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The Bretton Woods System: Concept and Practice*

The first (discouraging) thought that occurs to anyone asked to write about the Bretton Woods System is that there is nothing, no aspect of the subject, that has failed to attract careful and lengthy scrutiny over the last 50 years. The existing literature must be at least as voluminous as that on the Classical Gold Standard; and the number of devotees of the System is probably greater than the one that admired for so long its much-debated nineteenth-century precursor.

International financial crises since the early 1970s have frequently produced calls for 'a new' Bretton Woods System. The problem with this is that the system, like the gold standard, was a product of particular circumstances that cannot be reproduced easily. Moreover, it is never clear whether those who advocate a return to more orderly international economic relationships, such as those that existed in the 1950s and for most of the 1960s, mean the system as conceived at Bretton Woods or the system as it operated in practice.

Nevertheless, the conditions that inspired the search for a consensus in the conduct and control of economic relationships between nations in order to enhance their economic welfare, the solutions that were proposed in response to the specific problems that had destroyed in the 1930s the multilateral system of trade and finance created over the preceding half a century, and the obstacles that made it impossible to implement the whole of the Bretton Woods blueprint in practice – all have important lessons to offer to a world struggling with similar difficulties half a century later. Many of the problems that Keynes, White, and others tried to solve in the 1940s are still with us and will continue to lead to serious crises for as long as international economic integration and the growing interdependence to which it gives rise continue to increase in a world divided into a large number of independent states – all jealously guarding their national sovereignty.

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This chapter analyses, first, the extent to which the original plans for a new global monetary system were influenced by developments between the two world wars. After the principles, the chapter turns to the practice: the factors that made the system successful early on, but then progressively deteriorated, creating many of the difficulties which the architects of the Bretton Woods System tried to ensure would never happen again. It concludes with some suggestions why a Bretton Woods Mark II would have to be different from the old one and of the obstacles that make it unlikely on a global scale in the foreseeable future.

10.1 The supranational blueprint and its origins

As Machlup (1977) has shown, the idea of creating an international economic and monetary union has a long history. In spite of this, it remained for centuries only a dream for the simple reason that until the 1940s no government took a serious interest in any of the schemes proposed. For instance, in the 1920s a French economist, Nogaro, floated the idea of establishing an international bank to issue a new international currency (Gomes 1993, p. 215). A few years later, in 1929, Schacht, the President of the Reichsbank, proposed the creation of an international clearing union (Luke, 1985); and in 1930 Keynes ([1930] 1971, pp. 358–61) suggested a modified gold standard to be managed by a 'supernational bank' acting as the international lender of last resort. Nothing happened.

However, only a little over a decade later, both the Allies and the Germans were incorporating these suggestions into their plans for a new international economic order to be established once the war was over (Van Dormael 1978, Gardner 1980). Two important, inter-related developments, which took place in the intervening period, played a major role in contributing to this change in official attitudes. The collapse of the international economic system at the beginning of the 1930s, followed by the Great Depression, the rise of Fascism and the Second World War destroyed the old order created by trial and error before 1914 in response to growing international economic integration. Most contemporaries were convinced that each step in this sequence of events was a direct result of the one preceding it. The events also demonstrated the fact that industrial countries, in particular, were too advanced, specialized, and interdependent to contemplate genuine, lasting improvements in economic welfare after the war without re-establishing some sort of a new economic order. Moreover, the task was too important and urgent for the postwar recovery to be left to the slow, haphazard processes of the markets whose limitations had been exposed in the interwar period (Milward 1987a and 1987b). It had to be taken on, therefore, by governments; and the powerful vested interests that might have resisted this successfully were too shell-shocked and marginalized by the disastrous turn of events in the 1930s and early 1940s to put up an effective resistance to

fundamental, far-reaching changes. Hence, such changes became not only essential but also feasible.

British, American, and other plans and, ultimately, the Bretton Woods blueprint for the postwar order reflect, therefore, these preoccupations rooted in the inter-war experience. They were the outcome of a pragmatic approach to the major challenges of the time adopted by a remarkable generation of public-spirited politicians, administrators, and experts, often of widely different ideological persuasions. However, they had one thing in common: most of them had lived through two world wars and the Great Depression; and it was this experience that made them determined to create economic and social conditions which would ensure that the world would never again have to live through similar man-made disasters.

The starting point, which made all the subsequent development possible, was the widespread acceptance of the fact that economic interdependence requires consensus and cooperation if countries participating in the international division of labour are to achieve their national objectives; and that many of the problems experienced between the two world wars could be traced directly to a failure in this respect. Even the rather informal financial arrangements that had existed under the Classical Gold Standard (see Eichengreen 1992) broke down as, confronted with unprecedented economic and social crises, each country tried to solve its problems in isolation. In spite of this, very few of them managed to stage a genuine economic recovery before the outbreak of the Second World War; and those that did (for example Nazi Germany and the Soviet Union) achieved economic success at exceptionally heavy social cost.

The lessons that this experience had taught those who attended the Bretton Woods Conference were summarized in the opening speech by the US Secretary of the Treasury, Morgenthau (US Department of State 1948a, p. 81):

> All of us have seen the great economic tragedy of our time. We saw the worldwide depression of the 1930s. We saw currency disorders develop and spread from land to land, destroying the basis for international trade and international investment and even international faith. In their wake, we saw unemployment and wretchedness – idle tools, wasted wealth. We saw their victims fall prey, in places, to demagogues and dictators. We saw bewilderment and bitterness become the breeders of fascism, and finally, of war.

The important conclusion, as Morgenthau pointed out to a much wider audience in a radio broadcast, was that: “We have come to recognise that the wisest and most effective way to protect our national interests is through international co-operation” (quoted in Eckes 1975, p. x). Keynes went even further in his closing speech at Bretton Woods (US Department of State 1948a, p. 1110): “We have been learning to work together. If we can so continue, this

nightmare, in which most of us here present have spent too much of our lives, will be over. The brotherhood of man will have become more than a phrase."

What they had done 'working together' at Bretton Woods was to produce the first and, in many ways, the most ambitious blueprint for a global economic order ever attempted. It was designed to eliminate permanently a number of serious problems experienced in the inter-war period (and, indeed, before 1914) within a basically supranational, centralized institutional framework.

The first problem that they had to solve in setting up a new international monetary system was that of agreeing on (a) what should constitute liquid assets which would be universally acceptable in settling international debts and (b) how they were to be created. The practice from about the 1870s until the Second World War was to rely for this purpose on gold and one or two national currencies, with a few other currencies in a minor, supporting role. The snag, as those attending the Bretton Woods Conference knew from experience, was that the production of gold might fail to expand sufficiently to finance the growth of world trade and investment. This had happened before 1914 and to an even greater extent in the inter-war period, with the result that national currencies of the most important trading nations were used to fill the gap, effectively turning the international financial set-up into an extension of their national systems, mainly that of the dominant economy.

However, in a dynamic economic environment this only produces a temporary solution. In the medium to long term the relative position of countries in the international economy changes and with this the relative demand for their currencies. The once dominant country is overtaken by more dynamic economies whose firms become responsible for a larger share of international trade and investment. As a result, a high proportion of international exchange is conducted in its currency, in preference to that of the once dominant country. However, for the transition to be smooth, supporting a continuous expansion of world trade and investment, the authorities of the new leading economy have to be both willing and able to provide its currency in the quantity required. Otherwise, international trade, investment, and production will decline. The rate of decline may be slowed down for a time if the once dominant economy is determined to continue playing a major financial role and reduces the supply of its currency relative to the shrinking global demand for it, thus maintaining its exchange rate unaltered. The problem is that such a policy cannot be pursued for long because of its adverse effects on domestic output and employment.

All this is, of course, precisely what happened in the inter-war period, though there were already some signs of the changing roles of major economies and their currencies towards the end of the Classical Gold Standard. As Kindelberger (1973) has pointed out, after the First World War an economically weakened Britain was in no position to play the key role,

and the United States, because of the virtually closed nature of its economy, was both unable and unwilling to take over.

Both the British and US plans, prepared for Bretton Woods, tried to deal with these weaknesses: the British by creating an international currency ('bancor') to be made available on demand; and the American by revising contributions to a new international organization at intervals according to changes in the relative size and importance of the countries in the international economy (US Department of State 1948b, pp. 1536–7). The latter also proposed an international monetary unit ('unitas') for the new global organization (*ibid.* p. 1543). In the end, it was the US 'contributory' plan (minus 'the unitas') that was adopted at Bretton Woods and enshrined in the IMF Articles of Agreement. Nevertheless arguments about the relative merits of the two plans continued for years. Yet, as will be shown later, each had serious deficiencies and, therefore, little chance of success. (Both plans are reproduced in US Department of State 1948b.)

The next problem that architects of the Bretton Woods System set out to solve – that of establishing an international lender of last resort – was also prompted by their past experience. Even under the Classical Gold Standard, a country with temporary liquidity difficulties depended on the self-interest of other countries to come to its rescue in order to prevent an international financial crisis (Eichengreen 1992, Bloomfield 1963). In other words, although, at least in the case of major countries, it was likely that other countries would help, there was no guarantee that they would do so. No central bank was under an obligation to act as a surrogate international lender of last resort, nor were there generally agreed rules according to which this should be done.

The British and US plans for, respectively, a 'Clearing Union' and an 'International Stabilization Fund' were intended to overcome these problems by creating a supranational institution that would act, effectively, as a central banks' Central Bank, by stepping in to help countries with temporary liquidity problems. The end result of these labours, the International Monetary Fund, was therefore instructed (Article I) to act in such a way as to enable countries "to correct maladjustments in their balance of payments without resorting to measures destructive of national and international prosperity". It was to do this (Article V.1) by dealing only with national monetary authorities (that is, central banks, ministries of finance, and stabilization funds).

Moreover, like national central banks, the IMF was to provide clearing facilities, as all central banks were to hold reserves with it. In addition, again like a national central bank, it was given the authority to ask a country applying for help to take certain corrective actions in order to qualify for assistance. (IMF Articles of Agreement are reprinted in US Department of State 1948a, pp. 942–84.)

All these powers were, in principle, both necessary and desirable. However, to be effective in practice, the institution had to have sufficient

resources, independence of the influence of any one country, and undisputed authority to discharge its responsibilities. The founding fathers of the Bretton Woods System were in no position to provide this. Hence, their blueprint contained another serious deficiency that was to make it unworkable in the form intended.

Another important issue that the 44 countries participating at the Bretton Woods Conference were determined to resolve was that of preventing destabilizing capital flows and competitive exchange rate devaluations. Both were regarded – on the basis of pre-war experience – as a major obstacle to creating the viable system of multilateral trade and payments which they believed to be essential if they were to achieve high levels of output and employment after the war. For instance, Nurkse (1944) expressed a widely held view when he argued, in his analysis of international finance in the inter-war period, that floating exchange rates discouraged trade, led to misallocation of international resources, and encouraged destabilizing speculation. Hubert Henderson (1955, p. 291), another influential observer of economic disintegration in the 1930s, concluded that competitive devaluations were the least helpful policy instrument to the countries that employed them and most harmful to the rest.

Not surprisingly, both the British and US plans wanted member countries to hold a large proportion of their reserves with the new international organization. That would make it possible for the organization to clear external imbalances and thus avoid destabilizing flights of short-term capital from one financial centre to another, as happened in the 1930s. To ensure this, it was also essential – in the British but not the American view – to impose controls on international capital flows, especially those of a short-term, speculative nature. Keynes certainly believed, as Churchill explained in a letter written in 1941, that "the exchange regulations and controls imposed during the war" would have to be maintained "for some considerable time" (quoted in Van Dormael 1978, p. 10). Experience had taught him that only in this way would it be possible to sustain over a long period a system of fixed exchange rates in which all currencies would be pegged to the new international currency advocated in the British plan (see Moggridge 1986). At the same time, both British and American plans contained a provision for countries with persistent balance of payments difficulties to devalue their currency.

In the end, most of these proposals were incorporated into the IMF Charter. The Fund was given responsibility "to promote exchange rate stability" and "to avoid competitive devaluations" (Article IV.4a). Its members were allowed to devalue only "to correct a fundamental disequilibrium" (Article IV.5a) – although no attempt was made either then or subsequently to define this concept (see Solomon 1982). If a member changed the par value of its currency despite the Fund's objections it would become "ineligible to use the resources of the Fund unless the Fund otherwise" determined (Article IV.6).

What is more, a persistent offender in this respect might be required to withdraw from the IMF (Article XV).

There is obviously consistency and logic in these arguments and provisions. The problem is that their effectiveness depended critically on the Fund's ability to appropriate a significant part of member countries' national economic sovereignty. This was a much more important aspect of the Bretton Woods agreement than the often discussed fact that the system was a variant of the gold standard, as all the currencies were fixed to the US dollar which, in turn, was fixed to gold. The IMF, after all, was empowered to increase international liquidity, if its larger members approved, by altering the par values of members' currencies relative to gold (Article IV.7).

A system of fixed exchange rates, strictly and scrupulously observed, should in itself be sufficient to ensure that all countries participating in it have no alternative but to follow rigid stabilization and adjustment rules. That was certainly true of countries belonging to the Classical Gold Standard – even though, for various reasons, the system was much more flexible than is generally believed (Panić 1992). However, the risk with a quasi-monetary system (that is, a system of fixed exchange rates) is that there is no guarantee that when confronted with a serious internal imbalance a country will stick to the rules rather than change its exchange rate; or, alternatively, that a country earning current account surpluses will not simply increase its reserves rather than expand domestic activity and imports, invest abroad, or allow the rate of exchange to appreciate to the point at which it eliminates the surpluses.

All these practices had become so common in the inter-war period that the British plan included a provision empowering the new international organisation ('the Clearing Union') to impose penalties on both deficit and surplus countries (US Department of State 1948b, pp. 1554–5). The idea was that the organization should charge extra interest: in the first case if a country's reserves fell over a period of a year or so below a certain minimum; and in the second case if the reserves held by a country at the Clearing Union over a similar period were persistently over a specified maximum.

The Americans made no similar proposal – hardly surprising, as everyone expected them to be by far the most important surplus country for a long time after the war. Nevertheless, they agreed at Bretton Woods that a 'scarce currency clause' should be included in the IMF Charter. If there were a general scarcity of a currency, the Fund would try first to borrow it from the country concerned. However, if excess demand for the currency persisted, the Fund would declare it 'scarce' and start to ration it (Article VII.3a). The moment this happened, any member would have the right, after consulting the Fund, to impose restrictions on transactions with the country whose currency had been declared 'scarce' (Article VII.3b) – for as long as the scarcity lasted. The restrictive measures were to be discontinued only when the Fund declared the currency no longer scarce (Article VII.3c) – in

other words, after the country had taken appropriate steps to balance its external account.

In this way, the IMF was given extraordinary powers to force even its largest and most influential members to observe the stabilization/adjustment rules. It could do so in the case of a deficit country when asked to act as the lender of last resort; and in the case of a surplus country by declaring its currency scarce.

All the problems, proposals, and policy decisions described so far were designed to deal with the short-term aspects of economic activity: international financial measures needed to facilitate high levels of activity and trade without which the most important policy objective that industrial countries were determined to pursue after the war – that of high levels of employment and income – could not be achieved. However, there was another important factor that had contributed to the disintegration of the international economy in the 1930s: the unprecedented collapse of international long-term capital flows (see Bairoch 1976b, and Panić 1988, Chapter 9).

The three nations which provided most international investment before 1914 – the United Kingdom, France, and Germany – were in no position to play this role after the First World War. The Americans, on the other hand, had the resources but no inclination to take over the role on the scale required. Their financial institutions had little experience of investing abroad, as all but a small proportion of the country's savings were used to finance domestic investment. Moreover, those who borrowed from the United States found it difficult to service and repay their debts because of the country's highly protectionist policies.

It was this experience that led US Treasury officials, under Harry White, to propose the creation of a new institution whose task would consist of providing the long-term capital that would be required for the postwar reconstruction. The problem was obvious enough: after the war, economic and political uncertainties could be expected to be so great that private investors would be most unlikely to provide such finance, at least in the initial stages of postwar reconstruction. In the circumstances, as White put it: "Only an international, non-profit institution with enormous resources can afford to undertake the task of supplying adequate amounts of capital on the gigantic scale that will be necessary after the war" (quoted in Eckes 1975, p. 52).

The International Bank for Reconstruction and Development was created, therefore, to perform the function of an international allocator of last resort. Its Charter, agreed at Bretton Woods, makes it clear that the Bank's task was to assist and supplement private international investment, not to supplant it. This is emphasized in Article III.4 which, among other things, specifies that the Bank would lend mainly if the funds could not be obtained from other sources on reasonable terms. The Bank's Charter was also specific about the ways in which it would either make loans from its own resources or underwrite loans ("in whole or in part"), including those made "by

private investors through the usual investment channels" (Article IV.1a). The role intended for the Bank is, in fact, reminiscent of that played by the Japan Development Bank in the extraordinary growth and modernization of the Japanese economy after the Second World War. (The IBRD Articles of Agreement are reprinted in US Department of State 1948a, pp. 98–1014.)

Equally important for a *World* Bank, serving countries at different levels of development and with different political systems, the IBRD was not allowed (a) to specify in which country the proceeds of its loans should be spent (Article III.5a) and (b) to interfere in the political affairs of a country, or to be influenced in making its decisions by the political system of the member or members concerned (Article IV.10).

By agreeing on the Charters of the two institutions, delegates at the Bretton Woods Conference managed to achieve something that the world had never even attempted before: to create the basic framework of supranational institutions required to manage the economic and financial behaviour of a large number of nation states whose economies were closely integrated. As Keynes, White, and others involved in producing the Bretton Woods blueprint realized – and were to be proved right by subsequent events – the only viable, lasting framework for an integrated world economy is one that is managed by supranational organizations. For reasons that had become obvious during the inter-war period, dependence on a single, dominant country could not be expected to guarantee long-term improvements in global economic welfare of the kind planned by national governments after the war.

The problem that they could not solve at Bretton Woods was the one central – then as now – to the effective running of an internationally integrated economy: how to ensure in the absence of a world parliament and government that supranational institutions perform the role that such a system demands. It was this, in fact, that made the system which operated from the late 1940s until the early 1970s depart significantly in a number of respects from the blueprint produced at Bretton Woods.

10.2 The revival and fatal flows of a system managed by a dominant economy

Contrary to popular belief, the 'Bretton Woods System' never operated as intended by those who created it. Instead of being managed by the two supranational institutions, it was run by the dominant economic power after the Second World War: the United States. In that sense, its fortunes, like those of the Classical Gold Standard, were directly linked to those of the relative economic performance and policies of the country responsible for the largest share of world industrial production, trade, and finance at the time – precisely the outcome that those attending the Bretton Woods Conference had been anxious to avoid.

As there are already numerous accounts of how the post-war system actually operated, important lessons for the future can now only be gained by discovering the reasons why it departed from the original blueprint.

Warning signals that the system was unlikely to function as agreed at Bretton Woods were there from the start. For instance, a common complaint in the literature is that the founding fathers seriously underestimated the scale of the postwar reconstruction effort and the time that it would take; and that, as a result of this, the two international institutions were provided with totally inadequate resources to play the role for which they had been created. There is some justification in this, in the sense that it was commonly believed at the time that the postwar recovery would be accomplished within 5 years. In fact, in most cases it took 10 to 15 years (cf. Panić 1991a). As for the financial resources given to the IMF and the IBRD, it was agreed at Bretton Woods that they should receive $8.8 billion and $10 billion respectively (US Department of State 1948a, pp. 976 and 985). The two figures, although quite large at the time, would have been sufficient to cover the amounts provided in different forms to Western Europe and Japan by the United States (see Milward 1987a) during the first six or so years after the war. But there would have been very little left for other countries or purposes – even if the IMF and the IBRD had been in a position to spend every dollar, or its equivalent in other currencies and gold, allocated to them.

In fact, political considerations and economic realities ensured that the sums that the two institutions could actually use were considerably smaller. When the World Bank started its operations after the war it had effectively only $570 million (that is, the US contribution) available for lending – less than 6 per cent of the resources that it was supposed to have (Spero 1981, p. 36). Moreover, it could advance loans only in those cases where it was assured of repayment. IMF currency dealings between 1947 and 1952 amounted to no more than $850 million (Kenwood and Lougheed 1983, p. 255). As its responsibility was limited to short-term stabilization, it refused to come to the aid of countries with serious adjustment (that is, reconstruction and development) problems even when it was in a position to help them. Not surprisingly, in 1947, soon after they had started their operations, the two organizations expected to be the pillars of the Bretton Woods System admitted that they had inadequate resources to deal with the mounting international economic problems (Mason and Asher 1973, pp. 105–7 and 124–35).

There were basically two reasons for this. First, in agreeing on contributions to be made by individual countries to the IMF and the IBRD the founding fathers had to consider carefully what would be acceptable to national parliaments, especially the US Congress, and the powerful interests that they represented. (See, for example, Mickesell 1994.) The agreed quotas reflected this as much as what was thought to be either necessary or within the ability of individual countries to contribute. Second, it was important for

political reasons to treat at Bretton Woods all national currencies as if they were of similar importance and would, therefore, be equally in demand after the war. To distinguish 'key' currencies from others would have made it virtually impossible to achieve the consensus needed to create the postwar system. At the same time, it was clear that only a few countries – in particular, the United States – would be able to provide the goods and services needed for postwar reconstruction, for the simple reason that the economies of the remaining nations were either destroyed and dislocated by the war, or not sufficiently industrialized. To make things worse, the grossly uneven productive capacities and competitive strength of individual countries made it essential for almost all members of the two institutions to continue with the inconvertibility of their currencies after the war in order to avoid major financial crises of the kind experienced by the United Kingdom in the summer of 1947 (see Milward 1987a). The outcome was that the IMF and the IBRD had at their disposal a large stock of currencies that were for all practical purposes unusable.

The two supranational institutions were, therefore, in no position to manage the international financial system – the task for which they had been created in 1944. Not surprisingly, the supranational edifice that represented the Bretton Woods System as originally conceived collapsed almost as soon as it was created in 1946/47. The 'Bretton Woods System' that soon afterwards rose from the ashes was something quite different: managed by the United States because of its dominant economic position in the world, its fortunes were bound to be tied closely to that country's ability to maintain this supremacy. The problem is that no country can realistically be expected to sustain such a position for long in a dynamic world economy. Consequently, no international monetary system dependent on a dominant economy is likely to have more than a relatively short life span.

At the end of the Second World War, the United States accounted for half of world manufacturing output, half of world shipping, one-third of world exports and 61 per cent of total world reserves of gold (Kennedy 1989, p. 461). In 1950 its reserves were 2.73 times greater than its liquid liabilities (Milner and Greenaway 1979, p. 271). The dollar was not only fixed to gold but also, as an official reserve asset, convertible into it. In these circumstances, it is inconceivable that the bancor or any other international currency could have displaced the dollar as the international medium of exchange, unit of account, and store of value unless its creation had coincided with the abolition of all national currencies. Even in the 1960s the dollar accounted for more than two-thirds of the official reserves of all countries, with its share rising to over 77 per cent in the early 1970s when the 'Bretton Woods System' finally collapsed (cf. Walter 1993, p. 187).

With the US economy and currency in such a commanding position, it was also inevitable that it would be the US authorities and financial institutions that would manage the international system rather than the two

supranational institutions created at Bretton Woods for the purpose. In other words, as before 1914, the international monetary system became effectively an extension of the dominant country's system. It could hardly have been otherwise, as it was that country's authorities and financial institutions that determined the supply of the world's key currency – influencing the ability of other countries to reconcile their internal and external balances at desired levels of output and employment. Consequently, it was the US authorities and financial institutions that had a major influence on the stability and growth of the world economy; and, under the global economic conditions that existed for a quarter of a century after the Second World War, no supranational institution would have been able to challenge this influence. Hence, the position occupied by the United States under the 'Bretton Woods System' was very similar to that played by the United Kingdom under the Classical Gold Standard – in contrast to the original Bretton Woods concept and blueprint which were designed to provide a more permanent solution.

Initially, the system worked extremely well after the advent of the Cold War left the United States with little alternative but to take over its management in 1947 in order to prevent a major international economic and political crisis. US policies ensured a steady injection of dollars into the world economy, making it possible for imbalances in international payments to be adjusted in an orderly fashion, without imposing serious welfare costs either on the countries concerned or on their trading partners. In this way, the United States also helped preserve the system of fixed exchange rates, at least among industrial economies, for more than two decades.

Massive US economic assistance to other countries started with the European Recovery Programme (Marshall Aid) and other official transfers in the late 1940s. However, as the remarkable success of the programmes in Western Europe and Japan became apparent, official grants and loans for this purpose were reduced after the early 1950s without adversely affecting the supply of international liquidity provided by the United States. The reason for this was that the reduction in official transfers coincided with increases in the country's military expenditure and long-term investment abroad which, together, offset its large, persistent surpluses on trade in goods and services (cf. OECD 1964). In that sense, the United States, like the United Kingdom before 1914, provided other countries with its currency on a scale that facilitated the growth of world output, trade, and investment without compromising the confidence that the dollar enjoyed internationally. It performed, therefore, the role of a surplus, creditor country in a way that benefited the rest of the world and would have made it unnecessary for the IMF to apply the scarce currency clause against the dollar even if it had been able to do so.

However, unlike the British in the inter-war period and to a lesser extent before 1914, the Americans were unwilling to sacrifice any of their major

economic and political objectives when their economic supremacy and, thus, their position at the centre of the 'Bretton Woods System' began to wane. As the rate of growth of the economy accelerated in the 1960s and unemployment levels fell, US current account surpluses decreased progressively. At the same time, the country's military expenditure and investment abroad continued at high levels, producing large deficits on the basic and overall balance of payments. The result was a sharp deterioration in the ratio of US reserves to liquid liabilities: from 2.73 in 1950 to 0.92 in 1960 and 0.31 in 1970 (Milner and Greenaway 1979, p. 271). Not surprisingly, the dollar became vulnerable to speculative attacks, as doubts increased around the world about the country's ability to maintain the value of its currency fixed to gold at the existing parity ($35 to one ounce of pure gold).

The first run on the dollar occurred in 1960 when international speculators began to exchange it for gold on the London market. The general unease about US ability to manage the System and maintain the exchange rate of the dollar continued throughout the decade, intensifying after sterling's devaluation in November 1967. There was also increasing resentment in Europe that the Americans were deriving 'seigniorage' benefits from the role played by their currency and institutions under the 'Bretton Woods System'.

Clearly, to deal with these problems and complaints, the United States needed either to tighten macroeconomic policies to boost its surpluses on trade in goods and services, or to reduce its military expenditure and investment abroad. However, for domestic reasons, the successive administrations found it difficult to do either. Instead, they made some attempts in the mid-1960s to control capital outflows, tie foreign aid to orders from the United States, and introduce various schemes to encourage exports. Yet, despite the country's apparent determination to keep the dollar at the centre of the international system, no attempt was made to take the required stabilization/adjustment measures because of their potentially adverse effects on domestic output and employment.

In the end, as in the British case 40 years earlier, the conflicting objectives and policies could not be sustained. In August 1971, the Nixon Administration first abandoned convertibility of the dollar into gold and imposed a 10 per cent surcharge on imports; and a few months later, as part of the Smithsonian Agreement, devalued the dollar by 10 per cent – signalling, in effect, the end of the 'Bretton Woods System'. For the second time within a century, after initial success, a dominant country had failed to secure a viable, lasting international monetary system. The reason was the same in both cases: the inability of the country at the centre of the system to maintain its economic supremacy and, with it, the capacity to fulfil its international role without sacrificing domestic welfare. No international system can survive if the country responsible for managing it is unwilling to observe its basic rules. One of the consequences of this is that international consensus will start to

break down precisely at the moment when it is needed most: that is, when it becomes apparent that no country is capable of managing the system on its own.

The Americans played a major role in rebuilding international cooperation after the war, especially among the countries of Western Europe (see Milward 1987a, Panić 1991a). Marshall Aid was given on condition that the countries receiving the Aid cooperated in implementing it through the Organization for European Economic Cooperation (set up in 1948). The United States actively promoted intra-European trade and the clearing of external imbalances by helping create the European Payments Union in 1950. The success of these and other initiatives made an important contribution towards the greater European integration that is still in progress. Later on, in the early 1960s, there was an increase in collaboration among the central banks of industrial countries in supporting each other's currencies in times of speculative attack. The 1960s also saw a significant liberalization of international trade.

However, as the decade progressed there were serious disagreements among industrial countries about the policies required to deal with the growing disparities in their external balances and who should bear the main responsibility for taking steps to correct them: deficit countries, such as the United States and the United Kingdom, or surplus countries of the European Community, notably West Germany. In other words, neither side was prepared to observe the rules of the international stabilization/adjustment game when they began to come in conflict with their national objectives and policies.

This could have only one outcome: greater uncertainty and, consequently, international financial instability – especially as the weakening of consensus and cooperation among the major industrial countries coincided with rapid growth of international investment flows.

The scope for such flows was limited until the second half of the 1950s by two factors: tight controls of capital exports, practised by almost all industrial countries; and, where this was not the case (the United States), the risks and uncertainties associated with investing in economies struggling to recover from the economic and other damage and dislocation caused by the war. However, with the success of the recovery, the narrowing down of international income differentials, and improvements in transport and communications, there came a rapid growth of transnational corporations followed by transnational banks and other financial institutions.

By 1971 the value of liquid assets held by the top one hundred US transnational corporations (TNCs) exceeded the combined reserves of the largest industrial countries (Robbins and Stobaugh 1974, pp. 182–3). The growth of transnational banks (TNBs) was even more rapid. Between 1965 and 1974 the value of assets held abroad by branches of US banks had risen from $9 billion to $125 billion. Foreign banks operating in the United States held,

in 1974, assets worth $50 billion (United Nations 1981, p. 34). The gross size of eurocurrency deposits (that is, including inter-bank deposits) went up from $19 billion in 1964 to $210 billion in 1972 (Pilbeam 1992, p. 312).

Given the resources at their disposal, it was sufficient for these transnationals to switch a relatively small proportion of their assets from one currency to another to cause a major exchange rate crisis. The growing discord among industrial countries provided them with the incentive to do precisely that in order to protect the value of their assets. Yet, although their actions interfered increasingly with the ability of different countries to achieve their economic objectives, the fact that transnationals operated globally made it, as Chapter 6 shows, more and more difficult for any one government to control their actions. (See also Panić 1991b).

A system of fixed exchange rates cannot survive for long under these conditions, as Keynes and his contemporaries learned from experience, particularly when there are noticeable differences in the ability of different countries – including those whose currencies are used widely in international transactions – to reconcile their internal and external balances. Of the two reserve currencies, sterling was the first to be subjected to persistent pressure until it was devalued in 1967. The dollar followed four years later. The 'Bretton Woods System', resuscitated and managed with great success for a number of years by the United States, was no more.

An international monetary system, using a single global currency and run by supranational institutions, could have avoided the financial (though not the economic!) problems described in this section. As a result, it would probably be functioning even more effectively now than in the 1940s. Keynes and many of his contemporaries realized this. Unfortunately, like all visionaries, they were far ahead of their time.

10.3 Conclusion: is the world ready for a 'New Bretton Woods'?

The 'collapse' of the 'Bretton Woods System' in the early 1970s has been mourned ever since. However, as suggested in the previous section, the change has not been as dramatic or as complete as seems to be widely believed. The return of floating exchange rates – unavoidable in a world of massive capital flows – destroyed the quasi-monetary union (that is, the regime of fixed parities) that had existed from the late 1940s until the early 1970s. To that extent, the demise of the postwar system has increased economic uncertainty considerably by relaxing (though not removing!) the obligation to observe the well-known stabilization/adjustment requirements and, thus, weakening the need for international cooperation which such a system demands.

That has obviously imposed welfare costs on all countries. But the costs have been kept down by the fact that the industrial countries in particular

have been careful to avoid competitive devaluations and other protective devices of the kind that caused so much damage in the 1930s. Thus, the Bretton Woods spirit of international cooperation has survived, though mainly in a negative form: national governments have, in general, taken considerable care not to repeat the worst mistakes of the inter-war period, but have not made a genuine effort to create a new world economic and financial order. In the same spirit, the two international institutions created at Bretton Woods have not been abolished mainly because, as recognized in the 1940s, an integrated world economy needs supranational organisations. Although much more prominent since the 1970s than before, neither has been at the centre of international economic developments. This is neither surprising nor new. They had not been allowed to manage the international financial system during the preceding 25 years either.

All this may be unsatisfactory, but what is the likelihood of doing better by restoring a much needed order and predictability in international economic and financial relationships under a 'Bretton Woods Mark II'?

As I have argued elsewhere (Panić 1988), the basic economic requirements of such a system are straightforward enough and, from a technical point of view, relatively easy to implement. The reason for this is that, in principle, they are not different from those that have been applied for many years in the most successful industrial countries, especially those with federal constitutions. Hence, if the world had a single political authority the same blueprint could be implemented globally – by fiat if necessary.

The problem is, of course, that the day when nation states are ready to hand over sovereignty to a world authority, because it is much more likely to satisfy the economic and social aspirations of their citizens, belongs to a very distant future. Consequently, the critical issue in creating an effective supranational institutional framework is still the same as in 1944: how to make it worthwhile for a large number of countries at different levels of development, often with widely different problems and priorities, to collaborate in a way that makes all of them noticeably better off than they would have been otherwise.

Given that there are even more sovereign states now than at the time of the Bretton Woods Conference, with huge differences in their efficiency and income levels, global consensus and active cooperation of a lasting nature are extremely unlikely. The best that one can hope for are mini 'Bretton Woods' at regional levels. Arrangements of this kind should be easiest to achieve among industrial countries with similar problems and objectives – though the European Union, the most promising candidate for a successful regional grouping, has been demonstrating in recent years the difficulties involved.

The familiar alternative, a global system managed by a dominant economy whose actions have a marked effect on the welfare of other countries, appears to be a thing of the past. No single country currently in existence

is in a position to exert such an influence either at present or in the foreseeable future.

As a result, it is inconceivable that the global economy can be managed now either supranationally (as intended at Bretton Woods) or by a dominant economy (as practised effectively for a time after 1945 by the United States). A truly international currency ('son of bancor') is, therefore, as unlikely as it was 50 years ago; and it is even less realistic to expect a single national currency to fill globally the gap as successfully as sterling did before 1914 and the dollar after 1945. Nevertheless, given the size of the US economy, the dollar is bound to remain a major asset in settling international debts for quite some time, with its relative importance determined by the size and survival of regional blocs.

The existence of a number of major currencies – in a world in which transnational corporations and financial institutions can switch vast funds from currency to currency at short notice – makes return to a global system of fixed exchange rates extremely unlikely in the foreseeable future. As Keynes argued, controls of capital flows are essential for the viability of a global monetary union in a world of independent national currencies. Effective control of transnational enterprises is virtually impossible at a time when so many countries are desperate to attract their capital as well as their technical and managerial expertise. This, in turn, means that a global system of fixed exchange rates (that is, a global quasi-monetary union) would be unsustainable in the near future.

For all these reasons, the most likely prospect for quite some time is that of growing financial disorder, such as the world economy has been experiencing since the end of the 1960s. A new Bretton Woods – whatever aspect of the original model or the way that it was applied in practice this represented – is not a practical proposition. But regional groupings, such as the European Union, though very much a second best, are more likely, if organized properly, to enhance global economic welfare than almost two hundred squabbling countries of varying degrees of impotence.

Whether or not regional groupings materialize and survive long enough to provide in the long run a stepping-stone to a truly global system of the kind contemplated at Bretton Woods will depend on the extent to which those forming them respect the guiding principle which prompted that remarkable conference in 1944: that international integration and, ultimately, world peace are unsustainable without close collaboration between independent, sovereign states directed towards improvements in economic welfare, widely diffused within and between countries.