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On the System in Bretton Woods

By JOHN WILLIAMSON*

It has become customary to look back with nostalgia at the golden age when the Bretton Woods system held sway, from the early 1950's to around 1970. It also seems to be the conventional wisdom, however, that the rules of Bretton Woods contributed little to the impressive performance of the world economy over that period—a performance characterized not merely by the fastest and most widely distributed growth in history, but also by notable stability, including near price stability except at the beginning and end of the period. The deterioration in the performance of the world economy since the early 1970's is viewed as a coincidence, or a response to common causes, rather than as a consequence of the breakdown of Bretton Woods. My purpose in selecting the title to this session was to induce critical scrutiny of these conventional attitudes.

My own contribution to this task will start by describing what I conceive to have been the three essential rules of the Bretton Woods system. I shall proceed to examine the logic of those three rules in terms of recent contributions to the literature, in particular the emergent literature on policy coordination, and of recent historical experience.

I. Three Central Rules of Bretton Woods

An international monetary system comprises an exchange rate regime, rules governing the policies that are to be used to adjust payments imbalances, and a reserve supply mechanism to provide assets in which payments imbalances are settled.

Bretton Woods adopted the adjustable peg. *Exchange rates* were normally to remain stable within narrow margins, but could, and by implication should, be changed when there was a "fundamental disequilibrium." Although never formally defined, and therefore a target for much critical academic comment, there was never much doubt what this concept meant: a situation in which a country could not expect to achieve basic balance over the cycle as a whole without deflating output from full capacity or restricting trade or payments for balance of payments reasons. Thus the basic principle embraced was that exchange rates should be directed toward medium-run balance of payments needs rather than short-run anticyclical policy. The motivation was quite explicitly that of outlawing the beggar-thy-neighbor use of exchange rate policy that had occurred in the 1930's.

The IMF Articles adopted at Bretton Woods were not comprehensive in their specification of the practices that were to govern *balance of payments adjustment*. For example, there was no explicit specification of which country should initiate adjustment, or when. Exchange rates could be adjusted when there was a significant medium-run imbalance. Reserves were to be used to avoid the need for continuous external balance. It was universally assumed at the time of Bretton Woods, though not formally spelled out, that fiscal and monetary policy would be directed at the maintenance of full employment (or "internal balance"). But by the absence of alternative provisions to deal with modest non-self-reversing imbalances, one infers that the architects of Bretton Woods accepted that it would be necessary to shade fiscal-monetary policy with a view to the balance of payments position.

Although Keynes did not get the negative interest rates on creditor bancor positions that he sought, the *reserve regime* did imply something about the assignment of adjustment responsibilities. Countries were expected to restrict their deficits to the sums

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that could be financed from their available reserves supplemented by IMF drawing rights. Reserve currency countries (*sic*) had some additional latitude to finance payments deficits by issuing their own currencies, but it was assumed that this possibility would be limited by the need to maintain confidence in convertibility. Bretton Woods ratified the gold-exchange standard, it did not legislate a dollar standard. (The special position of the dollar was confined to the obligation to defend a par value in terms of gold rather than in terms of another currency.) Britain invested much energy in gaining an assurance that the United States would participate in the adjustment process (and secured the scarce currency clause to that end), which would have been anomalous in a dollar standard world.

In my interpretation, Bretton Woods was far more than just a commitment to pegged exchange rates, as has sometimes been claimed (for example, see Ralph Bryant, 1980, p. 475; Robert Solomon, 1984, p. 174). It embodied, rather, a comprehensive set of rules for assigning macroeconomic policies: exchange rates to medium-run external balance, fiscal-monetary policy to short-run internal balance, and reserves to provide a buffer stock (as distinct from a monetary base) that would allow short-run departures from external balance. This is the intellectual position that Keynes had developed in the interwar years, which in my view probably explains why he used his influence to secure British ratification of Bretton Woods despite his bitterness at the across-the-board rejection of the plans for postwar reconstruction that he had nurtured during the war years (see my 1983a article).

II. Implications of the Bretton Woods Rules

A vast literature developed in the 1960's on the ills of the Bretton Woods system. These were classified under the headings of the problems of adjustment, liquidity, and confidence. This is not the place to review those topics, save to say that this classification became such a part of the conventional wisdom that it has sometimes been used as a framework within which to evaluate *any* international monetary system. This is misguided. One may agree that adjustment, liquidity, and confidence are all handled better by present arrangements than they were by the Bretton Woods system, but nevertheless believe that *other* problems with present arrangements outweigh those gains. What seem to me the dominant problems with these arrangements are (a) their propensity to generate exchange rate misalignments, (b) the absence of any discipline on national overspending less drastic than the creditworthiness constraint that has now replaced the liquidity constraint, and (c) the lack of pressure they exert to coordinate policies. One may ask, with the benefit of hindsight, why these were *not* problems with the Bretton Woods system.

Exchange rate misalignments remained modest for most of the Bretton Woods period. The first rule of the system said that a misaligned rate (using that term as a pseudonym for fundamental disequilibrium) could be adjusted to eliminate the misalignment. One objective of the advocates of limited flexibility was to transform this *right* to change a misaligned rate into a positive *duty*. In the absence of such a duty, and in the presence of the pressures that the adjustable peg created to declare rates permanently fixed (so as to discourage speculative attacks), some substantial misalignments—especially of the reserve currencies—emerged by the second half of the 1960's. However, even these misalignments were smaller than those witnessed in recent years. Misalignments emerged from differential inflation and productivity growth, but not from exchange rate movements: indeed, since markets knew that governments would change par values only when they judged this appropriate on the basis of long-run fundamentals, speculative pressures acted as a check on the size of misalignments, rather than as a cause of them.

There is in my view a presumption that the vast exchange rate misalignments of recent years have had some negative effect on growth (via the promotion of deindustrialization in countries with overvalued currencies) and also some effect in ratcheting up inflation (see my 1983b study). These effects are,

admittedly, not well documented, though the supposed negative tests of the ratchet hypothesis are unpersuasive since they did not search for a ratchet effect on wages.

The virtues of a *liquidity constraint*, which resulted from the limited mobility of capital, were not always appreciated during the days of Bretton Woods. As recent work by Michael Jones (1983) has shown, however, a reserve constraint can substitute for explicit policy coordination, a theme discussed further below. The social function of a reserve constraint is there interpreted as that of disciplining macroeconomic policies so as to limit and make more predictable the demand and monetary spillovers received from abroad. In a world where policymaking is often myopic, the displacement of the former liquidity constraint by a creditworthiness constraint is not necessarily advantageous even from the standpoint of the individual country involved. Under Bretton Woods, countries suffered speculative attacks when their par values came to look vulnerable, instead of being able to pursue unsustainable policies for years while building up a vast mountain of foreign debt. That ability has already led Latin America into a devasting debt crisis, and it is now permitting the United States to pursue a policy course equally fraught with danger. Extensive capital mobility on the scale of the past decade is like fiat money: a social innovation with potential for great good, which in fact has almost certainly detracted from human welfare.

Overt (sometimes described as "continuous") *policy coordination* does not seem to have been much more effective in the golden age of Bretton Woods than it is in the days of Reaganomics. Hence the claim that Bretton Woods secured a useful measure of policy coordination has to rest on a demonstration that it was a successful case of what Richard Cooper calls a "rule-bound regime" (1985, p. 1226). That is, that the Bretton Woods rules were such as to ensure that spontaneous pursuit of national self-interest subject to continued observance of the rules ensured a broad consistency between national and world interests.

There is by now a significant literature showing formally that choice of monetary and fiscal policies with a view to short-run stabilization objectives (maximization of a utility function specified in terms of the activity level and inflation and/or the balance of payments on current account), taking other countries' policies as given and with exchange rates flexible, leads to an outcome (the Nash equilibrium) inferior to that available with policy coordination (the cooperative solution). See Matthew Canzoneri and Jo Anna Gray (1983), David Currie and Paul Levine (1984), and Gilles Oudiz and Jeffrey Sachs (1984). The first two of these three contributions investigate explicitly the merits of a fixed exchange rate rule as a way of ruling out manipulation of the monetary/fiscal mix with a view to gaining short-run benefits at the expense of other countries, and conclude that this constraint can indeed be mutually beneficial. The first of the Bretton Woods rules introduced precisely this constraint, but in a form that did not preclude an exchange rate change needed to facilitate payments adjustment.

The objective of precluding the manipulation of exchange rates as instruments of short-term anticyclical policy was indeed deliberately sought by the architects of Bretton Woods, with the experience of competitive devaluations in the 1930's in mind. Has experience since 1973 shown comparable evidence of antisocial behavior? To answer that question one has to know whether it is appreciation or, as in the 1930's, depreciation (relative to the *PPP* trend) that will have an adverse impact on other countries. Canzoneri and Gray have postulated that it is structural characteristics in the world economy, such as the degree of wage indexation and whether the oil price is fixed in terms of a particular currency, which determine whether the spillover benefits of monetary expansion on other countries are positive or negative. My own hypothesis would be simpler; that this depends primarily on whether unemployment or inflation is perceived to be the dominant problem confronting policymakers. In the 1930's, depreciation was antisocial. But when inflation is perceived to be the dominant problem, as in general since 1973, complaints will center on competitive appreciation—as they did in the debate on vicious and virtu-

ous circles in the mid–1970's, and in the reaction of Europe and Japan to the dollar appreciation of the early 1980's. The recent muting of European complaints on this score may reflect growing recognition that the problem of the decade in Europe is unemployment.

The second of the Bretton Woods rules as interpreted above assigned monetary-fiscal policy to short-run internal balance, subject to the need to maintain the exchange rate peg. As long as the basic presupposition of Keynesian demand management, that price levels are constant (or at least predetermined), remained approximately valid, this worked rather well: with hindsight, fine-tuning surely has to be rated a greater success than it was at the time. And as long as exchange rates remained properly aligned, the "stop-go" policies imposed on demand management by the Bretton Woods constraints served a social function that few appreciated at the time (but see Robert Triffin, 1960, pp. 82–83, for an exception). With a correctly aligned exchange rate, an external deficit provides an early warning that deflation is needed, while the automatic stabilizer provided by the deflection of excess demand into an external deficit constitutes a safety valve that helped prevent the development of inflationary inertia.

The third of the Bretton Woods rules required countries to respect a (reasonably symmetrical) reserve constraint, while using reserves as a buffer stock to reconcile continual pursuit of internal balance with only medium-run pursuit of external balance. The major benefit that arose from this rule, in conjunction with the first two, is that it helped to avoid a synchronized world business cycle. Robert Lawrence (1978) found that there was practically no synchronization during the period 1959–67 when the Bretton Woods system was functioning properly, with adequate but not excessive liquidity. There was synchronization in an earlier period, 1950–58, which he explained by a liquidity shortage that forced other countries into following the United States, especially during and after the Korean War. The recession of 1958 was the one case of a synchronized (but nonetheless relatively mild) world recession during the Bretton Woods period. Thereafter until 1969 recessions were essentially national, induced primarily by a need to curb payments deficits: France in 1959; the United States in 1960; Britain and Canada in 1962; Italy in 1963–64; Japan in 1964; Germany in 1966. Under the Bretton Woods rules, other countries tended to offset those recessions by expanding demand so as to preserve internal balance when exports fell, while one country's deficit (that pushed it toward restraint) was another's surplus (which nudged it toward monetary expansion). Thus the world as a whole did not deviate significantly from full employment because of payments imbalances. The mechanism that was supposed to secure this result under the gold standard (though it is doubtful whether it did—Barry Eichengreen, 1984) seems actually to have functioned during the golden age of Bretton Woods. Advocates of a dollar standard, such as Charles Kindleberger (1981), never gave sufficient weight to the loss of this mechanism that would follow abandonment of a U.S. reserve constraint. (That constraint *did* have an impact on U.S. policy: witness John Kennedy's nightmares about a rise in the price of gold, Operation Twist, and the 1968 tax increase.)

The evidence of Lawrence and Alexander Swoboda (1983) reinforces casual retrospection and an examination of the reference cycles of the Center for International Business Cycle Research in confirming that there has, in contrast, been a pronounced world cycle since 1969. The only question is the extent to which this can legitimately be attributed to the breakdown of Bretton Woods. Those of us who date the beginning of the end of Bretton Woods to the abandonment of the gold pool in March 1968, on the grounds that this transformed the reasonable symmetry of Bretton Woods' reserve constraint into the asymmetry of a dollar standard which paved the way for "benign neglect," may argue that the inflationary boom of the early 1970's can be explained that way. Doubtless the oil price increases of 1973 and 1979 were the primary causes of the ensuing global recessions, but the reason that both recessions were more severe than policymakers would have chosen *ex ante* on

grounds of anti-inflation policy can most plausibly be explained as a consequence of failure to appreciate the cumulative impact of other countries' policies (Lucio Izzo and Luigi Spaventa, 1981) and of attempts to engineer "virtuous circles."

III. Concluding Remarks

It has often been said by supporters of present arrangements that international monetary problems derive from the policies countries pursue, not from "the system." If only each country would look after its own fundamentals, the system would look after itself. The converse of that proposition is undoubtedly true: if countries do not take due account of fundamentals, including fundamentals that produce ill effects only in the long run (if they pursue unemployment targets below the natural rate, or accumulate debt in quantities that jeopardize credit-worthiness), the system is in trouble. But the proposition itself seems to be only as valid as the thesis that short-run anticyclical policies are useless. To the extent that there is a role for demand management policy to react to shocks, it is better that countries select their policies under the constraint that the (real) exchange rate not be changed except for medium-run adjustment. By imposing that constraint in the context of a system of reasonably symmetrical reserve constraints and an expectation that countries would aim for full employment, Bretton Woods contributed significantly to the stability, and therefore to the longevity, of the postwar boom. It accomplished this by influencing the policies that countries pursue: the antithesis between countries' policies and the international monetary system is a false one. To say that existing arrangements are the only ones that could have reconciled the policies pursued over the past decade is to condemn those arrangements, not to dismiss alternatives.

To recognize that the architects of Bretton Woods sought a comprehensive and enlightened policy assignment (and I cannot otherwise make sense of the wartime discussions), and that this assignment did indeed guide policy in the postwar world, is not to overlook the deep flaws in the Bretton Woods system. One can argue that the system worked as well as it did for a little over a decade because of a series of happy accidents: liquidity was about right despite the absence of any mechanism to secure that result, exchange rates were reasonably aligned despite the attempt to suppress realignments, inflation was low, the reserve center still acted as though the suspension of gold convertibility would be a disaster. Bretton Woods did not provide mechanisms capable of maintaining such a satisfactory conjunction of circumstances. The SDR agreement was intended to provide that flexibility with regard to the quantity of reserves, but it was not complemented by those additional reforms (limited exchange rate flexibility, asset settlement) that were needed to allow the system to survive. My contention is that the neglected virtues of Bretton Woods were sufficiently real to make that failure a matter of regret.

Bretton Woods worked for a while because its rules were consistent with the needs of the time and, until emergence of the dollar overvaluation, acceptable to the dominant power. Some of its rules, such as an orientation of exchange rates to medium-run objectives, could be a useful element of any return to an organized system. In other respects it is clear that the rules would have to be very different: there is no prospect of legislating a return to effective reserve constraints. But those who are shocked by the complacency with which Washington is viewing the current dollar overvaluation must agree with the political scientists Robert Keohane and Joseph Nye (1984, p. 25), as well as Cooper (pp. 1227–28), who argued that international regimes are to be sought to protect countries not only from competitive behavior by their peers, but also from their own short-sighted follies.

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