This is the fourth in our series of articles commemorating the fortieth anniversary of the Bretton Woods conference. Edward Bernstein is eminently qualified to write on this topic. He was a participant at Bretton Woods as a member of the U.S. delegation, after having played a leading role in the technical elaboration of the White Plan—the U.S. proposal for the Fund—as Assistant Director of Monetary Research at the U.S. Treasury. In 1946, he became the Director of the Fund's Research Department, a post he held for 12 years. As architect and builder, he had a profound influence on the institution and its staff in the formative years. After leaving the Fund in 1958, he established the consulting firm of EMB Ltd. and became its President. Among many other activities, he was Chairman of the U.S. government-appointed Review Commission for Balance of Payments Statistics and a member of the U.S. Advisory Committee on International Monetary Arrangements. Since 1982, he has been a guest scholar at the Brookings Institution. In this essay, he addresses a question that has been on the minds of many in recent years.

Do we need a new Bretton Woods?

Edward M. Bernstein

The international economic situation has deteriorated seriously in the past three years. The worldwide recession, from which most of the large industrial countries are only now emerging, was the most severe since the 1930s. The dollar value of world trade fell in 1981, 1982, and 1983, although it has recovered in 1984. Capital flows, on the other hand, have increased sharply, in considerable part to the United States. As a consequence, from mid-1980 to the end of 1983, the foreign exchange value of the dollar rose by an average of more than 60 percent relative to the other currencies of the Group of Ten and Switzerland, weighted by their global exports in 1977–1979.

These vast changes have had a very disruptive effect on international payments. The greatest adverse effect has been on the developing countries that are not members of the Organization of Petroleum Exporting Countries. Their trade deficit increased sharply in 1980–81, although it was reduced in 1982–83 through a severe restriction of imports. The difficulty they had in holding down their trade deficit was largely due to the sharp fall in the prices of their exports. From mid-1980 to late 1982, the Fund index of dollar prices of basic commodities, excluding gold and petroleum, fell by 32 percent. About half of the fall was due to the recession and the rest to the appreciation of the dollar. The adverse effect on their balance on current account was aggravated by the sharp rise in interest rates on their huge foreign debt. Several of the largest debtor countries found it necessary to arrange for rescheduling payments of principal and needed new credits to pay the accruing interest.

An international banking crisis has been averted with the help of the Fund, although the situation remains serious. To cope with their payments difficulties, the heavily indebted developing countries have adopted more cautious fiscal and monetary policies, limited wage increases, and reduced domestic consumption and investment. Even with these draconian measures, their payments position remains tenuous and they will continue to need new credits from abroad to pay for essential imports. The solution to their payments problems depends not only on the austere measures they have adopted but also on an increase in their export earnings and a reduction in interest rates. Fortunately, the recovery in the industrial countries has been accompanied by an increase in exports of the non-oil developing countries and an improvement in the prices of basic commodities. On the other hand, interest rates rose again in 1984.

The industrial countries have also been affected by the events of the past few years. Their trade balance deteriorated sharply in 1979 and 1980 because of the huge increase in the price of oil. Since then, the trade balance of most industrial countries has improved considerably as the recession reduced their imports, particularly of petroleum and petroleum products. In the United States, however, the trade deficit rose moderately in 1981, considerably in 1982, and sharply in 1983 and so far in 1984. This reflected the earlier U.S. recovery from the recession, the larger proportion of its exports to Latin America, and the huge appreciation of the dollar. The U.S. current account, however, was in surplus in 1980 and 1981, but shifted to a large deficit in 1982 and a huge one in 1983 and so far in 1984. The current account deficit was financed by an equally large net inflow of capital that caused the foreign exchange value of the dollar to rise in spite of the soaring deficit.

The appreciation of the dollar had a disturbing effect on the economic situation of other countries. In the United States, monetary policy was kept very tight until the third quarter of 1982 and interest rates rose to unprecedented levels. The purpose was to slow the inflation of prices and costs. This objective was achieved, although at the cost of a severe recession. Interest rates came down in late 1982 and early 1983, but they rose again in 1984 and are now very high. The appreciation of the dollar was helpful to the price-competitive position of other industrial countries in world trade, although it placed upward pressure on prices in their national currencies. Most industrial countries were more concerned about the adverse effect on inflation than the favorable effect on trade of the depreciation of their currencies relative to the dollar. For this reason, they followed the United States in tightening their monetary policies and letting their interest rates rise. This did not prevent their currencies from depreciating against the dollar, but it did slow their inflation. Unfortunately, these policies contributed to the spread of the recession from which the world economy has begun to recover.

The present economic and monetary difficulties are the culmination of ten years during which the world economy suffered numerous shocks and the international monetary system had to cope with wide fluctuations in exchange rates. The view that floating exchange rates give countries greater freedom in formulating fiscal and monetary policies has proved to be a delusion. Instead, countries have felt impelled to take measures not required by domestic economic conditions solely for the purpose of minimizing the disruptive effects of excessive fluctuations in exchange rates—that is, variations that were greater than required by changes in underlying economic conditions. These exchange and payments problems cannot be solved by countries acting alone. Perhaps that is why it has been suggested that an international monetary conference is needed for this purpose—a new Bretton Woods.

The United Nations Monetary and Financial Conference at Bretton Woods in 1944 was indeed very successful. One reason is that it had clear objectives on which there was widespread agreement. These aims were to prevent the recurrence of a great depression and to avoid a renewed breakdown in the international payments system after World War II. The agreement on these aims did not mean that all countries had the same views as to the cause of the depression of the 1930s or the reasons for the international payments difficulties in that decade. In fact, the United States disagreed with a number of other countries that thought the U.S. economy was doomed to stagnation and that the rest of the world would have to live with a permanent dollar scarcity. Nevertheless, there was general agreement on the measures that should be taken to deal with whatever postwar problems would arise. Of primary importance was the establishment of two permanent institutions for cooperation on international monetary and financial problems—the International Monetary Fund and the World Bank.

The Articles of Agreement of the Fund envisaged an international monetary system that would maintain orderly exchange arrangements and thus facilitate the expansion of world trade, the maintenance of high levels of output, and the development of the productive resources of its members. The exchange system established at Bretton Woods was based on fixed par values for members' currencies, which could be changed after consultation with the Fund, and in some instances only with its approval, if such a change was considered necessary to correct persistent balance of payments difficulties. Members were also required, after a transitional period, to eliminate exchange restrictions on current transactions and to establish convertibility of their currencies. The Fund was provided with resources through the subscriptions (quotas) of its members that could be used to extend reserve credit to finance seasonal and cyclical balance of payments deficits. The resources were expected to be increased from time to time through a general increase of quotas, and the Fund was required to undertake a review of the quotas of its members at five-year intervals.

The Bretton Woods system of fixed but adjustable par values worked very well for about 20 years, a period of sustained growth in the world economy and of rapid expansion in international trade. The United States began to experience payments difficulties in the 1960s, accompanied by large conversions of dollars into gold, which some economists attributed to the inadequate growth of gold reserves. The Fund attempted to remedy the reserve problem through the First Amendment to the Fund Agreement (effective July 1969), which provided for the issue of special drawing rights. Although this helped to make the growth of reserves less dependent on U.S. payments deficits, it did not prevent a further deterioration in the U.S. balance of payments and a continued drain on U.S. gold reserves. In August 1971, the United States terminated the convertibility of the dollar into gold, and at the end of the year a new pattern of par values was agreed for the dollar and other major currencies. Nevertheless, the U.S. balance of payments remained weak; and after the failure of a second devaluation, the United States abandoned a par value for the dollar.

The exchange system that evolved after March 1973 did not conform to the provisions of the Fund Agreement. A Second Amendment, therefore, was adopted (effective April 1978) which gave legitimacy to the then existing exchange arrangements. Specifically, members could maintain a par value for their currencies in terms of the SDR or another denominator, except gold; they could have cooperative arrangements for maintaining the foreign exchange value of a group of currencies in relation to each other, as in the European Monetary System; or they could have such other arrangements as they chose; in effect, they could have floating rates. Members were still obligated to collaborate with the Fund and with other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. And the Fund was required to "oversee the international monetary system in order to ensure its effective operation, and [to] oversee the compliance of each member with its obligations [on exchange rates]."

It is tempting to contrast the present state of the world economy and international payments with that of 15 or 20 years ago and to attribute the difference to the abandonment of the Bretton Woods system of fixed par values. The world economy grew more steadily and with less inflation, and international payments were better balanced in the 1950s and 1960s. To some extent, that was because the need to maintain the par values agreed with the Fund imposed discipline on its members. To a greater extent, however, the more favorable state of the world economy and the better balance in international payments made it possible for countries to follow policies conducive to exchange stability. The past ten years have been marked by a series of economic shocks, by widespread and persistent inflation, by several recessions, and by serious balance of payments difficulties. These disruptions have been accompanied by sharp fluctuations in exchange rates. As a practical matter, the disruptions in the world economy were the main cause of the volatility of exchange rates and the imbalance in international payments. Excessive fluctuations in exchange rates probably aggravated the disorder in the world economy, but they could not have caused it.

Although these are matters of urgent international concern, they have to be dealt with initially through national policies. Perhaps nothing is more important for restoring a stable and orderly international monetary system than to end the inflation in the United States, and considerable progress has been made in this regard during the past two years. If this country were to succeed in restoring a high degree of stability of prices and costs, other industrial countries would follow similar policies because of the great importance they attach to preventing a fall in the dollar value of their currencies. And if the industrial countries halted the inflation through appropriate fiscal and monetary policies, interest rates would decline, output would grow at a higher rate, world trade would expand, and the prices of basic commodities would become remunerative. This is the way, perhaps the only way, in which a well-balanced pattern of international payments, with stable and orderly exchange rates, can be restored.

It is essential, of course, for the large industrial countries to be aware of the international effects of the policies that they adopt for what seem to them to be purely domestic reasons. The Fund has a responsibility to see that the policies of its members take into account their international effects. It does not need additional authority from a new international monetary conference for this purpose. The Fund's Articles, as amended, give the Fund all the authority it needs to exercise surveillance over the international monetary system and compliance of its members with their obligations to collaborate in promoting stable exchange rates and orderly exchange arrangements. If at some time in the future there were to be general agreement among the members of the Fund "that international economic conditions permit the introduction of a widespread system of exchange rates based on stable but adjustable par values," that could be done under the present provisions of the Fund's Articles.

It may be said that a new international monetary conference could deal with other problems, apart from exchange rates. In fact, there is no need for a conference to deal with international monetary problems because the Bretton Woods Agreement established the Fund as a permanent institution for consultation and collaboration on international monetary problems. There are no problems that could come before an international conference that the Fund is not already empowered to deal with. As a practical matter, the Annual Meeting of the Board of Governors of the Fund is in every respect an international monetary conference. The governors have the power to set policies for the Fund and to propose amendments to the Fund's Articles. The process has been used successfully to widen the responsibilities of the Fund. The same process can be used again, if necessary. An international monetary conference, called to consider a wide range of questions, some of which would be irrelevant and on none of which is there a consensus, would inevitably cause confusion and interfere with the orderly evolution of the international monetary system. What the Fund needs to deal with the present monetary problems is not more authority, but more resources. And this is even more true of the other Bretton Woods institution, the World Bank. F&D

The institutional evolution of the IMF

Amendments to the Bretton Woods agreement

The Fund's Articles have undergone some fundamental changes since their inception. These involve, essentially, the supply and character of reserves and the regime of exchange rates under the international monetary system. A basic objective of the Fund is "To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation" (Article I, Section (iii)). This objective has remained, although the system providing for its attainment has been adapted to the changing international monetary environment.

In 1944, concerned to avoid the disruptive exchange rate fluctuations of the 1930s, the malpractices of that period, and the rigidity of rates under the gold standard, members of the Fund agreed to establish a system of par values for currencies in terms of gold as the common denominator, whose value was set at $35 per fine ounce.

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Par values were the centerpiece of the system; they were not immutable, but could be changed to correct a fundamental disequilibrium after consultation with, and the concurrence of, the Fund. In practice, however, most changes were relatively large and infrequent. The par value system worked well until the mid-1960s; levels of employment in member countries were high and rates of inflation relatively uniform. As regards reserves, the major source of global liquidity was the successive overall balance of payments deficits in the United States beginning in the early 1950s, and increasing in size after 1958. Countries with payments surpluses were willing to accumulate dollars, since the United States was, for its part, willing to convert the dollar holdings of other monetary authorities into gold at what was assumed to be a stable value of the dollar.

But international monetary conditions were not static; as a result of developments in the international economy in the late 1960s and early 1970s, some of the most fundamental tenets of the international