

14.7: Case Study - The Breakup of the Bretton Woods System, 1973

Learning Objectives

1. Learn how the Bretton Woods system of fixed exchange rates set up after World War II was supposed to work.
2. Learn how and why the system collapsed in 1973.
3. Recognize some of the problems inherent in one type of fixed exchange rate system.

In July 1944, delegates from forty-five of the allied powers engaged in World War II met in Bretton Woods, New Hampshire, in the United States to plan for the economic institutions believed necessary to assist in the reconstruction, development, and growth of the postwar economy. Foremost on the delegates' minds was the instability of the international economic system after World War I, including the experiences of hyperinflation as in Germany in 1922–1923 and the worldwide depression of the 1930s. One element believed necessary to avoid repeating the mistakes of the past was to implement a system of fixed exchange rates. Not only could fixed exchange rates help prevent inflation, but they could also eliminate uncertainties in international transactions and thus serve to promote the expansion of international trade and investment. It was further hoped that economic interconnectedness would make it more difficult for nationalism to reassert itself.

The *Bretton Woods system of exchange rates* was set up as a gold exchange standard, a cross between a pure gold standard and a reserve currency standard. In a gold exchange standard, one country is singled out to be the reserve currency. In the Bretton Woods case, the currency was the U.S. dollar. The U.S. dollar was fixed to a weight in gold, originally set at \$35 per ounce. The U.S. central bank agreed to exchange dollars for gold on demand, but only with foreign central banks. In a pure gold standard, the central bank would exchange gold for dollars with the general public as well.

The nonreserve countries agreed to fix their currencies to the U.S. dollar or to gold. More accurately, countries agreed to establish a “par value” exchange rate to the dollar and to maintain the exchange to within a 1 percent band around that par value. However, this detail is not an essential part of the story that follows. However, there was no obligation on the part of the nonreserve countries to exchange their currencies for gold. Only the reserve country had that obligation. Instead, the nonreserve-currency countries were obliged to maintain the fixed exchange rate to the U.S. dollar by intervening on the foreign exchange (Forex) market and buying or selling dollars as necessary. In other words, when there was excess demand on the Forex for the home currency in exchange for dollars, the nonreserve central bank would supply their currency and buy dollars, thus running a balance of payments surplus, to maintain the fixity of their exchange rate. Alternatively, when there was excess supply of the home currency, in exchange for dollars, the nonreserve central bank would supply dollars and buy its own currency on the Forex, resulting in a balance of payments deficit. Thus for all nonreserve countries the Bretton Woods system functioned like a reserve currency standard.

One of the problems that typically arises with a reserve currency standard is the persistence of balance of payments (BoP) deficits. BoP deficits require a country to sell its dollar reserves on the Forex market. When these deficits are recurring and large, a country will eventually run out of reserves. When that happens, it will no longer be able to defend its fixed currency value. The likely outcome would be a devaluation, an action that runs counter to the goals of the system, namely to maintain exchange rate stability and to ward off inflationary tendencies.

To provide a safety valve for countries that may face this predicament, the International Monetary Fund (IMF) was established to provide temporary loans to countries to help maintain their fixed exchange rates. Each member country was required to maintain a quota of reserves with the IMF that would then be available to lend to those countries experiencing balance of payments difficulties.

Today the IMF maintains the same quota system and member countries enjoy the same privilege to borrow even though many are no longer maintaining a fixed exchange rate. Instead, many countries borrow from the IMF when they become unable to maintain payments on international debts. Go to the [IMF Factsheet](#) for more information about the current quota system. International Monetary Fund, Factsheet, “IMF Quotas,” <http://www.imf.org/external/np/exr/facts/quotas.htm>

The Bretton Woods exchange rate system was an imperfect system that suffered under many strains during its history. Nonetheless, it did achieve fixed exchange rates among its members for almost thirty years. For a more detailed, though brief, account of the history of the system, see [Benjamin Cohen's article](#). Benjamin Cohen, “Bretton Woods System,” <http://www.polisci.ucsb.edu/faculty/cohen/recent/bretton.html>.

We can learn much about the intended workings of the system by studying the system's collapse. The collapse occurred mostly because the United States would not allow its internal domestic policies to be compromised for the sake of the fixed exchange rate

system. Here's a brief account of what happened. For a more detailed account, see Barry Eichengreen's *Globalizing Capital* Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton, NJ: Princeton University Press, 1996). and Alfred Eckes's *A Search for Solvency*. Alfred E. Eckes Jr., *A Search for Solvency* (Austin, TX: University of Texas Press, 1975).

Throughout the 1960s and early 1970s, there was excessive supply of U.S. dollars on Forex markets in exchange for other currencies. This put pressure on the U.S. dollar to depreciate and nonreserve currencies to appreciate. To maintain the fixed exchange rate, nonreserve countries were required to intervene on the private Forex. For example, the British central bank was required to run a balance of payments surplus, buy the excess dollars, and sell pounds on the private Forex market.

As was shown in Chapter 12, [Section 12.6](#), persistent balance of payments surpluses do not pose a long-term problem in the same way as BoP deficits. The British central bank had an unlimited capacity to “print” as many pounds as necessary to buy the oversupplied dollars on the Forex. However, persistently large BoP surpluses will result in an ever-increasing British money supply that will lead to inflationary effects eventually.

Indeed, U.S. inflation was rising, especially in the late 1960s. Federal government spending was rising quickly—first, to finance the Vietnam War, and second, to finance new social spending arising out of President Johnson's Great Society initiatives. Rather than increasing taxes to finance the added expenses, the United States resorted to expansionary monetary policy, effectively printing money to finance growing government budget deficits. This is also called “monetizing the debt.”

The immediate financial impact of a rising U.S. money supply was lower U.S. interest rates, leading to extra demand for foreign currency by investors to take advantage of the higher relative rates of return outside the United States. The longer-term impact of a rising U.S. money supply was inflation. As U.S. prices rose, U.S. goods became relatively more expensive relative to foreign goods, also leading to extra demand for foreign currency.

A look at the statistics of the 1960s belies this story of excessive monetary expansion and fiscal imprudence. Between 1959 and 1970, U.S. money supply growth and U.S. inflation were lower than in every other G-7 country. U.S. government budget deficits were also not excessively large. Nonetheless, as Eichengreen suggests, the G-7 countries could support a much higher inflation rate than the United States since they were starting from such low levels of GDP in the wake of post-World War II reconstruction. Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton, NJ: Princeton University Press, 1996), 131. Thus the U.S. policy required to maintain a stable exchange rate without intervention would correspond to an inflation rate that was considerably lower vis-à-vis the other G-7 countries.

In any case, to maintain the fixed exchange rate, non-U.S. countries' central banks needed to run balance of payments surpluses. BoP surpluses involved a nonreserve central bank purchase of dollars and sale of their own domestic currency. Thus the German, British, French, Japanese, et al., central banks bought up dollars in great quantities and at the same time continually increased their own domestic money supplies.

One effect of the continual balance of payments surpluses was a subsequent increase in inflation caused by rising money supplies in the nonreserve countries. In effect, expansionary monetary policy in the United States, and its inflationary consequences, are exported to the nonreserve countries by virtue of the fixed exchange rate system. This effect was not welcomed by the nonreserve countries like Britain, France, and Germany.

A second effect of the continual balance of payments surpluses was a rising stock of dollar reserves. Nonreserve central banks held those reserves in the form of U.S. Treasury bills; thus, increasingly, U.S. government debt was held by foreign countries.

Although such BoP surpluses could technically continue indefinitely, the inflationary consequences in Europe and Japan and the rising dollar holdings abroad put the sustainability of the system into question. Ideally in a fixed exchange system, BoP surpluses will be offset with comparable BoP deficits over time, if the exchange rate is fixed at an appropriate (i.e., sustainable) level. Continual BoP surpluses, however, indicate that the sustainable exchange rate should be at a much lower U.S. dollar value if the surpluses are to be eliminated. Recognition of this leads observers to begin to expect a dollar devaluation.

If (or when) a dollar devaluation occurred, dollar asset holdings by foreigners—including the U.S. government Treasury bills comprising the reserves held by foreign central banks—would suddenly fall in value. In other words, foreign asset holders would lose a substantial amount of money if the dollar were devalued.

For private dollar investors there was an obvious response to this potential scenario: divest of dollar assets—that is, sell dollars and convert to pounds, deutschmarks, or francs. This response in the late 1960s and early 1970s contributed to the capital flight from

the U.S. dollar, put added downward pressure on the U.S. dollar value, and led to even greater BoP surpluses by nonreserve central banks.

The nonreserve central banks, on the other hand, could not simply convert dollars to pounds or francs, as this would add to the pressure for a depreciating dollar. Further, it was their dollar purchases that were preventing the dollar depreciation from happening in the first place.

During the 1960 and early 1970s the amount of U.S. dollar reserves held by nonreserve central banks grew significantly, which led to what became known as the **Triffin dilemma** (dollar overhang). Robert Triffin was a Belgian economist and Yale University professor who highlighted the problems related to dollar overhang. Dollar overhang occurred when the amount of U.S. dollar assets held by nonreserve central banks exceeded the total supply of gold in the U.S. Treasury at the exchange rate of \$35 per ounce. Dollar overhang occurred in the system by 1960 and continued to worsen throughout the decade of the 1960s. By 1971 foreign holdings of U.S. dollars stood at \$50 billion while U.S. gold reserves were valued at only \$15 billion. Déclaration de Valéry Giscard d'Estaing à l'Assemblée nationale (12 mai 1971), dans *La politique étrangère de la France*. 1er semestre, octobre 1971, pp. 162–67. Translated by le CVCE [Declaration by Valerie Giscard d'Estaing to the National Assembly (May 12, 1971)].

Under the Bretton Woods system, foreign central banks were allowed to exchange their dollars for gold at the rate of \$35 per ounce. Once the dollar overhang problem arose, it became conceivable that the United States could run out of its reserve asset—gold. Thus the potential for this type of BoP deficit could lead to speculation that the U.S. dollar would have to be devalued at some point in the future.

Now, if one expects the dollar will fall in value at some future date, then it would make sense to convert those dollars to something that may hold its value better; gold was the alternative asset. Throughout the 1950s and 1960s, foreign central banks did convert some of their dollar holdings to gold, but not all. In 1948, the United States held over 67 percent of the world's monetary gold reserves. By 1970, however, the U.S. gold holdings had fallen to just 16 percent of the world total. Alfred E. Eckes Jr., *A Search for Solvency* (Austin, TX: University of Texas Press, 1975), 238. In a gold exchange standard, the linkage between gold and the reserve currency is supposed to provide the constraint that prevents the reserve currency country from excessive monetary expansion and its subsequent inflationary effects. However, in the face of BoP deficits leading to a severe depletion of gold reserves, the United States had several adjustment options open.

One option was a devaluation of the dollar. However, this option was not easy to implement. The U.S. dollar could not be devalued with respect to the pound, the franc, or the yen since the United States did not fix its currency to them. (Recall that the other countries were fixed to the dollar.) Thus the only way to realize this type of dollar devaluation was for the other countries to “revalue” their currencies with respect to the dollar. The other “devaluation” option open to the United States was devaluation with respect to gold. In other words, the United States could raise the price of gold to \$40 or \$50 per ounce or more. However, this change would not change the fundamental conditions that led to the excess supply of dollars. At most, this devaluation would only reduce the rate at which gold flowed out to foreign central banks. Also, since U.S. gold holdings had fallen to very low levels by the early 1970s and since the dollar overhang was substantial, the devaluation would have had to be extremely large to prevent the depletion of U.S. gold reserves.

The other option open to the United States was a change in domestic monetary policy to reduce the excess supply of dollars on the Forex. Recall that money supply increases were high to help finance rising federal deficit spending. A reversal of this policy would mean a substantial reduction in the growth of the money supply. If money supply increases were not available to finance the budget deficit, the government would have to resort to a much more unpopular method of financing—that is, raising taxes or reducing spending.

The unpopularity and internal difficulty of such fiscal and monetary prudence led the United States to resort to other options. One suggestion made repeatedly by the United States was that the nonreserve countries should “revalue” their currencies to the dollar. However, their response was that the fundamental problem was not their fault; therefore, they shouldn't be the ones to implement a solution. Instead, it was the United States that needed to change.

By the spring of 1971, the imbalances in the system reached crisis proportions. In April 1971, the Bundesbank (Germany's central bank) purchased over \$3 billion to maintain the fixed exchange rate. In early May, it bought over \$2 billion in just two days to maintain the rate. Fearing inflation after such huge purchases, Germany decided to let its currency float to a new value, 8 percent higher than its previous fixed rate. Austria, Holland, and Switzerland quickly followed suit. Alfred E. Eckes Jr., *A Search for Solvency* (Austin, TX: University of Texas Press, 1975), 261. Despite these revaluations, they were insufficient to stem the excess supply of dollars on the Forex. By August 1971, another major realignment seemed inevitable that substantially increased the pace

of dollar capital flight. On August 15, 1971, President Nixon announced a bold plan for readjustment. The plan had three main aspects:

1. A 10 percent import surcharge on all imports was implemented. This tariff would remain in effect until a new international monetary order was negotiated.
2. Suspension of dollar convertibility into gold. Foreign central banks would no longer have the option to exchange dollars for gold with the U.S. central bank.
3. Wage and price controls were implemented to stem the rising U.S. inflation

The import surcharge meant that an extra 10 percent would be assessed over the existing import tariff. This was implemented to force other countries to the bargaining table where, presumably, they would agree to a multilateral revaluation of their currencies to the dollar. The tax was especially targeted to pressure Japan, which had not revalued its currency as others had done during the previous years, to agree to a revaluation. The 10 percent import tax effectively raised the prices of foreign goods in U.S. markets and would have a similar effect as a 10 percent currency revaluation. The expectation was that the average revaluation necessary to bring the system into balance would be somewhat less than 10 percent, thus an 8 percent revaluation, say, would be less painful to exporters than a 10 percent import tax.

The suspension of dollar-gold convertibility was really the more significant change as it effectively ended the gold exchange standard and marked the death of the Bretton Woods system. With no obligation to exchange gold for dollars, the system essentially was changed to a reserve currency system. Previous constraints on the United States, caused when it runs a BoP deficit and loses gold reserves, were thus eliminated. There was no longer a possibility that the United States could run out of gold.

The wage and price controls, implemented for a ninety-day period, put added pressure on foreign exporters. Being forced to pay a 10 percent surcharge but not being allowed to raise prices meant they would not be allowed to push the tax increase onto consumers.

These three measures together resulted in a rapid renegotiation of the Bretton Woods system, culminating in the **Smithsonian Agreement** in December 1971. In this agreement, the nonreserve countries accepted an average 8 percent revaluation of their currencies to the dollar in return for the elimination of the import surcharge. They also enlarged the currency bands around the par values from 1 percent to 2.25 percent. By virtue of the revaluations, the dollar naturally became “devalued.” The United States also devalued dollars with respect to gold, raising the price to \$38 per ounce. However, since the United States did not agree to reopen the gold window, the change in the price of gold was meaningless.

More important, since the United States no longer needed to be concerned about a complete loss of gold reserves, the dollar overhang problem was “solved,” and it was free to continue its monetary growth and inflationary policies. During the following year, the United States did just that; within a short time, there arose renewed pressure for the dollar to depreciate from its new par values.

In the end, the Smithsonian Agreement extended the life of Bretton Woods for just over a year. By March 1973, a repeat of the severe dollar outflows in 1971 led to a suspension of Forex trading for almost three weeks. Upon reopening, the major currencies were floating with respect to each other. The Bretton Woods system was dead.

The hope at the time was that floating rates could be allowed for a time to let exchange rates move to their market equilibrium rates. Once stability to the exchange rates was restored, a new fixed exchange rate system could be implemented. However, despite negotiations, an agreement was never reached, and a unified international system of fixed exchange rates has never since been tried.

How Bretton Woods Was Supposed to Work

In theory, a gold-exchange standard can work to provide exchange rate stability and reduce inflationary tendencies. However, it will only work if the reserve currency country maintains prudent monetary policies and if countries follow the rules of the system.

For the nonreserve countries, their task was to avoid balance of payments deficits. These deficits would arise if they pursued excessive expansionary monetary policy. The lower interest rates and eventual inflation would lead to capital flight, creating pressure for the currency to depreciate. To avoid a devaluation, and hence to follow the fixity rule, the nonreserve country would have to contract its money supply to take pressure off its currency and to reverse the BoP deficits.

The problem that usually arises here is that contractionary monetary policies will raise interest rates and eliminate an important source of government budget financing, namely debt monetization (printing money). These changes are likely to result in an

increase in taxes, a decrease in government spending, a contraction of the economy, and a loss of jobs. Thus following the rules of the system will sometimes be painful.

However, this was not the source of the Bretton Woods collapse. Instead, it was excessive monetary expansion by the reserve country, the United States. In this case, when the United States expanded its money supply, to finance budget deficits, it caused lower U.S. interest rates and had inflationary consequences. This led to increased demand for foreign currency by investors and traders. However, the United States was not obligated to intervene to maintain the fixed exchange rates since the United States was not fixing to anyone. Rather, it was the obligation of the nonreserve countries to intervene, buy dollars, sell their own currencies, and consequently run BoP surpluses. These surpluses resulted in the growing stock of dollar reserves abroad.

However, if the system had worked properly, foreign central banks would have cashed in their dollar assets for gold reserves long before the dollar overhang problem arose. With diminishing gold reserves, the United States would have been forced (i.e., if it followed the rules of the system) to reverse its expansionary monetary practices. However, as mentioned above, contractionary monetary policies will likely result in higher taxes, lower government spending, a contraction of the economy, and a loss of jobs.

Most countries faced with a choice between a policy that violates international monetary system rules and policies that maintain domestic vitality, even if only temporarily, will usually choose in favor of domestic interests. Of course, this choice will likely have negative longer-term consequences. Price and exchange rate stability will be compromised through these actions, and it will eliminate the benefits that would have come from expanded trade and international investments.

The gold exchange standard might have worked effectively if the United States and the others had committed themselves more intently on following the rules of the system. In the final analysis, what matters is the importance placed on maintaining the integrity of the cooperative fixed exchange rate system relative to the importance placed on domestic economic and political concerns. In the Bretton Woods case, domestic interests clearly dominated international interests.

The Bretton Woods experience should cast a shadow of doubt on fixed exchange rate systems more generally too. Every fixed exchange rate system requires countries to give up the independence of their monetary policy regardless of domestic economic circumstances. That this is difficult, or impossible, to do is demonstrated by the collapse of the Bretton Woods system.

Key Takeaways

- The Bretton Woods system of exchange rates was set up as a gold exchange standard. The U.S. dollar was the reserve currency, and the dollar was fixed to gold at \$35 per ounce.
- The International Monetary Fund (IMF) was established to provide temporary loans to countries to help maintain their fixed exchange rates.
- U.S. expansionary monetary policy and its inflationary consequences were exported to the nonreserve countries by virtue of the fixed exchange rate system.
- The suspension of dollar-gold convertibility in 1971 effectively ended the gold exchange standard and marked the death of the Bretton Woods system.
- The Bretton Woods system collapsed in 1973 when all the currencies were allowed to float.
- A fixed exchange rate system requires nonreserve countries to give up the independence of their monetary policy regardless of domestic economic circumstances.

exercise

1. **Jeopardy Questions.** As in the popular television game show, you are given an answer to a question and you must respond with the question. For example, if the answer is “a tax on imports,” then the correct question is “What is a tariff?”
 - The Bretton Woods exchange system was this type of exchange rate standard.
 - The price of gold in terms of dollars when the Bretton Woods system began.
 - This international organization was created to help countries with balance of payments problems in the Bretton Woods system.
 - The percentage of world monetary gold held by the United States in 1948.
 - The percentage of world monetary gold held by the United States in 1970.
 - The name given to the problem of excessive U.S. dollar holdings by foreign central banks.
 - This country’s suspension of dollar convertibility to gold eliminated an important constraint that allowed the system to function properly.

- The name of the agreement meant to salvage the Bretton Woods system in the early 1970s.
- The month and year in which the Bretton Woods system finally collapsed.

This page titled [14.7: Case Study - The Breakup of the Bretton Woods System, 1973](#) is shared under a [CC BY-NC-SA](#) license and was authored, remixed, and/or curated by [Anonymous](#).

- [12.7: Case Study - The Breakup of the Bretton Woods System, 1973](#) by Anonymous is licensed [CC BY-NC-SA 3.0](#).