> <li>• tariff reduction</li> </ul>
Geneva ("Kennedy")	1962-67	<ul style="list-style-type: none"> <li>• tariff reduction</li> <li>• GATT negotiation rules</li> </ul>
Tokyo	1973-79	<ul style="list-style-type: none"> <li>• overall reduction of tariffs to an average level of 35% and 5-8% among developed nations</li> <li>• non-tariff barrier codes                             <ul style="list-style-type: none"> <li>• government procurement</li> <li>• customs valuation</li> <li>• subsidies and countervailing measures</li> <li>• antidumping</li> <li>• standards</li> <li>• import licensing</li> </ul> </li> </ul>
Uruguay	1986-94	<ul style="list-style-type: none"> <li>• broadening of GATT                             <ul style="list-style-type: none"> <li>• limit agricultural subsidies</li> <li>• include services trade</li> <li>• include intellectual property</li> </ul> </li> <li>• establishment of the WTO (World Trade Organization)</li> </ul>

# Figure 3: The “Impossible Trinity”

(Only TWO of the three following objectives are possible at any time)

(a) *Fixed Exchange-Rates*      (b) *International Capital Mobility*      (c) *Domestic policies aimed toward full employment*

YES	YES	NO	Gold Standard
YES (but adjustable)	NO	YES	Bretton Woods
NO	YES	YES	1971 - today

*Note:* A nation cannot have (a) fixed exchange-rates, (b) free capital mobility, and (c) modern democratic policies aimed toward full employment all at the same time. The classical Gold Standard had (a) and (b), but not (c). Bretton Woods gave up (b) to get (a) and (c)

# Figure 4: Marshall Plan helps resolve the “dollar shortage,” 1946-1958

**American Transfers Abroad as a Share of GNP**

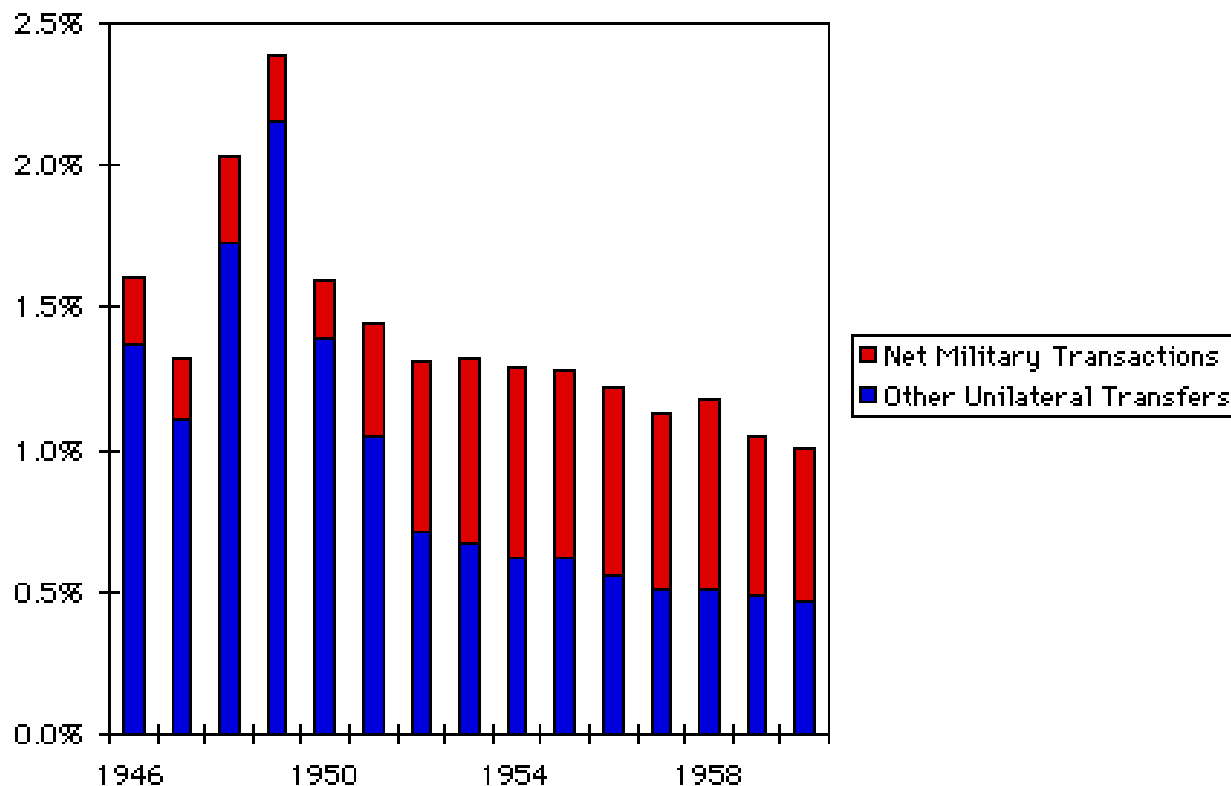
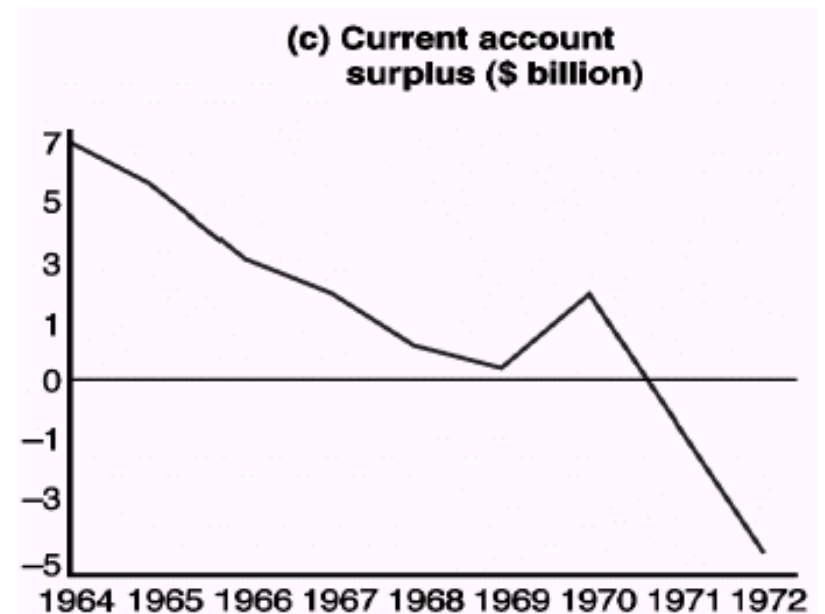


Figure 5: Rising inflation in the U.S. produced a real appreciation (\$ “overvalued”), harming the competitiveness of American industries



As inflation increased....



imports increased and exports fell