

## 5. Why Bretton Woods failed

*The Bretton Woods system of fixed exchange rates, created in 1944, was designed to bring stability to currency markets. Major currencies were fixed to the US dollar, which meant that other countries essentially adopted US inflation rates. The system broke down in the early 1970s. You have differing ideas about the system's successes and failures.*

**Milton Friedman:** Another example of a similar difference in judgement is with respect to Bob's comment, "I believe that larger countries can have a hard fix without establishing a currency board system or monetary union, and I would say that the Bretton Woods arrangements proved that." Hardly. There were repeated revaluations and devaluations under the Bretton Woods arrangement, and a number of severe international crises involving "larger countries." Had Bretton Woods behaved as well as Bob suggests, it never would have collapsed as it did in the early 1970s.

**Robert Mundell:** I agree that the Bretton Woods arrangements were not perfect, in large part because countries did not follow the rules of adjustment. The important reserve countries like Britain and the United States automatically sterilized reserve losses, throw-

ing the burden of adjustment onto other countries. But what was wrong with the experience of large countries like Germany and Japan with fixed exchange rates coupled with a monetary policy that kept their balances of payments in equilibrium? Over this period, which included Japan's "sudden economic rise" between 1955 and the 1970s, Japan had the longest period of two-digit growth in its or any other country's history.

Germany had its own "Erhard" miracle. Smaller countries like Italy, Austria and Mexico that had fixed exchange rates lasting over 20 years, enjoyed rapid growth, high employment and the same price stability as the United States. The period from 1950 to 1970 was a great period in the history of most of Western Europe and Japan. The United States, encumbered with punitive tax rates inherited from the war, was less fortunate, yet even so, the period 1950 to 1973 was better than the decade that followed it, despite the Korean and Vietnam Wars.

Some countries did get into trouble. Countries that did not obey the rules of a fixed exchange rate system had problems. Britain disobeyed the rules with its automatic sterilization of any change in reserves and its intermittent flirting with Keynesian policies. Dozens of developing countries

had problems because they tried to use the inflation tax as an instrument for financing economic development. Countries that break the economic laws required for stability should and did have problems. France had big problems in the 1950s, but after 1958 got its balance-of-payments mechanism working again under the influence of Jacques Rueff, General de Gaulle's economic adviser.

The Bretton Woods Arrangements did break down. But why? There were two main reasons. One was that the price of gold, set by President Roosevelt at \$35 per ounce in 1934, had become obsolete, after the inflations of the Second World War, the Korean War and the Vietnam War. All other prices had more than doubled and gold had become undervalued, creating speculation in its favour that led to vast withdrawals by foreign central banks. For political reasons—the two biggest producers were South Africa, with its noxious policy of apartheid, and the Soviet Union, the enemy of the West in the Cold War, along with the fact that US credibility was at stake—the US rejected the Bretton Woods solution provided for in the *IMF Articles of Agreement*, namely a universal reduction in the par value of currencies, putting up the price of gold. So, after losing more than half of its post-war gold stock,

## THE CHICAGO SCHOOL IN THE 1960s

Rudi Dornbusch

Chicago in the 60s, no doubt, offered one of the great times in economics; maybe Keynes was the center of a great moment in economics, but the time we had in Chicago is hard to match. Robert Mundell and Milton Friedman were very much at the centre of it, as were George Stigler, Harry G. Johnson, Al Harberger and more. There was the "oral tradition" and there were the "workshops," the formidable feeling for students and faculty alike of a revolution in the mak-

ing. The great issue of the day was just how the economy works and what role government must play, if any, and what role monetary policy must definitely not be allowed to play. This is when Keynes died—actually he was long dead by then but his powerful ideas were fully there and had just animated the great Kennedy-Johnson expansion—and the resulting inflation. Monetarism was born in the midst, and in reaction, to the wave of inflation of the time. This was when "Chicago Boys" were made, a derogatory term at the time but rather a brand name by now. Note Mexico's new finance minister, Francisco Gil Diaz, another Chicago boy trained just in

those special years in the late 60s.

Chicago economics was built on two pillars: price theory and monetary theory. Price theory was about resource allocation, how markets work, how government for good reasons (patronage or capture by business interests) misallocates resources to create rents for themselves or their clientele, how competition tends to be the rule, how ultimately all and everything revolves around incentives and economic responses, from crime and love to corruption and trade restrictions. In Chicago, complex problems had simple answers—easy to understand wrong answers, the enemies would say. >>

when important countries asked to convert dollars into gold, the United States said no, and the gold window was closed.

The closing of the gold window did not have to break up the system. The other countries could have continued to fix their currencies to the dollar. But there was a basic difference between the United States and Europe over the common rate of inflation. Partly to ease the financing of the Vietnam War, the United States wanted—and imposed on the rest of the world—a higher rate of inflation than was optimal for Europe. It was a hard choice for Europe: the Economic Community had, since the Hague Summit in 1969, already set out on its path to monetary union. Going on to flexible exchange rates would sacrifice the valuable convergence with one another their economies had achieved around the fixed dollar. But, in the end, the countries floated, partly because they thought (mistakenly) it would teach the US a lesson.

The breakdown of the Bretton Woods arrangements was therefore caused by 1. the undervaluation of the gold anchor; and 2. a difference between the inflation objectives of the United States and Europe. But the breakdown was by no means necessary. Had the US followed a tighter policy, not allowing its inflation rate

to increase in the late 1960s and early 1970s, or if Europe had been willing to accept a somewhat higher rate of inflation (but not nearly as high as they had after they floated!), the system could have been held together.

Beneath all this was a simmering dispute between Europe and the United States, based on French resentment against the asymmetrical dollar system and the Vietnam War, the inflation tax involved in holding excess dollar reserves, and a power struggle in which Europe was trying to free itself from its “quasi-colonial” status with respect to the United States.

**Milton Friedman:** In response to my brief comment on Bretton Woods, Bob Mundell granted that “Some countries did get into trouble” and that “The Bretton Woods Arrangements did break down.” However, he ends up saying, “Had the US followed a tighter policy, not allowing its inflation rate to increase in the late 1960s and early 1970s, or if Europe had been willing to accept a somewhat higher rate of inflation (but not nearly as high as they had after they floated!), the system could have been held together.”

His comment reminds me of Gottfried Haberler’s famous response to a similar “if” statement: “If my aunt had wheels, she would be a bus.” Any proposed policy—or past policy—must be judged in terms of how it will in

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fact operate, not how it might operate under ideal conditions. Bob’s excellent analysis of the breakdown of Bretton Woods shows that the factors that led to its demise were not accidental defects in the policies followed by the various countries, but important political and economic forces.

More important, the countries acted in the way they did, a way that proved fatal to Bretton Woods, in part because of the incentives Bretton Woods itself established. For example, take Bob comments, “Some countries did get into trouble. Countries that did not obey the rules of a fixed exchange rate system had problems. Britain disobeyed the rules with its automatic sterilization of any change in reserves and its intermittent flirting with Keynesian policies. Dozens of developing countries had problems because

The second pillar of the oral tradition was monetary theory, a formidably sophisticated and deep excursion in why there is money, how it works and how it can be destroyed. Anyone who sat through Friedman’s lectures emerged with an altogether profound respect for the proposition that tinkering with the quality of money is profoundly destructive of economic life and, indeed, society. This is where people learnt that stable prices promote long horizons, that monetary instability promotes economic misallocation.

Even though the ideology was patently free market economics, politics was really not to be seen. I might be

contradicted by those who note that during the 1968 campus riots, the department continued lectures as if the outside world had not stopped. I remember vividly demonstrators entering Friedman’s class only to be told that they were interfering with the freedom and choice to learn; moreover, not having registered they were not even free to stay quietly. In hindsight amazingly, the protesters left and our insular clique went on experiencing the quantity theory of money.

Beyond the classes, with a formidably competitive and merciless decimation of class size, one proceeded to the “workshops” where the real action was.

Here students and faculty presented their work in progress and submitted to the unrelenting bombardment of the workshop members. Yes, there were double standards; there was some kindness to students who made their first attempts; there was no mercy at all among the faculty; there was absolutely no mercy for junior professors who were plain beaten up. If they survived, there was nothing more to shock them or throw them off course.

Mundell and Friedman could not have been more different. They continue to be revered by their students but with starkly different memories. Milton one remembers for his >>

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they tried to use the inflation tax as an instrument for financing economic development." Agreed, but these countries were induced to behave as they did because under a fixed exchange rate system, a country that overexpands can benefit by imposing costs on the other members of the system. The initial gain to a country, developing or developed, from expanding its money supply is greater if other countries in the system will accept its currency, at least for a time, at an unchanging rate. Postponing the evil day is a strong incentive to an embattled politician. Bretton Woods carried within it the seeds of its own destruction.

I have long argued that a major

advantage of flexible exchange rates is that they mean that a country will bear fully the benefits and the costs of its own monetary policies. A mistake in monetary policy will not directly affect its trading partners—though, of course, it will affect them indirectly as it reduces the attractiveness of the initial country as a trading partner or locus of investment. This feature is important economically, but it is also important politically, since it reduces the occasion for political conflict.

Bob and my disagreement about the euro is identical with our disagreement about Bretton Woods. The euro encompasses 11 politically independent countries, differing in culture, resources and economic development, and subject to divergent influences. There are bound to develop among them differences about appropriate monetary, fiscal and other policies. Flexible exchange rates offered a way of adjusting to such differences through the market without political conflict. The euro closes that possibility. Bob is confident that other adjustment mechanisms will rapidly develop—greater internal flexibility in prices, regulations, and the like. I hope he is right, but I fear he may not be. If he turns out not to be, the euro will generate more political conflict, not political unity.

unbelievably baggy brown suits (from East Germany I surmise), his incisive uncompromising mind and a sweet smile going along with "what you really mean to say ..." Bob Mundell, by contrast favored a continental appearance and demeanor, his Canadian background notwithstanding. His mind looked for paradigms and always it was about upstaging received wisdom, challenging dogma, being the *enfant terrible* that he still is. Friedman's workshop was molded on his own principles of rules and responsibilities, no exceptions. Everybody present had to present a paper, no spectators. Everybody had to read the paper ahead of time (i.e. there was a paper) and discussion would pro-

ceed page by page. Friedman ruled, the rest mostly trembled or slurped the biblical pronouncement. The international workshop of Mundell and Harry Johnson was quite the opposite; often there were no papers and even when there was something, Mundell's tendency for going off course to his latest ideas easily penetrated; order was discouraged, speculation was at a premium. Harry Johnson would carve little animals from wood and occasionally pronounce, Mundell was unstoppable and Socratic. He never, never in the time I saw him in Chicago answered any question other than with another question. He always held that what was already on paper was too stale to look at or talk about,

## 6. The Gold Standard

*At various times, both of you have expressed views on gold (or some other commodity base) as a national or global currency standard. What are your current views?*

**Robert Mundell:** The gold and silver standards of the past were means by which countries could share a common currency (or metallic backing for a currency) without political integration. The silver, gold and bimetallic standards gave the world a kind of monetary unity even though the European empires were frequently at loggerheads with one another. And it kept inflation within bounds, completely in contrast with the paper currency inflations of the 20th century.

Silver was gradually eased out of the system (for not very good reasons!) in the 1870s and gold became the dominant monetary metal. What killed the gold standard? Charles Rist, the French economist and central banker, once said that "democracy killed the gold standard." He meant by this that democracy led to drastically inflated expectations of what government could do for people and led to increased government spending and budget deficits that often had to be

what was just in the making was the challenge. That was not easy for the paper presenter. Michael Mussa, probably the most brilliant of the group and today chief economist at the IMF, came close to strangling Mundell (at least in his mind). What did it do for us? The most extraordinary learning experience, questioning established truth, learning to think through a proposition, getting a view of the economy in our head with which to think on our feet.

Mundell and Friedman ran very different schools. For Friedman open economy was a short topic: flexible exchange rates—fully flexible—and free trade. What else was there to say? For Mundell it was, rightly, hard to >>

financed by money creation. This was an important insight, but I believe it does not put the finger on another problem.

The other problem was the change in the power configuration of countries. The gold standard was a decentralized monetary system that could work as long as it was not controlled by a single power. But with the creation of the Federal Reserve System in 1913, a central bank for the economy that was already before the First World War several times larger than any other economy, the future of the gold standard became dependent on the policies of the Federal Reserve System. The United States killed the gold standard. I wrote about this in more detail in my Nobel Prize Lecture published in the *American Economic Review* in June, 2000 [available at <http://www.columbia.edu/~ram15/nobelLecture.html>].

How can gold be used in the current system? If it were stable or could be made stable against commodities, it would once again make a fine universal unit of account and means of payment for the world economy. But I am skeptical that governments would want to reinstate a gold standard or that they would not screw it up if it were reinstated. So I would as an alternative prefer that it became a non-gov-

ernmental unit of account and means of payment for ordinary transactions and the Internet. It would then serve as a check on inflationary governments.

**Milton Friedman:** My views remain those I expressed in 1962 in *Capitalism and Freedom*: "My conclusion is that an automatic commodity standard is neither a feasible nor a desirable solution to the problem of establishing monetary arrangements for a free society. It is not desirable because it would involve a large cost in the form of resources used to produce the monetary commodity. It is not feasible because the mythology and beliefs required to make it effective do not exist." (p. 42)

In the 19th century, when gold or silver standards or bimetallic standards were common, governments were spending about 10 per cent of the national income and exerting little control over the economy. The public took for granted that gold or silver was the "real" money and were willing to accept the costs of adjusting to inflows or outflows of gold. The gold standard produced long term relative stability in prices at the cost of a great deal of short term instability.

Whatever may be the verdict on the gold standard for that period, the situation is very different today.

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Governments are spending 40 per cent or more of the national income and are intervening extensively in the economy. The public now takes it for granted that a central bank, not an amount of gold, is responsible for the quantity of money. No major country would tolerate the discipline of a real, effective gold standard.

For the United States, I have long believed that the policies of government storage of wheat and gold are equally illogical, and that the government should get out of the storage business for both and for other commodities as well. For gold, I have proposed that the government commit itself to auctioning off one-fifth of its stock in each of the next five years.

understand how Friedman could talk about monetary policy in a closed economy as if there were such a thing. As time went on and the world moved to flexible rates, Mundell increasingly favored fixed rates, monetary areas, a world money. He always knew that fashions move in a circle so now his view is back to full chic.

Every so often there was a gladiator event, a workshop where for some reason faculty from different areas got together and got at each other. Mundell vs. Friedman were special events. Friedman obviously admired the sheer creativity of Mundell but would not let him get by, sparks would fly. Mundell recognized Friedman as an icon but understood that he could play the bad

boy with success. I remember the unspeakable from Mundell: "Milton, the trouble with you is you lack common sense". Both won the argument, we could not choose. But even so, each had their cohort and the cohort would imitate the master in style and speech and mannerisms. It must have been peculiar for anyone looking in, maybe that is why it was called the Chicago School.

And then there was the day when Mundell presented to a full-full house his new theory of the policy mix—monetary policy for price stability, fiscal policy for supply-side growth. Suffice it to say that this a very noisy afternoon.

In the Italian city of Siena those born inside the city walls think them-

selves the true Sieneese, born *sulle pietre*, unlike those from the surroundings, born *sulla terra*. Much the same goes for Chicago economists; having vaguely right-wing tendencies does not make for not having been there and being part of a great experience. These were formidable years for economics, they have changed the way our profession today thinks about money and the world economy. Two Nobel laureates later, with independent central banks, flexible exchange rates, low inflation and "new economics" what was done there has helped change the world.

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