

Part VII: The International Economy

Objectives for Chapter 25: The International Economy After 1945

At the end of Chapter 25, you will be able to answer the following:

1. Describe the "*Bretton Woods System*" and the way it operated. Why did it end?
2. What is a "*devaluation*" and a "*revaluation*"?
3. What is the *International Monetary Fund (IMF)*?
4. What were the advantages and disadvantages of the Bretton Woods System?

Chapter 25: The International Financial System from 1945 to 1973 (latest revision October 2004)

As we saw in Chapter 11, the Gold Standard came to an end during the 1930s. In 1944, a conference was held in the small resort town of Bretton Woods New Hampshire to create an international financial system for the postwar period. The new system took its name from this town and came to be called the *Bretton Woods System*. It lasted from the late 1940s until 1973. In this chapter, we will describe the Bretton Woods system and explain why it ended.

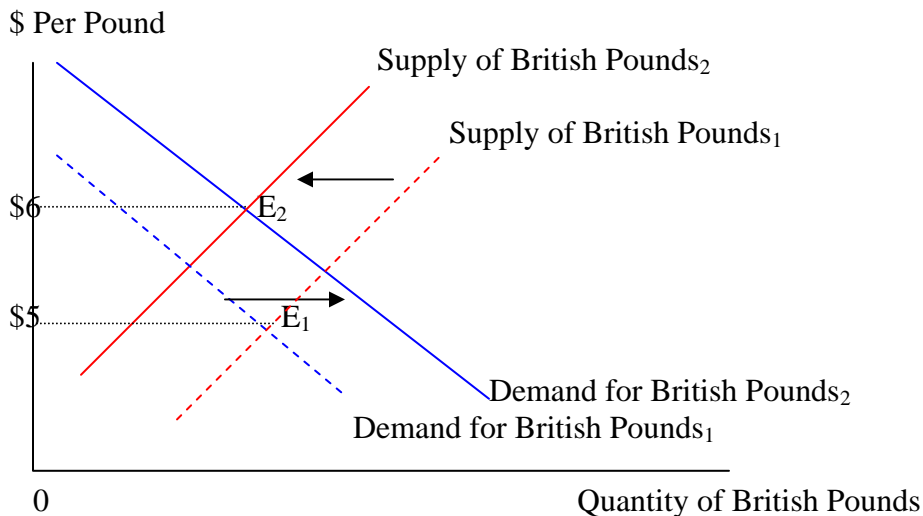
1. How the Bretton Woods System Operated

The Bretton Woods system attempted to maintain two of the main advantages of the Gold Standard. (At this point, you should review the operation of the Gold Standard in Chapter 11.) **First, the Gold Standard imposed monetary discipline on the countries involved.** Any country experiencing inflation would lose gold and therefore would have a decrease in the amount of money available to spend. This decrease in the amount of money would act to reduce the inflationary pressure. **Second, the Gold Standard maintained fixed exchange rates.** Fixed exchange rates were seen as desirable because they reduced the risk of trading with other countries. **However, a full return to the Gold Standard was not feasible.** There was not enough gold available to allow people to buy all the new goods and services that could be produced. And the gold that was available was mainly located in the Soviet Union, a Cold War enemy of the United States and Western Europe, and in South Africa, whose policy of apartheid was strongly condemned by the United States and the Western European countries.

The United States had emerged from World War II as the strongest economy in the world. Unlike Europe and Japan, the United States had experienced very little destruction on its own land. Because of the strength of the American economy, *the American dollar came to be the fundamental money in the international financial system*. It took over the role that gold had played under the Gold Standard, and was called a "*reserve currency*". But to provide faith in the American dollar, it was linked to gold at the rate of \$35 per ounce of gold. Foreign governments and central banks could exchange dollars for gold at this rate. All other countries' monies were pegged to the American dollar at a fixed exchange rate (plus or minus 1%). So for example, the British pound was set at \$4.86 equals one pound. The Japanese yen was set at 360 Japanese yen equal \$1. And the German mark was set at 4 marks equals \$1. **Countries agreed to**

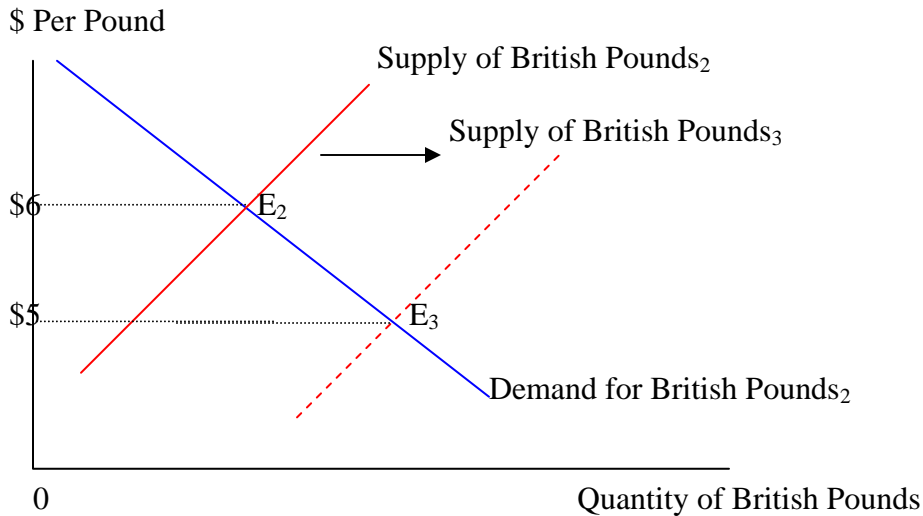
intervene in their foreign exchange markets (that is to buy or sell foreign money) in order to preserve these fixed exchange rates. In order to provide some flexibility, countries were allowed to change the rates up to 10%. This would be allowed only if there was what was called a *“fundamental disequilibrium”*. It was envisioned that these changes in exchange rates would be quite rare. A decrease in the value of the country’s money was called a *“devaluation”* while an increase in the value of the country’s money was called a *“revaluation”*. As an illustration of how rare these changes were, Great Britain devalued the pound only twice in the period of the Bretton Woods system --- first to \$2.80 to the British pound in 1949 and then to \$2.40 to the British pound in 1967.

To see how this system operated, let us use two countries only: Great Britain and the United States. Assume that the exchange rate is to be \$5.00 to the British pound. Now let us assume there is inflation in the United States but not in Great Britain. As prices rise in the United States, Americans want to buy more British goods and services. To pay for them, Americans have to buy British pounds. So the demand for British pounds rises (demand for pounds shifts to the right). As prices rise in the United States, British people want to buy fewer of the more expensive American goods. So they desire fewer American dollars and therefore supply fewer British pounds on to the foreign exchange market (supply of pounds shifts to the left). These two changes both would tend to raise the number of dollars to buy one pound, say to \$6. The dollar would depreciate and the pound would appreciate.



However, as members of the Bretton Woods system, both countries have agreed that the exchange rate is not to change. **In London, the Bank of England was pledged to go on to the foreign exchange market and sell British pounds (buy dollars) in order to drive the price back to \$5.** Where does the Bank of England get the British pounds? Since pounds are the money of Britain, the Bank of England simply created the British pounds. How a central bank creates new money was covered in Chapter 21. **In New York, the Federal Reserve Bank was also obligated to sell British pounds (buy dollars) in order to drive the price back to \$5.** So the exchange rate stays fixed at \$5,

making it easier for American and British businesses to do business with each other over a long time period.



How does the Federal Reserve Bank in New York get the British pounds to sell? After all, British pounds are not money in the United States so the Federal Reserve Bank cannot just create them. It is possible that the Federal Reserve might have bought some British pounds in the past (to keep the dollar from appreciating) when inflation rates had been lower in the United States. These British pounds that had been bought in the past by the Federal Reserve Bank in New York were held as *“international reserves”*. These reserves of British pounds could now be sold (to keep the dollar from depreciating). But if the international reserves were not sufficient, the United States had a problem. **One option for the United States was to sell gold it owned** and use the proceeds to buy the British pounds it needed. A second option was to deal with a new international institution that had been created for this purpose. This was called the *International Monetary Fund (IMF)*. The International Monetary Fund, headquartered in Washington D.C and in Paris, was created to be a collection of monies. Each member country contributed gold and a certain amount of its own money to the Fund. So the International Monetary Fund would have the British pounds that the Federal Reserve Bank in New York needed. The United States, through the Federal Reserve Bank, would borrow the British pounds and sell them in the foreign exchange market in New York in order to maintain the exchange rate at \$5 per British pound. In order to obtain this loan, the United States would have to demonstrate to the satisfaction of the International Monetary Fund that it had a plan to reduce the inflation that had been the reason for it having to borrow. The United States would have to show that it would not need British pounds for very long and that it would be able to earn British pounds and pay them back to the Fund in the near future. **A third option was for the United States to borrow the pounds directly from Britain,** circumventing the IMF.) If the United States could not solve its problem and had no further ability to borrow from the International Monetary Fund, **the last resort was to declare that there was a “fundamental disequilibrium”**. In that case, the United States would devalue the dollar and therefore revalue the British pound.

Test Your Understanding

In each case below, show the foreign exchange market between dollars and Japanese Yen in equilibrium. Then, assume that there is a recession in the United States but not in Japan.

1. Show the effects in the foreign exchange market assuming that **there are freely floating exchange rates**. Explain why you made the changes that you did.

\$/Y



What would be the effects on the American economy of this change?

2. Show the effects in the foreign exchange market assuming that the world is on the classical **gold standard**. Explain why you made these changes.

\$/Y



What would be the effects on the American economy of this adjustment?

3. Show the effects in the foreign exchange market assuming that the world is on **the Bretton Woods system**. Explain why you made the changes that you made.

\$/Y



What would be the effects on the American economy of this adjustment?

Let us examine the effect that this system had on each of the economies. The Federal Reserve Bank in New York would enter the foreign exchange market and sell British pounds. Therefore, people obtained the British pounds and the Federal Reserve Bank obtained the American dollars. **Fewer American dollars were available to the American people to spend. With fewer dollars to spend, spending by Americans declines.** This decline in spending helps reduce the inflationary pressure that caused the problem in the first place. *Therefore, the Bretton Woods system had a self-correcting mechanism just as the Gold Standard had had.* However, as we have seen, a decline in the money supply in the United States after World War II was more likely to cause a

recession than it was to bring about a deflation. Prices had become *inflexible downward*. Experiencing a recession in order to maintain fixed exchange rates was not politically acceptable in the United States. (The Federal Reserve could have offset the decline in the money supply. As we shall see, the Federal Reserve has several ways to create new dollars. Overcoming the decline in the American money supply by creating new dollars was called “*sterilization*”.)

In Britain, the Bank of England was also selling pounds. British people were exchanging American dollars with the Bank of England for British pounds. The Bank of England would now have more American dollars. The British people would now have more British pounds. What will they do with the new British pounds? Since British pounds are money in Britain, they will spend them. The increased spending in Britain will contribute to inflation there. *Therefore, under the Bretton Woods system as under the Gold Standard, the United States would reduce its problem of inflation partly by sending it to Britain.*

2. The End of the Bretton Woods System

The Bretton Woods system was ended in large part because of speculation. Go back to the situation described above. The exchange rate is \$5 per British pound. The United States, through the Federal Reserve Bank in New York, is borrowing British pounds (either from the International Monetary Fund or from Britain itself) to keep the exchange rate fixed at \$5 per British pound. Or perhaps the United States is selling its gold to get the British pounds; the gold supply owned by the United States is dwindling. This situation created a great opportunity for a speculator. The speculator would take perhaps \$5,000,000 and buy one million British pounds. In doing so, the speculator is betting that the United States will soon devalue the dollar and the price will go to \$6 per British pound. The speculator can then sell the million pounds back to get \$6,000,000. If the speculator is correct, he or she has gained \$1,000,000. But what if the speculator is wrong and the United States does not devalue the dollar. The speculator then sells the million pounds and gets his or her \$5,000,000 back. **If correct, the speculator gains \$1,000,000. If incorrect, the speculator breaks even. There is nothing to lose** because, given the situation, there is no possibility of the dollar going up in value.

When many speculators are buying British pounds, they cause the price of the British pound to rise. The Federal Reserve Bank in New York must sell more and more British pounds to keep the exchange rate fixed. These British pounds become harder and harder to get. As British pounds become harder for the Federal Reserve Bank in New York to obtain, there becomes a greater likelihood that the dollar will be devalued. This greater likelihood brings more and more speculators into the process.

In 1971, President Nixon shocked the world when he announced that the American dollar would no longer be exchanged for gold at \$35 per ounce. He also announced that **the American dollar “would be allowed to float”.** **This means that the United States, through the Federal Reserve Bank, would no longer intervene in foreign exchange markets to keep the exchange rates of the dollar fixed.** The exchange rate would now be whatever rate was determined in the market. The new system became the one we first met in Chapter 7. The Bretton Woods system was dead, although it was not officially

abandoned until 1973. How the new international financial system has evolved since 1973 will be considered in Chapters 26 and 27.

3. Conclusion

Through the 150 years of the Gold Standard and the Bretton Woods System, the main industrial countries of the world had created a system that would impose monetary discipline on countries. Countries could not undertake policies that would cause inflation. If they did, they would lose money and the inflation rate would decline. However, as we have seen, these international financial systems had flaws that led to their demise. In particular, as prices and wages became less flexible downward, the country losing money would most likely experience a serious recession. This became politically intolerable. And the Bretton Woods System was vulnerable to speculation.

When the Bretton Woods system was ended in 1973, it was not replaced by a new system that could impose monetary discipline on countries. It was also not replaced by a system that would maintain fixed exchange rates. Indeed, **the new system is mainly one of flexible exchange rates**, such as we encountered in Chapter 7. From that time on, monetary discipline would have to come only from the choices of those responsible for controlling the supply of money.

Practice Quiz for Chapter 25

- Under the Bretton Woods System, which of the following became a **reserve currency**?
a. Gold b. the American Dollar c. the British Pound d. All of the above
- The **international agency** that would lend foreign monies to countries that needed them for specific development projects is called
a. the UN b. the World Bank c. the IMF d. NATO
- Under the Bretton Woods System, an official **decrease** in the international value of a country's money was called
a. appreciation b. revaluation c. devaluation d. diminution
- Under the Bretton Woods System, if there were **inflation** in the United States,
a. Gold would leave the United States c. Britain would sell American dollars
b. The United States would sell British Pounds d. The dollar would depreciate
- Which of the following was true about the **Bretton Woods System**?
a. It imposed monetary discipline on the countries involved
b. It maintained fixed exchange rates
c. It was subject to speculation
d. All of the above

Answers: 1. B 2. C 3. C 4. B 5. D