The System of Bretton Woods

A lesson from history

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Abstract

This text introduces the system of Bretton Woods, which was established in 1944 at the conference of Bretton Woods, New Hampshire. Starting with the economic situation after World War I, this essay outlines the importance of creating a supranational organisation promoting international trade flows and monetary stability. After stressing the dominant role of the USA in this system its main institutions, the International Monetary Fund and the World Bank, are presented. Furthermore, the most important adjustments to the changes in the economic environment from the point of the system's establishment until now are explained. The system's crises in the 1970s especially is examined and latest activities are described. This review of the Bretton Woods system concludes with some future prospects. Recent criticism brought up by human rights activists are mentioned and the World Bank's reactions to these criticisms are identified. Finally, ideas about a new system of Bretton Woods are introduced.

Keywords

Bretton Woods
International Monetary Fund
World Bank

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1. Introduction

In times of globalisation the economic environment changes rapidly. Capital movements become larger and at the same time less controllable. Therefore, the need for a stabilising system becomes more and more apparent. In the past such a system has been established at the conference of Bretton Woods. Already in 1944 the British economist John Maynard Keynes emphasised "the importance of rule-based regimes to stabilise business expectations- something he accepted in the Bretton Woods system of fixed exchanged rates."[1] Recently leading industrial nations have been calling for a renewal of the purpose and the spirit of this system in order to cope with the growing size of international trade and capital flows. This essay gives a short overview of the system's development from 1944 until today and stresses especially problems and obstacles. It identifies mistakes that have been made and points out aspects that have to be taken into account when implementing a "new system of Bretton Woods".

2. Development of the system

2.1. The international economic situation

After World War I most countries wanted to return to the old financial security and stable situation of pre-war times as soon as possible. Discussions about a return to the gold standard began and by 1926 all leading economies had re-established the system, according to which every nation's circulating money had to be backed by reserves of gold and foreign currencies to a certain extent. But several mistakes in implementing the gold standard (mainly that a weakened Great Britain had to take the leading part and that a number of main currencies where over- or undervalued) led to a collapse of the economic and financial relations, peaking in the Great Depression in 1929. Every single country tried to increase the competitiveness of its export products in order to reduce its payment balance deficit by deflating its currency. This strategy only led to success as long as a country was deflating faster and more strongly than all other nations. This fact resulted in an international deflation competition that caused mass unemployment, bankruptcy of enterprises, the failing of credit institutions, as well as hyper inflations in the countries concerned.

In the 1930s several conferences dealing with the world monetary problems caused by the Great Depression had ended in failure. But after World War II the need for a stabilising

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[1] see The Economist, November 25th 2000, p. 112

system that avoided the mistakes, which had been made earlier, became evident. Plans were made for an innovative monetary system and a supervising institution to monitor all actions. First negotiations took place under wartime conditions.

2.2. The conference of Bretton Woods

In 1944 an international conference took place in Bretton Woods, New Hampshire (USA). 44 countries attended this conference in order to restructure international finance and currency relationships. The participants of this conference created the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD/World Bank). Additionally, they agreed on implementing a system of fixed exchange rates with the U.S. dollar as the key currency.

The plans for the system of Bretton Woods were developed by two important economists of these days, the American minister of state in the U.S. treasury, Harry Dexter White, and the British economist John Maynard Keynes who stated: " We, the delegates of this Conference, Mr President, have been trying to accomplish something very difficult to accomplish.[...] It has been our task to find a common measure, a common standard, a common rule acceptable to each and not irksome to any." [2] This statement outlines the difficulty of creating a system that every nation could accept. The ideas of John Maynard Keynes and Harry Dexter White have been described as very different from each other on several occasions but in fact there are extraordinary similarities. According to the White plan, a Bank for Reconstruction (today the World Bank) and an International Stabilisation Fund should be established. The Keynes plan called for the same. The only difference was that Keynes wanted to vest the IMF with possibilities to create money (a fact that can easily be understood in the background of Great Britain's suffering from the deflation policies in the Inter-War period) and with the authority to take actions on a much larger scale. In case of balance of payments imbalances John Maynard Keynes recommended that both sides, debtors and creditors, should change their policies. Countries with payment surpluses should increase their imports from the deficit countries and thereby create a foreign trade equilibrium. Harry Dexter White, on the other hand, saw an imbalance as a problem only of the deficit country. Economists today agree that White was mistaken and Keynes was more farsighted.[3] However, Keynes' plan was never discussed seriously at Bretton Woods and the participants agreed on the White plan. The United States defined the value of its dollar in terms of gold, so that one ounce of gold was

[2] see Moggeridge, 22 July 1944, p. 103
[3] see J. Bradford DeLong, 2000

equal to $ 35. All other members had to define the value of their money according to what was called the “par value system” in terms of U.S. dollars or gold.

2.3. The dominant role of the USA

The USA has been and still is the dominating power of the Bretton Woods system. After World War II the United States was the country with the biggest economic potential. The U.S. dollar was the currency with the most purchasing power and it was the only currency that was backed by gold. Additionally, all European nations that had been involved in World War II were highly in debt and transferred large amounts of gold into the United States, a fact that contributed to the supremacy of the USA. Thus, the U.S. dollar was strongly appreciated in the rest of the world and therefore became the key currency of the Bretton Woods system. The headquarters of the two main institutions (the IMF and the World Bank) are situated in Washington D.C. The dominant role of the USA already became apparent when the American ideas of the Bretton Woods system gained more acceptance than those of Great Britain. The plans of the British economist John Maynard Keynes were rejected and the model of the American economist White was favoured. Despite “Keynes’s part in constructing the Bretton Woods system, [...] his vain struggle, over five wartime missions to Washington, to preserve Britain’s financial independence from the United States” [4] the Bretton Woods system is dominated by the USA.

3. The International Monetary Fund

3.1. Purpose

The IMF was officially established on December 27, 1945, when the 29 participating countries at the conference of Bretton Woods signed its Articles of Agreement. It commenced its financial operations on March 1, 1947. The IMF is an international organisation, which today consists of 183 member countries. The purposes 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 disequilibriums in their

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[4] see The Economist, November 25th

balance of payments are provided with the opportunity to correct their problems by making the financial resources of the IMF available for them.

3.2. Operations

When joining the IMF, each country must contribute a certain sum of money, which is called a quota subscription and is a sort of credit deposit. These quotas form the largest source of money at the IMF's disposal and the IMF uses this money to grant loans to member countries with financial difficulties. Each nation that has joined the system can immediately withdraw 25 per cent of its quota in case of payment problems and it may request more if this sum is insufficient. The debts have to be paid back as soon as possible. Additionally, the country must demonstrate how the payment difficulties will be solved. The higher a country's contribution is, the higher is the sum of money it can borrow from the IMF. Furthermore, the quotas determine the voting power of each member.

The money, which the IMF lends, should not be compared to a loan of a conventional credit institution. For the country that files an application it is rather an opportunity to buy a foreign currency and paying with gold or the national currency. Within three to five years the country has to pay back its debts. According to the IMF in the course of a typical year circa 20 currencies are borrowed and "most potential borrowers want only the major convertible currencies: the U.S. dollar, the Japanese yen, the deutsche mark, the pound sterling, and the French Franc."[5] Therefore, although quotas are worth about $193 billion in theory, the sum at the IMF's disposal is deceptively large.

3.3. Organisation

The IMF has no control over national economic policies of its members. On the contrary, the chain of command runs from the governments of the member countries to the IMF. The highest authority is the Board of Governors, which consists of one Governor (usually the minister of finance or the head of the central bank) of each member country. Additionally, there is an equal number of Alternates (representative Governors). The Board of Governors gathers only on the occasion of annual meetings.

The IMF's day-to-day work is managed by the Executive Board, which is formed of 24 Executive Directors who meet at least three times a week to supervise the implementation of the IMF's policies. The member countries with the highest quotas send one Executive Director to the Board, who has as many votes as the quota regulation assigns to his country.

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[5] see www. imf.org

The remaining Directors are elected by the rest of the countries and they only have as many votes as they had in the election. This point illustrates the dominance of the USA in the System of Bretton Woods as the "United States, with the world's largest economy, contributes most to the IMF, providing about 18 percent of total quotas (about $35 billion)".[6] Thus the USA have most votes, by now more than 265.000.

4. The World Bank

4.1. Goals

The World Bank is the world's most important source of financial aid for developing nations. It provides "nearly $16 billion in loans annually to its client countries. It uses its financial resources, highly trained staff, and extensive knowledge base to help each developing country onto a path of stable, sustainable, and equitable growth in the fight against poverty."[7] Its goals are to improve living standards and to eliminate the worst forms of poverty. 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 aims to keep payments in developing countries balanced and fosters international trade. It is active in more than 100 developing economies. It forms assistance strategies by cooperating with government agencies, nongovernmental institutions and private enterprises. It offers financial services, analytical, advisory, and capacity building.

4.3. Organisation

The World Bank is an independent organisation of the United Nations. Each country that wants to join it, has to be a member of the IMF. The highest authority of the World Bank is the Council of Governors, which consists of one representative of each country. The Executive Board consists of five Directors to whom the Council of Governors transfers responsibility for nearly all issues. The President of the World Bank is de facto elected by the U.S. government and then confirmed by the Executive Board. He is involved in the current activities.

[6] see www.imf.org
[7] see www.worldbank.org

5. Adjustments and reactions to the changing environment

5.1. Integration of developing countries

Only a few years after the establishment of the Bretton Woods System an economic restructuring throughout the world necessitated a new orientation of the organisations. In the 1950s the decolonialization of many developing countries took place. In order to meet the challenge of integrating those countries into the Western world and solving their social and economic problems the IMF and the World Bank changed their plans and founded new organisations. However, in this phase the developing countries were seen only as suppliers of important resources, a fact that led to vehement protests of the developing nations and the Eastern-Block states, since they did not perceive this role as promoting. For this reason two affiliated organisations of the World Bank were created. In 1956 the International Finance Cooperation (IFC) was established. Its purpose is to grant credits to private organisations that lack capital for projects in the developing world. In 1961 the International Development Association (IDA) was founded and its main function is to grant credits to especially poor countries at very favourable conditions. For example the period of repayment can be up to 50 years and the interest rates are far below market standard. The establishment of both mentioned organisations made the World Bank the centre of foreign aid of the United Nations today.

5.2. Special Drawing Rights

In the 1960s the world experienced a substantial economic expansion, especially the warring nations of World War II grew unexpectedly fast. This led to a weakening of the position of the USA and a devaluation of the U.S. dollar. It appeared that the reserves were inadequate to back the trade expansion and slowed down economic development. The IMF reacted by issuing Special Drawing Rights (SDRs), which member countries could add to their holdings of foreign currencies and gold. SDRs were assigned with a value based on the average worth of the world’s major currencies. These were the U.S. dollar, the French franc, the pound sterling, the Japanese yen, and the German mark.

5.3. Crisis of the system

In the 1960s and 1970s enduring imbalances of payments between the Western industrialised countries weakened the system of Bretton Woods. One substantial problem was that one national currency (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 heavily influencing those external economies. To ensure international liquidity the USA were forced to run deficits in their balance of payments, otherwise a world inflation would have been caused. However, in the 1960s they ran a very inflationary policy and limited the convertibility of the U.S. dollar because the reserves were insufficient to meet the demand for their currency. 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."[8] The system of Bretton Woods 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."[9] This led to a lack of trust and destabilising speculations.

In March 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. The IMF required that the countries no longer based this value on gold and that it was common knowledge how each nation determined its currency's value. 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. After this reform the system of Bretton Woods was more about "information exchange and consultation, conditional policy understandings, than about rule based guarantees."[10] In the years of floating exchange rates the level of cooperation varied with the economic and political developments.

5.4. Recent activities

The field of activities of the Bretton Woods institutions was broadened by the deep-rooted changes in the East-bloc economies and the collapse of the Soviet Union. In the past the communist states had feared entrance into the IMF and the World Bank because of the economic superiority of the United States but after the changes in their own economies they saw the chance of solving their problems by joining those organisations. Thus, supporting the process of economic restructuring is one of the main activities of the Bretton Woods

[8] see Onkvist/Shaw, 1997, p. 708
[9] see www.imf.org
[10] see Braithwaite and Drahos, 2001

institutions nowadays. A massive campaign was started to establish free-enterprise systems and to shift from centrally planned to market economies.

Furthermore, the IMF and the World Bank want to ensure that their mechanisms and operations meet the requirements of the new world of integrated global markets. Especially the heavy financial crises in Mexico and Asia during the 1990s exposed weaknesses in the international financial system. The increasing size and importance of cross-border capital flows necessitated a better surveillance of the member countries. In particular the assessment of potential risks in member countries has been improved by collecting more timely and accurate data to ensure transparency. A second major field is the development and assessment of internationally accepted standards of good practices. To prevent future crises the IMF created the Contingent Credit Lines in 1999, which motivate countries to "adopt strong policies, be transparent, adhere to internationally accepted standards, and have a sound financial system."[11]

6. The future of the system of Bretton Woods

During the last five to ten years especially the system of Bretton Woods has been topic of many public discussions with controversial opinions. Human rights activists argue that the programmes for the structural adjustment of the developing countries initiated by the World Bank and the IMF led to a "thirdworldisation" of the East-bloc states, which means that they dramatically increased poverty in those countries. Large-scale agrarian and industrial projects destabilised national economies, destroyed the environment and social patterns. It is pointed out that the inner structure of the Bretton Woods institutions, where the right to say is proportional to the amount of money that each country contributes, is symbolic of the capitalistic ideology, which completely ignores the interests of the people living in developing countries.[12] Thus, human rights activists demand that the IMF and the World Bank stop interfering in national policies of sovereign countries. The World Bank is well aware of the problems that can be caused by projects in less developed areas. It reacted by providing the possibility to file requests to an Inspection Panel. A person that files a request to the World Bank has to show that he/she lives in the project area and will most likely be affected negatively by activities related to the project. These negative effects must be caused by a failure from the World Bank to follow its policies and procedures. Additionally, the request must have been discussed with the Bank management with an unsatisfactory outcome. In

11 see www.worldbank.org
12 see www.glasnost.de
13 see www.imf.org

contrast to these discussions the major industrialised nations have begun to worry about the implications of the growing size and the speculative nature of financial movements in times of globalisation. Calls for a “new system of Bretton Woods” could be heard in almost every industrialised country. In 1996, Michel Camdessus, the Managing Director of the IMF, stated that even though the monetary system had changed since 1944 the goals of Bretton Woods were as valid today as they had been in the past. He underlined that international cooperation would be required to create a new Bretton Woods system, which in his point of view means that “ countries must make a greater effort to understand the economic policies of other countries and that they must listen to the judgement of others about their own national policies. It also means that they must take a more enlightened view of their own national interests, recognizing that it is in their own self-interest to take the interests of other countries into account.”[13]

7. Conclusion

The system of Bretton Woods 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.

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 industrialised 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.[14] It has to be noted that leading economists nowadays argue “whether macroeconomic performance stability was responsible for the successes of Bretton Woods, or the controverse.”[15]

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.

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[14] see Schwartz, Anna J.

[15] see Bordo and Eichengreen, 1993, p. 626

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."[16] It is crucial that national economic policies (i.e. budget deficits) and economic outcomes (i.e. 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 system of Bretton Woods 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.

[16] see Bordo and Eichengreen, 1993, p. 650

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