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TALES FROM THE BRETTON WOODS

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ABSTRACT

An analogy has been made between the collapse of the Bretton Woods system in 1971 and the recent Eurozone crisis. The build up of TARGET balances in the Eurosystem of Central Banks after 2007 with the GIPS (deficit countries having large liabilities) and Germany (a surplus country) with large claims is seen as similar to the rising and persistent balance of payments deficits and declining gold reserves by the United States as center country of the BWS gold dollar standard in the 1960s.

This paper argues that a better Bretton Woods analogy is between the UK which ran persistent balance of payments deficits reflecting low productivity growth and overly expansionary financial policies (an analogy to the GIPS) countries with West Germany which ran persistent balance of payments surpluses reflecting high productivity and conservative financial policies (analogous to Germany today).

However Bretton Woods is very different from the Eurozone in many dimensions. An even better analogy than BWS is a comparison of the clearing mechanism in the U.S.—The Gold Settlement account—with the Target payments mechanism for the Eurozone. In the early 1930s massive gold flows from the interior, hard hit by banking panics, to New York City were similar to the payments imbalances within the Eurozone in the recent crisis. The Federal Reserve did little to accommodate the demands for liquidity leading to a collapse of the payments system in March 1933. By contrast the build up of TARGET reflected full accommodation of the liquidity demands of the member states. TARGET represented an institutional innovation that prevented a repeat of the 1930s payments crisis.

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"Tales from the Bretton Woods"

During the recent Eurozone crisis, an analogy was made by Hans Werner Sinn and Timo Wollmershaeuser (2011) and Wilhelm Kohler (2012) between the events in Europe between 2007-2012 and the collapse of the Bretton Woods System (BWS) 1968-1971. The build up of Target balances in the Eurosystem of Central Banks after 2007 (with the GIPS countries) having large liabilities and Germany (and several other countries) with large claims is compared to the burgeoning balance of payments deficits by the United States, the center country of the Bretton Woods gold dollar standard, corresponding to growing balance of payments surpluses in Germany (and other continental countries). As reserve currency center the U.S. did not have to adjust its payments deficit. It would be settled by the issuance of dollars held as international reserves by the other countries of the system. In the face of rising U.S. inflation after 1965, growing payments imbalances and inflationary pressure on the surplus European countries, the BWS collapsed between 1971 and 1973.

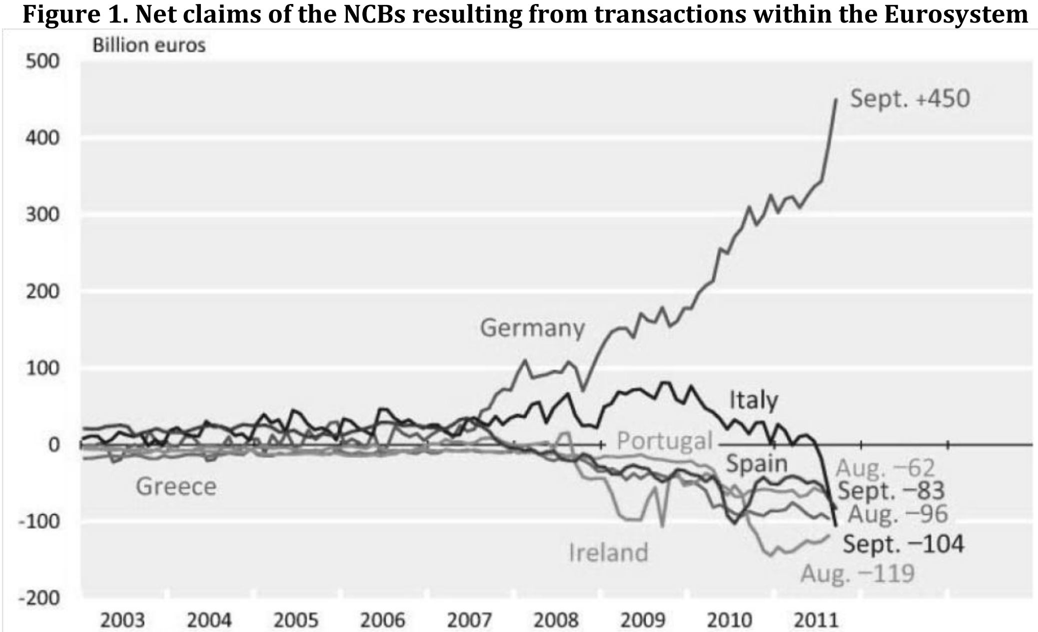
Another Bretton Woods analogy with relevance to the Eurozone's problems is between the United Kingdom, which ran persistent current account deficits, was faced with ongoing deflationary pressure and eventually had to devalue in 1967, and Germany which ran persistent current account surpluses, was faced with ongoing inflationary pressure and on two occasions was forced to revalue the DM. Which analogy is more apt? And are there other analogies which may be even more relevant?

Analogy 1. The Eurozone Crisis and the Collapse of Bretton Woods

In the European Monetary Union, the European Central Bank and the Eurosystem of National Central Banks operates a real gross time payments settlement account called TARGET (Trans-European Automated Real-Time Settlement Express Transfer). TARGET has many similarities to the U.S. Federal Reserve System's ISA (Interdistrict Settlement Accounts) which operates in the U.S. monetary union. In both systems, in normal times, net claims between different countries central banks (Fed districts) tend to cancel out. However during major crises like 2007-2012 when shocks hit unevenly across the monetary union, settlement imbalances between countries (districts) tend to build up as the central bank(s) finances the demands for liquidity.

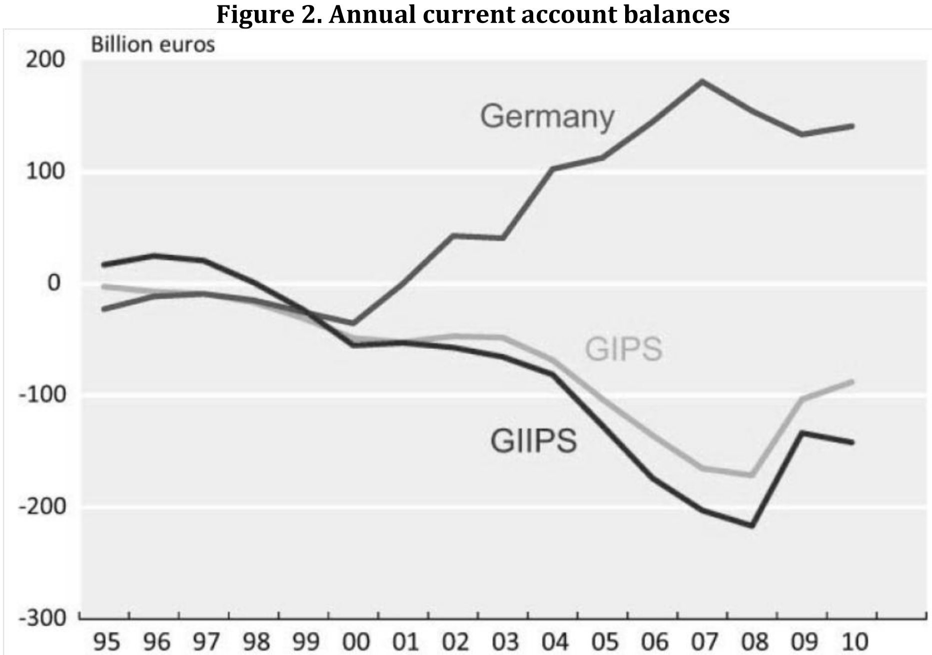
Beginning in 2007 TARGET liabilities in the peripheral countries of Europe (Greece, Ireland, Portugal, Spain) with the reversal of capital inflows and the global seizing up of interbank markets. (See Figure 1). At the same time TARGET claims on Germany (and the Netherlands) increased. This process was worsened by the Greek Sovereign Debt crisis in 2010 and similar (less dramatic) events in Portugal, Ireland, Spain and Italy. Sinn and Wollmershaeuser (2011) also show that TARGET balances are highly correlated with current account imbalances between the GIIPS countries (with deficits) and Germany (with surpluses). (See Figure 2). Sinn and Wollmershaeuser express concern that the growing TARGET imbalances pose a risk to Germany in the event of a sovereign default and exit from the euro zone. They are also concerned that the provision of TARGET liquidity would prevent the peripheral deficit countries from making the necessary structural adjustments to reduce their imbalances. They and Kohler (2012) make the analogy to the events in the final years of the Bretton Woods system when the continental European countries became increasingly reluctant to absorb the dollars that resulted from the persistent and growing U.S. balance of payments.

Figure 1. Net claims of the NCBs resulting from transactions within the Eurosystem



Source: Sinn and Wollmershaeuser (2011)

Figure 2. Annual current account balances

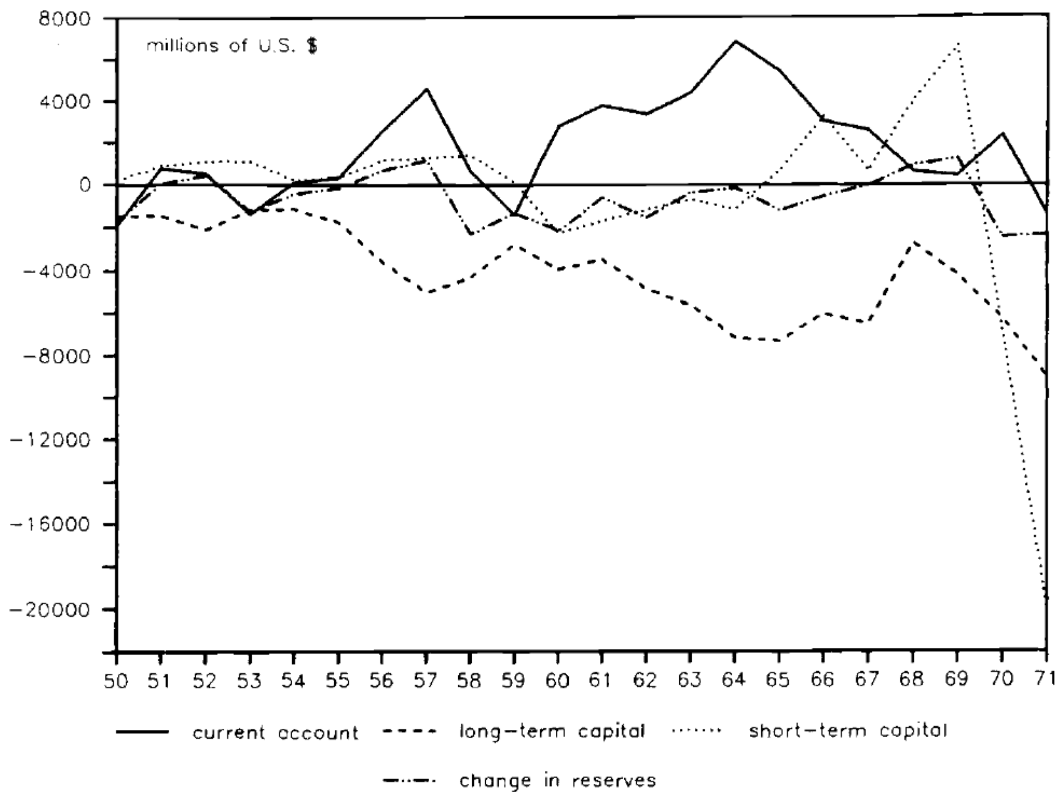


Source: Sinn and Wollmershaeuser (2011)

Under the Bretton Woods System, members would declare a par value in terms of U.S. dollars (peg their currencies). The U.S. would peg its currency to gold at the fixed price of $35 per ounce. The rest of the world would use dollars (and until 1968 pounds) as international reserves. The U.S. maintained extensive gold reserves as backing for the dollar. The Bretton Woods system also incorporated an adjustable peg whereby members could change their parities in the event of a 'fundamental disequilibrium' aka persistent structural imbalance. The BWS also prescribed capital controls.

The Bretton Woods System became fully operative in December 1958 when many European countries declared current account convertibility. As time elapsed, it evolved into a gold dollar fixed exchange rate system which embodied an asymmetric adjustment mechanism under which the U.S. did not need to adjust to a balance of payments deficit by contracting aggregate demand. The deficit would be financed by dollar outflows to be absorbed as international reserves by surplus countries. The U.S. had official settlement balance of payments deficits from 1958 until the end of Bretton Woods (with the exception of 1968). (See figure 3). With the exception of 1959 the U.S. had a current account surplus until 1970. The balance of payments deficit arose because capital inflows exceeded the current account surplus (Bordo 1993).

Figure 3. Balance of Payments, United States, 1950-1971

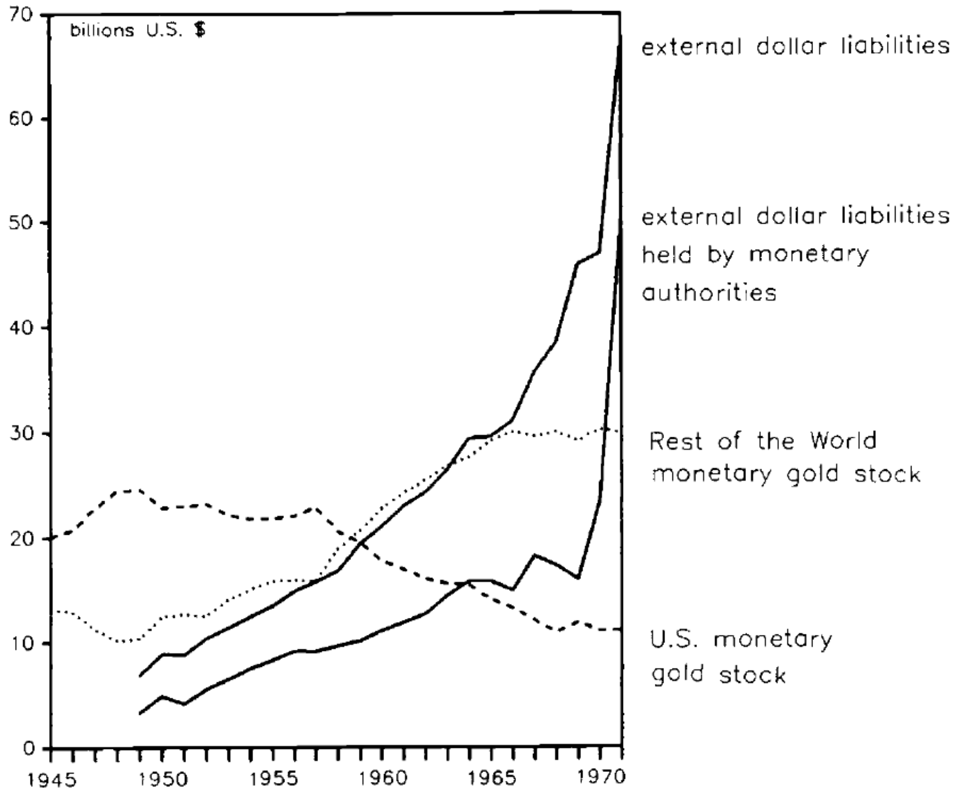


Source: Bordo (1993)

The balance of payments deficit was perceived as a problem by the U.S. monetary authorities because of the effect on confidence. As official dollar liabilities held abroad increased with successive deficits the likelihood would increase that dollars would be converted into gold and the U.S. monetary gold stock would reach a point low enough to trigger a run. By 1959 the U.S. monetary gold stock equaled total external dollar liabilities and the monetary gold stock in the rest of the world exceeded the U.S. monetary gold stock. By 1964 official dollar liabilities held by foreign monetary authorities exceeded the U.S. monetary gold stock. (See figure 4). A second reason the U.S. balance of payments deficit was perceived as a problem was the dollar's role in providing liquidity to the rest of the world. Eliminating the U.S. deficit would create a worldwide liquidity shortage (Triffin 1960).

Figure 4. Monetary Gold and Dollar Holdings, the United States

and the Rest of the World, 1945-1971



Source: Bordo (1993)

For the Europeans, the U.S. balance of payments deficit was a problem because, as the reserve center country, the U.S. did not have to adjust its domestic economy to the balance of payments. As a matter of routine, the Fed automatically sterilized its dollar outflows. The Europeans resented the asymmetric adjustment. The Germans viewed the U.S. as exporting inflation to the surplus countries through its deficits. They wanted the U.S. to pursue contractionary monetary and fiscal policies. The French (Charles DeGaulle) resented U.S. financial dominance and the seigniorage earned on outstanding liabilities. In 1965 acting on this perception, France began systematically converting its outstanding dollar liabilities into gold (Bordo, Simard and White 1996).

The policy response to the growing deficit by the U.S. monetary authorities included; controls on capital exports; measures to improve the balance of trade; altering the monetary fiscal mix (Operation Twist); instituting measures to stem conversion of outstanding dollars into gold (the Gold Pool).

The Bretton Woods system collapsed after 1968 in the face of rising U.S. inflation driven by expansionary monetary and fiscal policies (financing the war in Vietnam and the Great Society). U.S. inflation was transmitted abroad by the classical price specie flow mechanism augmented by capital flows (Bordo 1993 p. 77). As dollar reserves accumulated in Germany and other continental countries and Japan, they were sterilized to prevent the domestic money supply rising, leading to inflation. As the process continued it became increasingly difficult to sterilize the reserve inflows leading to a dramatic increase in money and inflation. The only alternative to importing U.S. inflation for Germany and the other surplus countries was to float, which they did in 1971. The collapse of the system began in August 1971 when France and the U.K. signaled their intention to convert their dollar assets into gold leading President Nixon to close the gold window on August 15.

Analogy 2: Persistent Imbalances Within the Bretton Woods System

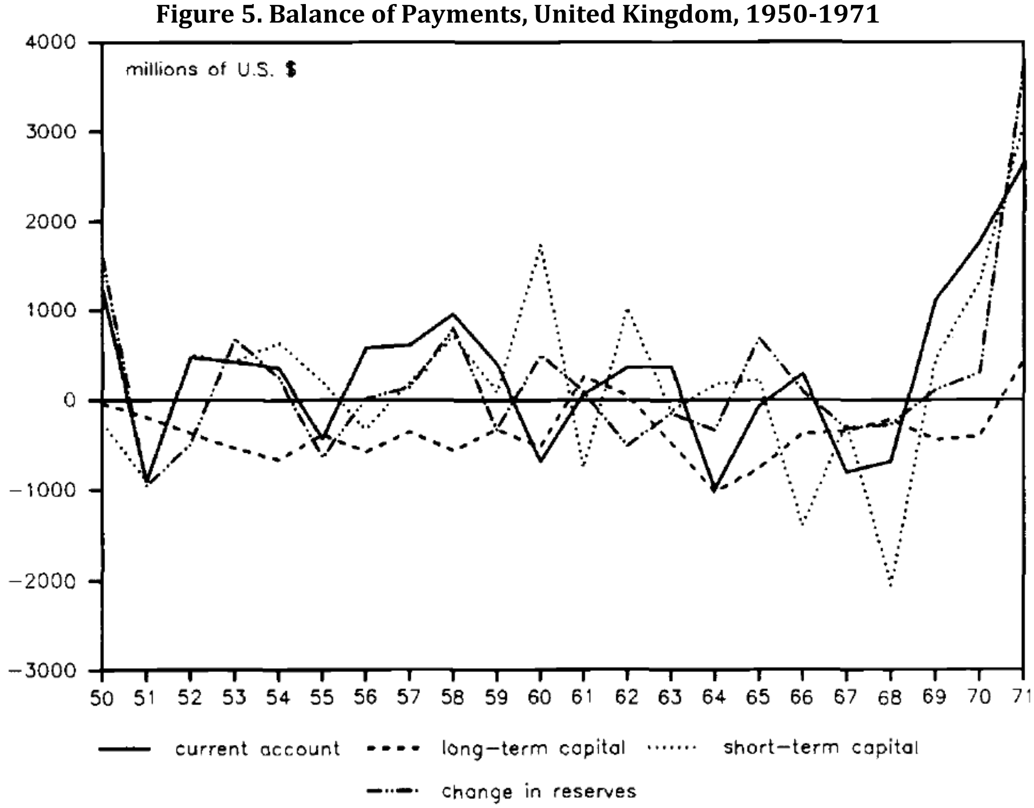
In addition to the imbalance between the U.S. and the rest of the world emphasized by Sinn and Wollmershaeuser (2011) and Kohler (2012), another Bretton Woods imbalance has important relevance to the ongoing problems of the Eurozone. It was between major European countries prone to persistent deficits (eg the U.K.) and countries prone to surpluses (eg Germany). This reflected significant fundamental structural and policy differences between countries. The U.K. had a lower underlying productivity and real growth rate and tended to follow expansionary monetary and fiscal policies to maintain full employment. . Its exchange rate was persistently overvalued. Germany had faster productivity and real growth and a 'stability culture' which deplored excessive monetary growth and inflation. The D mark was persistently undervalued.

The UK 1959 to 1967

Between 1959 and 1967 the UK alternated between expansionary monetary and fiscal policy designed to maintain full employment and encourage growth, and austerity programs when a balance of payments crisis threatened—a policy referred to as stop-go. Expansionary monetary policy and rapid growth in 1959 led to a current account deficit in 1960 and a crisis in 1961, resolved by a $ 1.5 million standby from the IMF and austerity (See figure 5). The balance of payments improved and was followed by an expansionary policy in 1962-63. By 1964 the current account deteriorated and international reserves declined. The incoming Labour government refused to devalue, imposed an import surcharge in October

1964 and kept expansionary financial policy. The balance of payments again deteriorated, reserves dropped followed by a speculative attack on sterling and a $ 4 billion dollar rescue package by the G10 and the IMF. Expansionary policy continued through 1966 and pressure on sterling led to a massive austerity package in July 1966 and assistance from the Federal Reserve. The stop-go pattern continued until a massive deterioration in the balance of payments in the summer of 1967 led to a $ 3 billion rescue package. It was insufficient to stop the pressure on sterling until a devaluation of 14.3% was announced in November 1967. That action was the beginning of the end of sterling's role as a reserve currency.

Figure 5. Balance of Payments, United Kingdom, 1950-1971

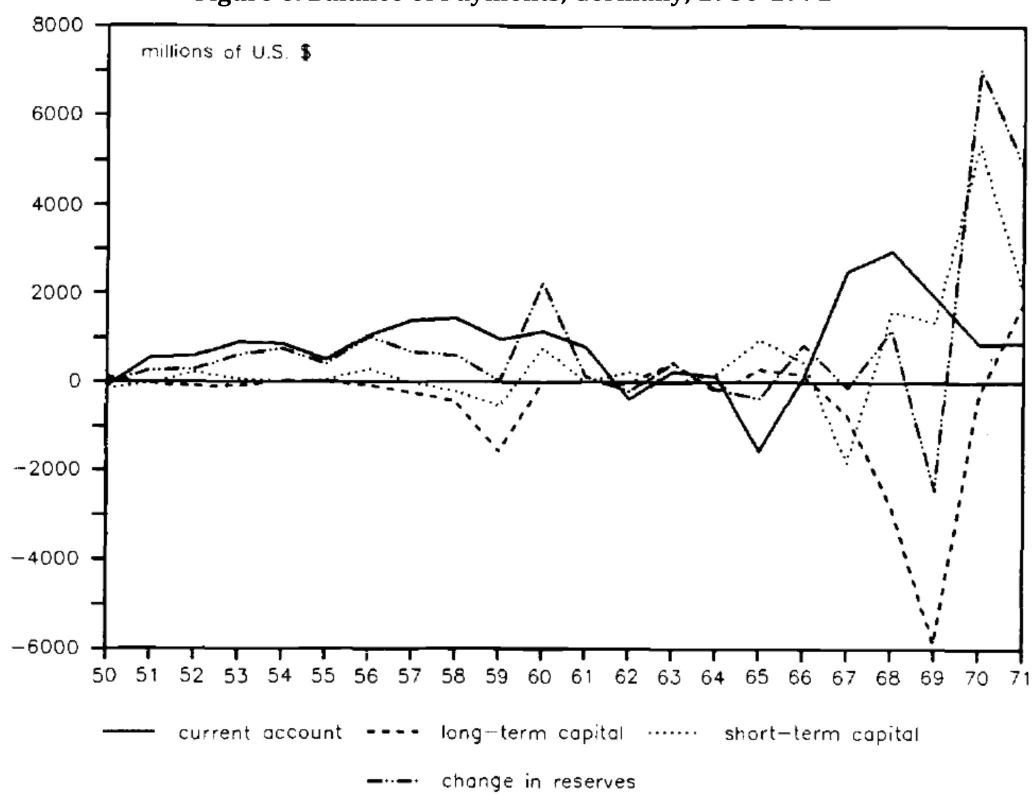


Source: Bordo (1993)

Germany 1959 to 1968

West Germany ran persistent balance of payment surpluses and had opposite problems to the U.K. It had rapid growth in real output and exports and a lower underlying rate of inflation. This led to a series of current account surpluses and reserve inflows throughout the 1950s. Concern over the inflationary consequences of balance of payments surpluses led the German monetary authorities to tighten monetary policy and institute measures to prevent capital inflows: a prohibition of interest payments on foreign deposits and discriminatory reserve requirements on foreign deposits (Bordo 1993 page 54).

Figure 6. Balance of Payments, Germany, 1950-1971



Source: Bordo (1993)

Tight monetary policy led to recession and further reserve inflows in 1960. In 1961 the Dmark was revalued by 5%. With the exception of two years, 1962 and 1965, the current account was in surplus until the end of 1965. The package of tight money and capital controls was repeated in 1964, 1966 and 1968. Opposition to further revaluation, largely by exporters, increased throughout the 1960s. Thus Germany resisted adjustment during Bretton Woods. The German monetary authorities believed that the key problem of the international monetary system was inflation imported from abroad. This was the case at the end of the 1960s but not before.

Some Lessons

The UK, German story is an important analogy for the eurozone's ongoing problems. The periphery Eurozone countries, like the UK in the 1960s have had lower productivity and real growth, higher inflation and overall uncompetitiveness compared to the core countries of Western Europe. This has led to a build up of imbalances in the Eurozone—current account deficits in the periphery and surpluses in the core. This is a classic case of maladjustment. But, unlike under Bretton Woods, the Eurozone countries with imbalances can not adjust their exchange rates and nominal and structural rigidities have impeded real adjustment. Nor can a one size fits all monetary policy be very effective in a monetary union with such large real imbalances and rigidities. Hence in the absence of a fiscal union the periphery has needed to adjust by internal devaluation. The global financial crisis of 2007-2008 exacerbated the dilemma. Ongoing recession and expansionary fiscal policy (and a housing bust in Ireland and Spain) created a debt crisis and a banking crisis in the periphery.

Which Bretton Woods Analogy is More Relevant?

The Bretton Woods System was an adjustable peg international monetary system with member countries having independent monetary and fiscal policies. It also had restrictions on capital flows. By contrast, the Eurozone is a monetary union with perfectly fixed exchange rates with no option for adjustment. Members do not have access to monetary policy as a palliative and capital is freely mobile.

Under Bretton Woods the adjustable peg allowed some adjustment between deficit and surplus countries and independent monetary and fiscal policies, the IMF and capital controls gave members with imbalances some temporary respite. For the U.S. as reserve center country, devaluation would require raising the price of gold (as advocated by France). This was strongly resisted by the US on the grounds that it would be time inconsistent and would benefit the pariah states USSR and South Africa. As it turned out, ending the system was the only way out.

The Eurozone is not a pegged exchange rate system nor is one member's currency used as a reserve currency. The Maastricht Treaty abolished members' currencies and created a new currency, the euro, and a new common central bank, the ECB. The escape valve of the Bretton Woods adjustable peg is not present. Moreover unlike national monetary unions like the United States the Eurozone does not have a fiscal union or a Eurobond to facilitate adjustment.

But a more important difference between the Bretton Woods breakdown analogy and the crisis in the Eurozone is the existence of a payments clearing mechanism, the TARGET system and the Eurosystem of national central banks and the ECB. In the Eurosystem a key mandate is a uniform currency across the Eurozone – that a euro always be worth the same in every member country (Cour Thimann 2012). Thus under TARGET, country imbalances are financed by access to the liquidity facilities of the Eurosystem of national central banks using the ECB as a clearing platform.

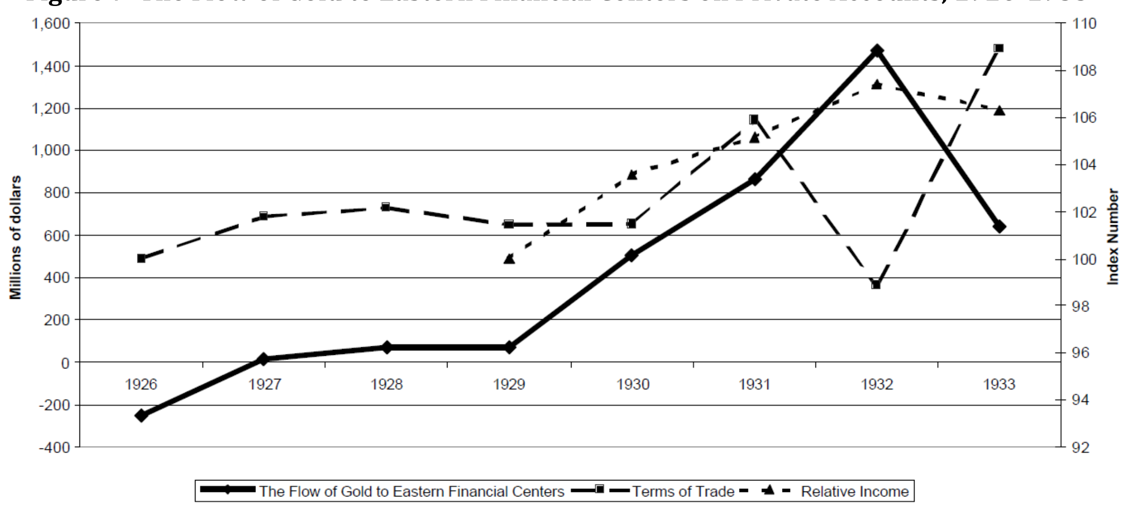
What happened in the Eurozone after 2007 is that the TARGET liabilities in the periphery (and the TARGET claims in the core) built up because the ECB acted to prevent the breakdown of the payments system after the interbank market collapsed and private capital flows disappeared (Cour Thimann 2013). Indeed , before 2008, most flows between countries in the Eurozone were intermediated by banks. After that the interbank market dried up and national regulators started treating banks as legally separate entities even when they were part of a euro wide banking group. So what was previously a Eurowide banking system became fragmented. TARGET substituted for the Euro banking system. The Federal Reserve performed the same function in the 2007-2008 crisis in the U.S. but unlike Europe the big banks still transferred money across the country.

Bretton Woods did not have an international central bank to act as a clearing mechanism as Keynes wanted with his International Clearing Union. If it did perhaps the outcome would have been different. Clearly the Bretton Woods breakdown analogy(1) is less relevant than the persistent imbalances between countries analogy(2).

<u>An Alternative to the Bretton Woods Analogy: The Payments Crisis in the US in the Great Depression</u>

An alternative and perhaps more appealing analogy to the TARGET imbalances in the Eurozone than Bretton Woods is the breakdown of the payments mechanism in the US during the Great Depression. The Federal Reserve System established in 1914 had a clearing mechanism between the member Reserve banks called the Gold Settlement Fund. The Fund recorded the flow of funds among Federal Reserve districts. There was also considerable inter district borrowing (James 2013). During the Great Contraction 1929-33 there were massive gold flows between regions (See figure 7). This reflected a substantial drain of gold from the interior southern and western regions hardest hit by the successive banking panics which closed thousands of small unit banks, to the safety of the Eastern money centers, especially New York (Rockoff 2004).

Figure 7. The Flow of Gold to Eastern Financial Centers on Private Accounts, 1926-1933



Source: Rockoff (2004)

Unlike in the recent financial crisis in Europe and the U.S., the Fed did much less to accommodate the demands for liquidity. By the fall of 1932, the breakdown of the payments system was so widespread that many of the U.S. states declared banking holidays to prevent depositors from making withdrawals from their bank accounts.

Banking holidays spread from state to state as the authorities in neighboring states tried to prevent depositors who could not get cash in one state turn to banks in neighboring states, The contagion culminated with Franklin Delano Roosevelt , right after he was inaugurated as President in March 1933, declaring a nationwide banking holiday which effectively ended the panic (Friedman and Schwartz 1963). Thus the build up of TARGET balances in the Eurozone since 2007 rather than being a signal for the collapse of EMU, as was the case for Bretton Woods 1968 to 1971, was an institutional innovation that prevented a repeat of 1933.

Conclusion

Hans Werner Sinn and Timo Wollmershaeuser (2011) have made the analogy between the collapse of the Bretton Woods System in 1971 and the recent Eurozone crisis. The build up of TARGET balances in the Eurosystem of Central Banks after 2007 with the GIPS (deficit) countries having large liabilities and Germany (a surplus country) with large claims is seen as similar to the rising and persistent balance of payments deficits and declining gold reserves by the United States as center country of the BWS gold dollar standard in the 1960s.

This paper argues that better analogies can be made. One analogy from the history of Bretton Woods is a comparison of the experience of the United Kingdom which ran persistent payments deficits reflecting low productivity growth and overly expansionary financial policies (an analogy to the GIPS countries) with Germany which ran persistent balance of payments surpluses reflecting high productivity and conservative financial policies(analogous to Germany today).

However Bretton Woods is very different from the Eurozone because member countries central banks could use their tools of domestic monetary policy, the exchange rate was an adjustable peg and they had access to the IMF's resources when a crisis loomed. By contrast the Eurozone has perfectly rigid exchange rates among its members, monetary policy is determined for the Eurozone as a whole by the European Central Bank and, before 2010 the members were discouraged from accessing the IMF nor was there a European equivalent. Thus the BWS is not a particularly good analogy for today.

A better analogy than BWS is a comparison of the clearing mechanism in the U.S. during the Great Contraction of 1929-1933 with the TARGET payments mechanism for the Eurozone. The Federal Reserve System had the Gold Settlement Account which recorded flows of funds between the twelve Federal Reserve Districts. In the early 1930s massive gold flows went from the interior South and West, which were hard hit by massive bank failures, to the East coast money center banks. These flows were similar to the payments imbalances within the Eurozone in the recent crisis. Moreover the Federal Reserve did little to accommodate the demands for liquidity leading to a full breakdown of the payments system in March 1933. By contrast the build up of TARGET balances in the Eurozone Crisis reflected full accommodation of the liquidity demands of the member states. TARGET represented an institutional innovation that prevented a repeat of the 1930s payments crisis.

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