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President Obama and Bretton Woods

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Roundup: Historians' Take

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On the occasion of this weekend's G-20 meeting in Washington, the global economic crisis seems more entrenched than ever. Calls for the return to a Bretton Woods-like system can be heard around the world. The Washington Post has said that a new Bretton Woods "could reform the IMF" (October 20). The Times of London has reported Prime Minister Brown's call for a new international financial architecture (November 14). Le Monde has printed favorable coverage for a "Bretton Woods acte II" (November 14). Before getting caught up in the momentum of "reform", the incoming administration of President-elect Obama should carefully heed the lessons of history.

The Bretton Woods system was set up in July 1944 by 44 nations in New Hampshire. The system allowed the recovering economies of Europe to accumulate U.S. dollars--including postwar American aid such as the Marshall Plan--which could be converted to gold at the rate of 35 dollars an ounce, guaranteed by the U.S. Treasury's gold reserves. The American guarantee was maintained in exchange for other countries' obligations to ensure monetary discipline at home.

The United States did not have this same discipline imposed upon it, so American debts could be paid by issuing new currency. During the late 1950s and 1960s this occurred with greater frequency as a result of ballooning American foreign aid programs, Lyndon Johnson's "Great Society" initiatives, and the funding of growing American involvement in Southeast Asia. After 1958, the total number of dollars in circulation had eclipsed the gold held in reserve, a violation of a key tenet of the Bretton Woods system. This ultimately set in motion a series of monetary crises throughout the 1960s.

After a gold crisis in 1960, the Eisenhower administration worried that the entire Atlantic alliance might collapse. The Kennedy administration once mused that payments deficits worried the president more than nuclear weapons, and President Lyndon Johnson was concerned that he might be blamed for a global economic depression. This system was also painful for American consumers. Expansionary monetary policies without a devaluation of the dollar attracted imports, causing inflation, increased prices, and reduced exports. Thus, even in its purest form, the Bretton Woods system had a certain amount of instability built into it from the beginning.

Knowing that American gold reserves could not withstand a mass conversion of dollars into gold, throughout the 1960s American policymakers created a series of political inducements to compel Europeans (and later, Japanese) to hold onto their dollars rather than exchange them for gold. Beginning in 1961, the U.S. negotiated "offset" agreements with West Germany. In 1963, the Group of Ten leading industrial nations began discussions to develop a new monetary system, without success. Then, in 1968, Special Drawing Rights were created in an attempt to meet shortages in liquidity.

This was the system that Richard Nixon inherited in 1969. Nixon ignored the advice by Milton Friedman and Paul Volcker that the change in administration was an ideal time to overhaul Bretton Woods. Friedman argued that the dollar must be set free from the burden it carried as the pivot to the system. Ignoring advice to act in 1969, Nixon announced his New Economic Policy on August 15, 1971. Considered to be the mortal blow to Bretton Woods, Nixon suspended the conversion of dollars into gold, and included a host of other domestic initiatives (e.g. wage and price controls) and international programs (e.g. import taxes) that were in the spirit neither of Bretton Woods nor Nixon's conservative beliefs.

The lesson here for the Obama administration is that references to a "new Bretton Woods" must be understood carefully. Many calls for such a system appear with little context, and do not take into account the fact that the system depended on perennial manipulation, or that it was solvent for less than half of its existence. In 2009, there are too many unanswered questions. What would the currency pivot and reserve asset be? What will the responsibilities of membership be? What will the mechanism of enforcement be? What will the penalty for not playing by the rules be? Calls for reform are simple, but answering these questions are much more difficult. The system was unable to meet the liquidity demands of the 1960s, and it appears dramatically more out of step today.