The Real Reason Bretton Woods *Failed*

By Reuven Brenner

TIE*'s Summer 2021 issue on the subject reads like* Hamlet *without the ghost.*

This brief is in response to the Summer 2021 issue of *TIE* dedicated to fiftieth anniversary of abandoning the Bretton Woods agreement.

The issue started by interviewing Jeffrey Garten, author of the recent book *Three Days at Camp David,* which, as Garten admits, is neither a theoretical nor a policy book, but deals with the personalities involved in the decision of abandoning the fixed exchange regime. The other articles are theoretical and policy-oriented—but all of them read like *Hamlet* without the ghost. None address the question and the wide-ranging evidence that stable exchange rates are crucial—especially for countries not having deep capital markets, which constitute much of the world, China included, the evidence being sharp and clear that financial and political crises are the predictable outcome in their absence. That's the ghost—that stability of contracts is the basis of commercial societies and what happens in its absence—that is missing in this Summer 2021 issue.

Following World War II, the Bretton Woods system, which fixed the major currencies (the franc, the pound, the mark, and the yen) to the dollar while anchoring the U.S. dollar in gold (priced at $35 since the Roosevelt devaluation of 1934), worked well as long as the gold anchor matched a very strong U.S. economy. The market expected and required the United States to have a robust tax base—the collateral—to back its bonds, and the commitment of the parties to the agreement to expand trade and commerce "fairly."

Here is what "fairly" was supposed to mean: When Bretton Woods was negotiated, economist John Maynard Keynes worried that with fixed exchange rates there would be countries with chronic balance-of-payments problems and others with constantly rising dollar reserves. To sustain stable exchanges,

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Reuven Brenner holds the Repap Chair at McGill University's Desautels Faculty of Management.

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editor@international-economy.com

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the latter countries had to "commit" to expand domestically and liberalize imports. To achieve such commitment, Keynes suggested penalizing countries with prolonged trade surpluses (though he expected the United States to be that country, not Japan, China, or Germany). The International Monetary Fund, created as part of the Bretton Woods agreement (that with the shift to floating lost the rationale for its existence, but, typical of bureaucracies, perpetuated itself by becoming an unaccountable international consulting company, drawing on faddish macro-astrological models), allowed for such countries to be penalized by limiting purchases of their exports, a clause that was never enforced. It also provided for occasional, one-time devaluations once the IMF identified a "fundamental (not drawing on narrow domestic political interests) disequilibrium."

By the end of the 1950s, the United States had experienced sizable deficits, with foreign central banks accumulating large amounts of dollar reserves. With investor skepticism rising, the price of gold jumped to $40 in October 1960 (though Bretton Woods fixed it at $35). U.S. President John F. Kennedy, however, understood the importance of sustaining the monetary yardstick. He announced during that year's presidential campaign that, if elected, he would not devalue the dollar. The stability of the dollar and the fixed gold price became an uncontested feature of the Kennedy administration.

However, by 1964, foreign official dollar holdings came to exceed the value of the U.S. gold stock. If confidence in American policies was maintained, that in itself would not have been a problem at all. But the confidence was shattered by that year: The United States imposed restrictions on the outflow of capital—tying foreign aid to U.S. exports, defense purchases, or support for U.S. troops abroad; asking banks to curtail overseas lending, and restricting overseas investments of American corporations. These changes were intensified by the Vietnam War, beginning in 1965.

At the same time, economist Robert Triffin's 1960 book, *Gold and the Dollar Crisis,* became influential. The book argued that as the volume of trade expanded, an increase in acceptable international money was needed under a fixed exchange rate system to have sufficient reserves. Future gold production at the $35 price was not enough, so only the U.S. dollar could be the source of such increased reserves. If this reasoning was accurate, only increased U.S. balance of payments could supply the dollars needed by the rest of the world.

This conclusion was not accurate then, and it is not now. As long as investors expected the United States to continue to grow, expanding its tax base—and other countries around the world to adhere to the Bretton Woods "fairness" clauses noted above—the United States could have sustained the system by persuading countries signed on to the Bretton Woods agreement to enforce the penalty imposed on those accumulating reserves. If they were unable to do so (because of a genuine need to correct the value of their own currencies, not narrow domestic political interests), then a one-time devaluation under the "fundamental disequilibrium clause" would

Triffin Was Wrong

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Robert Triffin, *author of* Gold and the Dollar Crisis.

be allowed. Even the United States could have resorted to this clause and then stuck to the new yardstick: It only had to be trusted that the devaluation was an emergency, one-time affair, but that its commitment to stable exchange rates would remain. This did not happen.

The cracks in the system were spreading. In 1964, Britain elected a government committed to variations of "five-year plans" (a communist slogan), nationalization (steel), increases in top income taxes (raised to 83 percent) and capital gains tax rates, and price and wage controls. Such centralization of spending power and economic control led to expectations that Britain would devalue the pound, which was becoming a Soviet-kind accounting device. Britain did so in November 1967.

France's Charles de Gaulle attacked Bretton Woods directly, arguing against the privilege it granted to the United States by allowing its balance of payment deficits to be settled in dollars. Instead of advocating for the enforcement of the "fairness" clauses in the Bretton Woods accord—penalizing countries accumulating reserves, or advocating for the expansion of imports in creditor countries rather than centralization in debtor countries—he advocated a return to the classical gold standard. De Gaulle failed to take note of the obligations of the countries accumulating reserves and the unenforced penalty clauses.

By the 1970s, George Shultz, then secretary of the U.S. Treasury, advocated moving toward floating exchange rates without any evidence that such a regime could be a satisfactory solution, as Paul Volcker, then undersecretary of the Treasury for international monetary affairs, repeatedly pointed out in his memoirs. Shultz and others concluded—erroneously—that there was nothing better. Consistent with this view, some economists argued that exchange rates were all a technical matter anyway, and that after taking account of the important things like differences in inflation, productivity, and interest rates, shifts in exchange rates were merely a harmless residual—in models where contracts played no roles (a point never made, not even relegated to footnotes).

These economists assumed that if domestic inflation was controlled and within similar ranges across countries, exchange rates would stabilize. Though facts have proven all these claims false—among Western-kind countries, with similar inflation rates, the exchange rates fluctuated in the plus/minus 50 percent range—floating prevails to this day. It accounts for much financial and political turbulence around the world, though attributed by economists trapped by dogma to "culture" or "structural" matters—though the latter have been refuted quickly too—as soon as exchange rates stabilized. Never mind. Academic fads that governments find convenient have long lives, until a devastating crisis happens.

The Western world shifted to a floating system, as Volcker concluded, with "little energy expended on questions of long-term reform" … [and whether] the absence of a sense of a greater structure and discipline in the international monetary system … has somehow contributed to the world's poorer economic performance after the system broke down." Further, "exchange rate management remained an area of intellectual confusion" to this day, as the Summer edition of *TIE* shows.

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The shift to floating currencies undermined the stability of the unit of account. By failing to stick to principles that make commercial societies thrive—a necessary basis of which are contracts—the United States threw out the baby with the bathwater. The shift has raised the costs of contracts, and vastly inflated the West's financial sector, where hundreds of trillions in notional values of derivatives were now needed to sustain the value of contracts. A trivial numerical example shows why. Say there are a thousand rights to goods and services to be transferred now and in the future. In the absence of a monetary yardstick, there would be 499,500 possible prices, as each commodity, service, or right would be priced in relation to every other. With one common yardstick, there would be only 999 prices.

The wide range of futures and derivatives complementing contracts mitigated the volatility in contractual agreements due to currency volatility and allowed larger companies in Western countries to stay in their lines of business and continue to grow—though at a cost, as Wall Street services do not come cheap. Countries with deep financial markets could make this adjustment and still move on, though they too did so at significant visible and less visible costs. (The latter include the allocation of well-compensated brainpower to financial markets at the expense of having "Main" street employing it.) Macroeconomists mismeasured the expansion as adding to prosperity, rather than reflecting a massive increase in "transaction costs" to compensate for the gravely mistaken floating exchange regime.

But countries without deep financial markets could not do this, preventing the financing of potentially growing companies. Worse, with countries linking their currencies to the dollar—recall the crises that plagued Thailand, Indonesia, and the Philippines when the yen/dollar fluctuated suddenly in the 50 percent range, these countries were exposed to both currencies, and lacked deep domestic financial markets. The crises had nothing to do with "structural" or "cultural" issues to which economists attributed them, and order was indeed restored once currencies stabilized.

There is no doubt that governments and central banks have the technical ability to stabilize currencies—except for unique events, for which the Bretton Woods agreement offered escape clauses. After all, there are many "moneys" in circulation. Dollar bills as well as an array of foreign currencies circulate, with the U.S. denominations staying in fixed relation to one another. Why can the $10 bill always be exchanged for forty quarters, whereas the number of foreign currency units it can be exchanged for varies daily? After all, the demand for the $10 bills and quarters fluctuates. With fewer parking meters, more automatic machines accepting credit cards, and cell phones, the demand for quarters has been dropping, and the demand for paper bills changing. Why doesn't the value of the quarters drop relative to the $10 bill? The answer is that as fewer coins are being used, they get returned to the central bank, which then issues $10 dollar bills instead.

This same process can work for any two currencies of different countries. If people decide that they intend to spend less in the United States, they can go to a bank and ask to exchange their unwanted U.S. dollars for, say, Canadian ones. The Federal Reserve would notice that the demand for U.S. dollars decreased, so it would absorb the unwanted U.S. dollars by selling U.S.-denominated bonds on the open market. The exchange rate between two countries can stay stable just as the "exchange rate" between the two U.S. denominations stays stable.

When taxes are lowered, having the impact of expanding commerce and increasing the demand for a particular currency, the central bank could respond. And, if a country's tax base is weakened, whether because of wars or extravagant spending on "investments"—which are anything but—monetary authorities could either sustain stable exchange rates by absorbing the unwanted liquidity through selling bonds, while restructuring, or they could be allowed to devalue—but with enforceable strings attached. Also, countries accumulating excessive reserves (such as China, unwilling to deepen its domestic financial markets for fear of weakening the Communist Party's monopoly power), would face penalties, rather than playing blame games and accusing the debtor countries issuing the reserve currency of not saving enough.

Briefly: exchange rates can be stabilized once Bretton Woods–type agreements are made and are combined with the commitment to expand trade both domestically and internationally. The essential issue is enforcing the two clauses of the original Bretton Woods agreement that were not enforced while the original agreement was in place: allowing for occasional devaluation and penalizing countries accumulating excess reserves.

In the Summer 2021 issue of *TIE,* though some articles refer to the "economic professions' artificial narrative," none makes reference to either the need to start the analyses with prospering commercial societies' reliance on

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stable contracts, or to the sequence of events at all times, everywhere when monetary stability was abandoned. Yet such analyses reveal how political and economic issues cannot be separated, how crucial sustaining a stable monetary yardstick is, and how superficial the present economic analyses are. One article does refer to the anachronistic "capital versus labor" debate, though still offering no alternative drawing on simple observation that societies' prosperity depends on negotiated contractual matching between talents and capital, holding all parties—talents, providers of capital, and the matchmakers (be they private or in government)—accountable. Such accountability requires monetary stability—and neither the 2 percent annual inflation out of the magician's hat nor the pompous academic jargons. Big words can mean so little. ◆