CHAPTER

8

The End of Bretton Woods?

In August 1971, the classical Bretton Woods system came to an end. The par value system was killed by mutual disagreements and recriminations about who should adjust—in other words, because of the absence of a truly effective mechanism for multilateral surveillance. It was destroyed, in the first place, on the most general level, because of insufficient flexibility in the system. Exchange rates had hardened, a discussion of alteration had become impossible outside of the dramatic circumstances of a major crisis, and other sorts of adjustment (for instance, in fiscal policy) were too contentious politically. Second, the immediate disturbance that destroyed the system had a particular cause, the monetary expansion of the United States in the late 1960s associated with the Viet Nam war, and a very loose approach to monetary policy in the face of an exchange crisis in 1971. The criticism that had been most cogently expressed by General de Gaulle in the mid-1960s now seemed vindicated by the manner of the collapse. Third, the trigger that demonstrated the incompatibility of different national policy stances within the system was given by the larger flows of capital.

These three considerations combined in the destruction of the system. Without any one of them, the story would have been substantially different. With greater flexibility, different fiscal policies could have been accommodated more easily; although changes in parity within a fixed rate system were almost bound to be accompanied by crisis. Or, if there had been no capital mobility, then the crises of the late 1960s would not have occurred; although it might be argued that it was precisely the new dynamism of capital markets that helped to sustain the economic growth of the 1960s. Or, finally, if national policies had been less divergent, if, for instance, Germany and Japan had been willing to have higher rates of inflation, the system could have been maintained.
„Ich will deine Dollars nicht!“

"I don't want your dollars."
There is little doubt that the systemic disintegration would have occurred anyway at some time. It required too much in terms of the coordination of national policies. Countries were more and more committed to domestic growth, while at the same time the technological forces that were driving economic growth required internationalization, of goods markets but also of capital. The crisis of the Bretton Woods system can be seen as a particular and very dramatic instance of the clash of national economic regulation with the logic of internationalism. In the circumstances of 1971, the disruption of the system followed very obviously and directly from the policies of the United States. The course of events followed a predictable logic. Once one country (the United States) decided to use the system for the sake of power politics, other members would legitimately object, the markets would realize the unsustainability of the divergent national positions, and begin to prepare for a collapse of the parity structure. It would then only be a matter of a short time before the country that had tried to manipulate the rules realized that it could not forever continue that operation; and once that happened, it would be prepared to act more boldly to attack the system as a whole, as no longer suiting or serving its interests.

The circumstances in which Bretton Woods broke up made management of the system nearly impossible. At first, the crisis had appeared to center on Europe; then the attention shifted to the United States. The institutions charged by treaty with the task of preserving the system realized the extent of the problem and made some suggestions—but they were largely ignored. Only after, and not before, the crisis could there be a fruitful process of reform.

**U.S. Deficits**

For a long time, it had been assumed both that the U.S. balance of payments deficits helped to make the system operate and that they would be limited and temporary. In 1963, an influential Brookings Institution publication predicted that there would be substantial U.S. surpluses by 1968.\(^1\) Instead, the increased imbalances—the result of national disparities in monetary policy and the increasing dollar overhang—helped to make discussions of monetary and exchange rate policy much more politically contentious. The result was evident in the bad blood of the Bonn G-10 meeting of 1968. The U.S. position also raised conceptual difficulties. Since the deficits were in one interpretation needed by the system as a source of liquidity, they could
not be analyzed in conventional terms, according to which a long-run balance of payments deficit could not be sustained. One observer as a result wrote that “in fact, for the United States the very notion of a balance of payments makes no sense.” What would be the appropriate U.S. balance of payments position? Most modern economists prefer to use the current account when thinking about problems in a country’s external position: and, on this measure, there was no U.S. difficulty at all until 1971! The reserve debate, and the importance attached to reserves, had the effect of highlighting the overall balance of payments: the fact that the United States was exporting capital that could be expected to produce a return in the future was as a result ignored.

American external deficits became entangled in two complex political debates: a domestic one, focused largely on trade policy, and an external one, about the hegemonic implications of the dollar’s “exorbitant privilege.” Imbalances on the balance of payments (as measured by reserve losses) led to a much greater general political sensitivity within the United States to trade issues: because payments problems were often traced back to trade flows, and then blamed on nationalist and protectionist trading practices of other states. Increasingly cantankerous disputes about trade accompanied the slide of the Bretton Woods parity system into chaos. Although international trade continued to grow faster than world production, as it had done in the 1950s, it now began to provoke more concern and comment.

At the same time internationally, the political actions of the United States captured attention as a cause of U.S. deficits and a stimulus to worldwide inflation much more than did the inexorable but less contentious process of economic catch-up in other countries and the associated changes in price structure. Escalation of war in Viet Nam led to a major increase in U.S. military expenditure, which affected the U.S. budget and the payments position. The gross military outflow of dollars largely to Asia, which had averaged less than $1 billion a year between 1960 and 1964, rose to an average of $2.7 billion in 1969 and 1970, despite attempts by President Johnson to close nonessential military bases and “Vietnamize” the war in Southeast Asia. At the same time, Johnson’s domestic reform agenda of the “Great Society” involved an additional sharp rise in government spending at home. Pushed by military and social objectives, the federal deficit rose from $5,922 million in 1964 to $8,702 million in 1967 and $25,161 million in 1968. The stimulatory effect of the deficit on domestic economic activity affected the trade balance: on the merchandise balance, the U.S. surplus fell from $6.80 billion in 1964 to $3.80 billion in 1967 and then almost disappeared ($0.64 billion in 1968 and $0.60 billion in 1969). The current
account balance deteriorated in 1967, and became negative in 1968. As a result, the United States in 1968 needed to make its first drawing for balance of payments purposes from the IMF, although it remained within the gold tranche. There were new drawings in May 1970, and on August 6, 1971, just before the final crisis of the Bretton Woods system, a drawing of $862 million was approved.

From 1965, U.S. gold reserves fell steadily, leading to doubts about the ability of the United States to meet its dollar claims. Nervousness about the dollar was in consequence reflected in the gold market. The losses of central banks in the London gold pool mounted until they became unsustainable and the pool was obliged to stop operating in March 1968. The argument now presented by the world's monetary authorities was that since the creation of the SDR, no further need existed for gold except for speculative purposes. "As the existing stock of monetary gold is sufficient, in view of the prospective establishment of the facility for special drawing rights, the governors [of the central banks of the Gold Pool countries] no longer feel it necessary to buy gold from the market." In practice, the separation of the private market (in which gold might rise above $35) from the official markets in which central banks dealt made impossible a "private" run on the dollar through gold conversions. But private speculators, pushed out of the gold business, simply moved with greater energy to the currency markets.

**Power and Economics**

The new U.S. administration that entered office in January 1969 had a rather different concept of foreign economic policy to that held by its predecessors. President Richard Nixon spoke exclusively the language of national power and national advantage. International cooperation appeared to be suspect; international agencies futile. In Nixon's memoirs, there are 15 index references to the Internal Revenue Service, 4 to the ITT corporation, but none to the IMF, and none to its Managing Director Pierre-Paul Schweitzer. In the text there is just a one-line mention of Paul Volcker, the very influential Treasury Under-Secretary for Monetary Affairs. In the diaries of the White House chief of staff, "Bob" Haldeman, the only reference to Schweitzer is when Nixon became "a little bit upset" that his adviser on foreign economic policy, Peter Peterson, had been to lunch with the IMF's Managing Director, and wanted in consequence to move the unfortunate adviser to another position. "He said that Peterson is to quit talking to
people such as Schweitzer.”

For Richard Nixon, the international economy provided just one more arena for power politics; but effective economic performance also held the key to political success. For the final third of the twentieth century, Nixon thought, “economic power will be the key to other kinds of power.” As a result, he did not wish to make any American sacrifices for the sake of economic internationalism.

Nixon’s achievement was to push to its logical and ultimate limit the role of the United States as a reserve center. There would be no need to consult with other countries on the creation of reserves or how they should be held. He viewed the SDR exercise with mistrust. But such a manipulation of the system would produce its first obvious result in the accumulation of vast surpluses in the international accounts of other countries. Eventually the United States would run into the problem that other countries would no longer be willing to make concessions: they would not promote greater domestic expansion or take specifically targeted measures to restrict their export performance.

Volcker asked later, “with the world enjoying the sort of economic expansion that it had never before experienced, why was there so little sense of commitment to an international monetary system associated with that performance?” At the time, Volcker was highly reserved on issues related to the world economy. A nearly contemporary account stated: “Never, however, was it clear, even to Volcker’s Treasury colleagues, where he stood on any of these issues.”

This hesitancy was a product of the structural constraints on the United States: the domestic political concern with growth (and its effects on electoral behavior); and the feeling that in international affairs the United States was powerless to implement change. The latter sense of impotence helped to reinforce the obsession with purely domestic economic affairs. As a result, it proved in fact impossible to formulate a coherent view of the international dimensions of U.S. policy.

The United States adopted an extreme version of the policy politely referred to as “benign neglect,” but expressed in picturesque terms by the Treasury Secretary appointed by Nixon in 1971, John Connally. Speaking to the Europeans, Connally put the American position in the following terms: “The dollar may be our currency but it’s your problem.” An American audience got a cruder version: “Foreigners are out to screw us. Our job is to screw them first.”

A subcabinet level interagency group, generally known as the “Volcker Group,” on which the Treasury, the Council of Economic Advisers, the State Department, and the National Security Adviser were represented, prepared a paper on “Basic Options in International Monetary Affairs.” It
included a review of the past: “The available financing for our deficits has permitted the United States to carry out heavy overseas military expenditure and to undertake other foreign commitments, and to retain substantial flexibility in domestic economic policy.” But it added that an important goal of policy was to “free . . . foreign policy from constraints imposed by weaknesses in the financial system.”16 It was inappropriate to adjust foreign policy to a particular monetary system. Later, looking back from the perspective of the 1990s, Volcker concluded that “Presidents—certainly Johnson and Nixon—did not want to hear that their options were limited by the weakness of the dollar.”17 Because of this constraint, the United States could not modify its policies substantially in order to satisfy the requirements of the international monetary system. But because of foreign policy considerations, it could not openly destroy the Bretton Woods order either. The outcome of these two sets of calculations was the benign neglect that eventually undermined the Bretton Woods system.

An additional constraint existed in that under Bretton Woods, at least in the way that it had emerged as a “key currency” system, par values were defined with reference to the dollar, so that initiatives for alterations lay with other countries but never with the United States. The view that the dollar parity could not be altered commanded widespread political as well as academic agreement (where the thesis was generalized as the “n — 1” problem: in a system with n currencies, it is only possible for n — 1 of them to change their parity with regard to other currencies). At the G-10 deputies meetings, for instance, it was taken for granted as a “given fact” by non-Americans that it “was not possible to adjust the exchange rate of the United States dollar by direct action in the same way as for other countries.”18 In taking this position, the United States appeared completely to ignore the possibility of using the SDR as the defining point for a new parity system. By adding an additional artificially created reserve currency, the “n — 1” issue might have become in effect a “n + 1 — 1” equation, and the dollar might have been in a less peculiar position. The practical argument of the Americans that any U.S. movement against gold (or the SDR) would be followed by equivalent movements in other currencies was difficult to refute.

In the summer of 1970, some Europeans argued that the dollar was overvalued and that “at some point consideration would have to be given to, say, a 10 percent increase in the gold price with other leading countries agreeing not to join.”19 France’s President, Georges Pompidou, had asked Finance Minister Valéry Giscard d’Estaing to redraft his speech for the Annual Meeting of the Fund in 1970 in order to make it clear that the fundamental problem on international markets lay with the dollar. In a handwritten note,
he stated: "It appears to me that it is necessary, without being aggressive, to show how unhealthy the role of the dollar is and how it is constantly losing its purchasing power. ... I remember that I said in New York that one could not eternally ask people to set their watches by a defective clock." Giscard reflected these views in his speech to the IMF Annual Meeting in 1970: "Nations whose currency is widely used in the world thereby have increased responsibilities, a natural counterpart to the advantages they derive from the dissemination of their currency. ... A currency that aims to play an international role as an accounting unit must obviously be of a highly fixed nature, since the other currencies cannot be permanently determined in relation to a standard that is no longer fixed but variable. None of you would agree to set his watch by a clock that was out of order. I therefore unreservedly support the opinion of the Managing Director of the IMF that the restoration of the U.S. payments position is the most urgent task still to be accomplished in the sphere of international payments." How could the United States respond to the growing criticism? Already before the 1968 presidential election, a Republican task force chaired by the distinguished conservative economist Gottfried Haberler investigated ways of depreciating the overvalued dollar. A particular strategy ("benign neglect") was evolved as a means of dealing with the practical difficulties arising for the United States of being the nth member in the n-1 system. "At that time there was no possibility of devaluing the dollar unilaterally, since several other countries had made it clear they would devalue by an equal amount, thus nullifying our move. These countries therefore had to be persuaded by a continuing accumulation of inconvertible dollar balances." Connally's appointment only meant a "departure from the tactics, though not the strategy, of benign neglect." It meant simply the adoption of a more bullying and brutal way of dealing with international issues. What was being applied here was the logic of sterling balances—but, in this case, used as a deliberate strategy in order to force adjustment. By 1970, officials in the Federal Reserve Board began warning that "a crisis of confidence in the dollar could begin at any time; that is, both foreigners and Americans could begin to shift financial assets out of dollars into foreign currency in order to profit from an expected change in the value of the dollar." One way of dealing with the potential crisis lay in the negotiation of a new exchange rate structure; but this would be difficult to achieve in a secret negotiation, and any leak would provoke a general crisis. More generally, the United States actually needed the crisis as part of its negotiating position. "The trump card in U.S. hands is the ability to suspend gold sales and purchases. Such a suspension could trigger a crisis or it could
come after a crisis has begun. In either event, it leaves it up to other countries whether and how much to revalue in order to restore order and balance in international payments.” The weakness of the U.S. position was the best hope of attracting international support: what was this but a larger version of U.K. policy in the mid-1960s?

**The International Exchange Rate System**

At the same time as the policy debate was evolving, among economists a theoretical consensus had emerged on the need for greater flexibility in the international system. Writing in 1970, Arthur Okun claimed that: “Research economists and academic experts today agree broadly, although not unanimously, that a greater degree of flexibility in exchange rates would be a desirable innovation.” The extreme position of nonintervention by governments and monetary authorities, and a completely free float, found few proponents. Its major advocate, Milton Friedman of the University of Chicago, was at that time regarded as an eccentric outsider. The German Council of Economic Experts, which had endorsed similar conclusions, was seen as politically irresponsible. But many agreed that the existing system had become too inflexible. Some specific suggestions for more flexibility short of a general floating included a wider margin for movement than the 1 percent of the Bretton Woods Articles of Agreement, and periodic small changes in par values (“the crawling peg”).

The IMF took up and participated in these discussions, in large measure because its staff was appalled by the chaotic and economically damaging approach to exchange rate readjustment that had been evident in the 1968 Bonn G-10 meeting. In 1970 the Research Department prepared a paper on “The Mechanism of Exchange Rate Adjustment Proposals with Respect to Exchange Rate Flexibility.” The major alternatives were sketched out: wider margins, small changes in parity, the suspension of margins for a particular currency, and the implementation of an exceptional regime involving exchange control in particular cases (Brazil or Chile were cited as possible applications). After discussion on the hesitant and rather conservative Executive Board, this paper became a very cautious and heavily qualified statement on “The Role of Exchange Rates in International Adjustment” (September 1970). It now excluded wider margins or the crawling peg; argued that there should be only a slight widening from the Bretton Woods 1 percent (5 or 10 percent would give scope for too much adjustment); and presented temporary
deviations as a helpful mechanism for dealing with crises. But the paper insisted that comprehensive capital controls (which had been seen, especially in France, as the preferred answer to exchange rate instability) were neither necessary nor desirable. The adjustments of the pound, franc, and deutsche mark that had occurred between 1967 and 1969 had, when taken together with the creation of SDRs and the elimination of pressures emanating from the private gold market, helped to stabilize the par value system. The rather rosy conclusion stated that: “With the help of these improvements and adaptations, it would seem that the risk that a parity change for one currency would spread instability in the system as a whole has been considerably alleviated.” The excessive optimism of this report sprang paradoxically from a profound sense that the U.S. dollar problem could not be addressed.

Suggestions for reform had foundered in practical terms on the American problem and on American resistance. Discussing the IMF Research Department paper, Volcker said that though he was prepared to consider suggestions on reform, none of the proposals would deal with the dollar issue. “He saw no way in which the intervention currency could take any initiative in the limited parity changes being considered; such a currency, by its nature, would have to continue to maintain a passive role.” The existing arrangements contained a bias towards devaluation vis-à-vis the dollar (the only revaluations in the Bretton Woods system had been the 1961 and 1969 deutsche mark revaluations and an associated movement of the Netherlands guilder). Such changes would only worsen the American payments position. Volcker concluded that provisions for greater exchange rate flexibility “might involve the risk of increasing that bias.” He could see no way out of the U.S. dilemma within the framework of Bretton Woods. The first initiative to respond to the problems created by the U.S. position did, in fact, indeed come from elsewhere, from one of the surplus countries.

**German Unilateralism**

In 1968–69 U.S. banks had borrowed heavily from abroad. Short-term capital inflows to the United States amounted to $3,710 million in 1968 and $8,130 million in 1969. Then, as U.S. monetary conditions eased, the flows reversed and major outflows started, attracted by the interest rate differential. The net capital outflow from the United States in 1970 was $12.9 billion, and in 1971 $29.6 billion (of which $11 billion occurred in the third quarter). Germany provided almost a mirror image of the U.S.
position. Otmar Emminger later said that the deutsche mark was "the epicenter of the American currency quake." Capital inflows from January 1970 to May 1971 amounted to DM 35.3 billion ($9.6 billion).

In dealing with the inflows, Germany initially followed a double strategy, both prongs of which involved coordinated international action. In 1970 Germans energetically pushed for a common European action, so that they could share their problem with other European states. Emminger argued for a wider band for the combined European Economic Community (EEC) currencies. Second, in addition, German policymakers thought that international institutions, and particularly the IMF, should play a more substantial role in pressing the United States to modify its lax monetary policies. Economics Minister Schiller believed that the SDR issue was in part responsible for the flood of liquidity in 1970 and that the United States should be obliged to bargain a limit to the growth of dollars against a further issue of SDRs.

In 1971, Germany abandoned the multilateral approach, because it transparently had failed to produce any change in U.S. policy or any substantial coordination in Europe, and went on an isolated course. The Germans took the new line with considerable trepidation and with very visibly and painfully divided counsels. In March 1971, the Bundesbank cut its discount rate, in an unsuccessful attempt to curb the inflows of dollars. The only result appeared to be a rise in the German inflation rate. At the end of April 1971, leading figures from the Bundesbank and the German government discussed with Schweitzer the option of a floating of the deutsche mark. The most dramatic meeting occurred in the Bundesbank building, when of the Bundesbank representatives present two (including Emminger) strongly supported floating, while the President, Karl Klasen, was equally forcefully opposed; and Karl Schiller, the Minister who ultimately bore responsibility for German exchange rate policy, also wanted to float. A revaluation was ruled out because no one wanted to make a firm decision about a particular new rate. Schweitzer, who was clearly very committed to the principle of fixed rates, argued that a float might increase rather than halt the movement of funds to Germany. "The world’s belief in the strength of the deutsche mark was such that the rate might have to rise very sharply before speculation was curbed. But at these levels it would provoke difficulties for German exporters." The float in the end emerged because all other German options were closed off: the IMF had predicted that it would be adopted as the "easiest answer" by a "weak government coalition."

Schiller tried in Brussels a last effort to establish a common EEC float against the dollar. When he failed, on May 10, 1971 Germany adopted floating unilaterally, even though both the Bundesbank President and the
supreme German monetary policymaking body, the Central Bank Council, remained opposed. There was no doubt that this was a decision that came from the government alone, and that the central bank did not want to share this responsibility. The German measure defied all the warnings and was an immediate success in halting speculative movements into Germany.

The U.S. Response

Connally had been U.S. Treasury Secretary since March 1971. In the middle of the German crisis, on May 4, he had authorized a press release which stated that no change in the structure of parities was necessary or anticipated. (He apparently added in private: “That’s my unalterable position today. I don’t know what it will be this summer.”) He was particularly unwilling to see a problem in the very loose U.S. monetary policy of 1971. A sharp fall in U.S. interest rates had accompanied the recession of 1970, while rates remained high in Europe. U.S. three-month Treasury bill rates, which had been at 7.9 percent in January 1970, fell to 3.3 percent by March 1971, while the German three-month interbank rate was still 7.6 percent. In the last instance, the only opportunity to rescue the dollar would have been to stem the outflow of funds by increasing rates; but Americans saw this course as imperiling the chances of a domestic recovery. When the Managing Director of the IMF suggested to Connally, at a very strained lunch meeting, that it might be better to alter the policy mix and increase fiscal stimulation but tighten money in order to protect the international position of the United States, the suggestion was rejected contemptuously. “Monetary restraint was not the solution, and that the need was for strong measures to alter the balance of payments structure.” Connally meant cutbacks in U.S. military spending abroad, but chiefly a re-examination of American trading arrangements.34

Japan, which was replicating Germany’s dramatic buildup of a surplus position with a lag of a few months, attracted Connally’s particular attention. As in Germany, there had been a short-term capital outflow in 1969. In 1970 there was little movement, but in May 1971 the German float suddenly transferred the force of global speculative pressures against the dollar to Japan. Measures taken on May 17, 1971 to prohibit foreigners from buying a large range of Japanese securities failed to halt the rapid dollar inflow. In all, in 1971, an inflow of $4,910 million occurred. Was this just a matter of speculation, or were deeper and more fundamental causes at work?
The domestic political situation determined the way the United States interpreted the crisis on the world’s currency markets. In a dramatic meeting in May 1971, the IMF’s Managing Director, Pierre-Paul Schweitzer, told Connally that in his view the dollar should be devalued—a piece of advice for which Connally never forgave him. The Treasury Secretary replied brusquely that the basic problem was trade and not exchange rates, and that “Japan had a controlled economy.” He believed that the IMF should press Japan to alter its rate in the wake of the German decision (Connally had not been particularly moved by the German float: “it would have been a disservice for the United States to intervene, since the Germans obviously wished to float the mark . . . the United States could not tell the Germans what to do”). A yen revaluation might stem the flood of Japanese exports. The question of Japanese textile exports to the United States, which appeared a likely issue in the 1972 U.S. election and which was already the subject of protectionist congressional initiatives, had a particular urgency. Connally also threatened much broader political measures. In order to arrive at payments adjustment, “the United States would have to revise its mutual security arrangements especially relating to Japan and Germany . . . He repeated that the United States had tried to do too many things and would have to cut back.”

On May 28, 1971 Connally made a speech to a meeting in Munich of the International Banking Conference of the American Bankers Association. He promised: “We are not going to devalue. We are not going to change the price of gold.” The main theme of his speech was that the burden of U.S. defense spending needed to be spread more evenly with other countries and that U.S. goods should be given freer entry into Japanese and European markets. “The question is only—but the ‘only’ is important—whether those nations now more amply supplied with reserves as well as with productive power should not now be called upon for fresh initiative in opening their markets to the products of others . . . No longer can considerations of friendship or need, or capacity, justify the United States carrying so heavy a share of common burdens.”

In the absence of any fundamental alteration in U.S. policy, the short-term outflows continued. The deficit for the first half of 1971 on the official settlements basis amounted to $22 billion at an annualized rate. For the third quarter alone the figure was $13 billion.

On August 6, 1971, the U.S. Congress Joint Economic Committee’s Subcommittee on International Exchange and Payments (chaired by Henry Reuss) issued a report with the title *Action Now to Strengthen the U.S. Dollar*. It presented as “inescapable conclusion” that “the dollar is overvalued.”
argued that the “dollar overvaluation leads to the perpetuation of U.S. deficits and thus increases the risk of an international monetary crisis that would break the system apart.” Only precipitate action by international authorities could prevent such a disaster. Exchange rates should be altered so that the U.S. balance of payments would be strong enough to allow the financing of “normal levels of unfettered net private investment abroad.” The IMF “should explicitly assume the responsibility for recommending to member countries exchange rate changes needed to correct any fundamental disequilibrium, particularly between the United States, as the country at the center of the system, and the remainder of the industrial world.” In the case of “recalcitrant” surplus countries, the IMF should consider invoking the scarce currency clause. The U.S. Governor of the Fund (that is, Secretary Connally) should “assure that the IMF does not avoid facing” its responsibility over exchange rates.36

In fact, it was the report of the Joint Economic Committee that precipitated the final crisis of the Bretton Woods par value system. A new wave of dollar selling began on the international currency markets. On August 12 and 13, 1971, foreign central banks bought about $1 billion in an effort to support the dollar; but the Bank of England also asked the Federal Reserve to cover a part of its dollar holdings by a swap drawing, as if it were unsure that the dollar parity could be maintained and anxious to avoid losses on the dollar.37

The Final Crisis

It appeared likely that when the markets reopened on Monday, August 16, 1971, the United States would lose reserves at an even faster rate. At an emergency meeting called for the weekend at Camp David, the Chairman of the Federal Reserve Board, Arthur Burns, firmly opposed abandoning gold convertibility. It would lead to other countries retaliating, it would end the “mystique of gold,” reduce world trade, and, in general, be a signal of the collapse of capitalism. Instead of “closing the gold window,” the United States should impose a special duty on imports, fight inflation domestically, wait to see if this course worked, and, meanwhile, renegotiate the general structure of exchange rates. Burns’s position was backed by an apocalyptic briefing paper from Charles Coombs of the New York Federal Reserve Bank, which claimed that closing the gold window would inexorably lead to a “massive destruction of international liquidity” and “would pull out the cornerstone of the IMF and immediately paralyze any lending operations by that institution.”
From the beginning of the meeting, however, it was clear that this view did not represent the general policy consensus. Nixon opened the discussion with the statement that "it is generally agreed we must act on the international monetary front" and that the imminent measures would be "the most significant economic action since World War II." (On his way to Camp David, the President's speech writer William Safire had been told, even more explicitly, that "this is the most important weekend in economics since March 4, 1933," President Roosevelt's inauguration day.) Connally began his contribution by saying: "It is generally assumed we are going to have to move. We have to close the gold window." Together with a price and wage freeze, and an import tax of 10–15 percent, this action, he told the President, would make "the international finance people . . . realize you moved across the board strongly. This would be acting in consonance with the way people view you—great statesmanship and great courage. That's the right posture for you—a man ready to make far-reaching moves." To Burns's arguments, Connally replied: "So the other countries don't like it. So what?"; and when Burns added that they might retaliate, "Let 'em. What can they do?"

Volcker argued more modestly for a general realignment, although it was difficult to see practically how such a measure, however desirable, might be achieved. In practice, it could only be realized in the aftermath of the shock of an American closing of the gold window. Volcker's final concession to the idea of negotiating a realignment was: "But don't let's close the window and sit—let's get other governments to negotiate new rates."

In the end, the unilateral abandonment of gold as part of a New Economic Program announced on Sunday, August 15, 1971 in a televised address by President Nixon owed everything to domestic political considerations. The speech was turned by skillful writing into an assertion of American strength and a blow against inflation rather than any acknowledgment of economic failure. The program contained tax cuts in order to boost employment; a 90-day freeze on wages and prices; the suspension of the Federal Reserve swap network; a temporary 10 percent surcharge on imports "to ensure that American products will not be at a disadvantage because of unfair exchange rates"; limitations on the use of U.S. international reserve assets (that is, gold); and a notification to the IMF that there would no longer be free buying and selling of gold in the United States.

**A System Without Rules**

It was a decision in which international institutions had had no role. The Managing Director of the IMF, Schweitzer, was invited, with one hour's
notice, to attend a meeting in the U.S. Treasury with Paul Volcker (Secretary Connally was in the White House), who told him about the major elements of the Nixon program and said that no one else had been given advance notice. Then Schweitzer was able to see Nixon’s speech on television. Choosing this method to inform the IMF of the end of America’s commitment to a par value constituted a very clear breach of U.S. obligations under the Bretton Woods Articles of Agreement. Volcker now said that he believed that international discussions would be needed, not in any large-scale Bretton Woods like conference, but possibly in the G-10. He added that “the Executive Board of the Fund was also a possibility, but was not likely to be the main point.”

Most countries followed the German and Dutch moves of May 1971 and stopped interventions in the exchange markets, meaning that in fact the dollar was in practice now floating against the major world currencies. France tried to deal with inflows of dollars by imposing capital controls and introducing a dual market for foreign exchange for current and capital transactions. But there was one major exception to the response of floating or using exchange controls, an experience that demonstrated quite how hard negotiations for realignment would have been in the absence of an intense crisis. Japan appeared absolutely determined to stay with its old parity, despite its strong surplus position. After the August 15 announcement, a Japanese Finance Ministry official, Yusuke Kashiwagi, telephoned Volcker during his meeting in the Treasury with Schweitzer and almost immediately flew to be present in Washington in person. (During this phone call, Secretary Connally, most of his business in the White House over, put in a brief personal appearance at the Treasury meeting.)

After complaining that Japan had not been consulted prior to the Nixon measures, Kashiwagi stated that Japan would not change the yen rate and that the Bank of Japan was prepared to accept losses in order to maintain the current parity. For two weeks, the Bank of Japan continued to support, at great cost, the old yen-dollar rate of ¥ 360. On August 16, 1971, it bought $600 million, the next day $700 million, and within two weeks had added an additional $4 billion to its reserves. The argument made in defense of this action was that Japanese business, in particular, shipbuilders and manufacturers of industrial equipment, had large unsecured foreign currency credits (the figure given by the Japanese Shipbuilders Association in March 1971 was $8.4 billion outstanding foreign currency credits, of which only $2.7 billion was hedged against a yen revaluation). But, in fact, over the summer many firms had begun to insist on yen-denominated export contracts, and a major part of the sales of dollars for yen after August 15 went to
Japanese banks. The degree of political commitment to the dollar parity created for these institutions a one-way bet, in which they acquired large amounts of yen that were extremely likely to appreciate. At last on August 28, 1971, the Bank of Japan gave up its support of the dollar rate, and the yen floated.

Immediately after the August 15 decision, Volcker traveled to London for a G-10 deputies meeting, in which he presented the U.S. decision in the same way Richard Nixon had done: as the assertion of U.S. strength. The United States "wanted to end the position of feebleness which it had occupied in the monetary and trade spheres for about eight years." He denied that the United States would devalue the dollar relative to gold. He also saw the leading European figures individually. The French Finance Minister, Valéry Giscard d'Estaing, told him that the floating dollar had produced a danger of a worldwide protectionist response and that the United States had broken the rules of the IMF. Volcker did not seem concerned, and replied: "Yes, we are aware of the problem that our decision provokes."

In the light not merely of the unprecedented size of the international capital movements of the late 1960s, but also of a widening incompatibility between different national objectives, the room for intervention by multilateral institutions was severely restricted. As the situation became increasingly strained, and as the major players were unwilling to take action, in public these institutions had little choice except to affirm their belief in the stability of the system. Such attempts to reassure nervous markets inevitably make rather peculiar retrospective reading. Thus Schweitzer, speaking in December 1970 and referring to the creation of SDRs, told the Los Angeles World Affairs Council that "since the early part of 1969, the international monetary climate has shown a remarkable improvement."

The alternative of applying real pressure on major countries through public statements carried great political risks. In a situation in which each country was attempting to impose a larger part of the burden of adjustment on other countries, any statement or calculation about exchange rates looked as if it constituted an intervention in a complex and ferocious international bargaining process. The Europeans were arguing that the dollar should be devalued; and, as a result, any claim that the dollar was overvalued would be interpreted as a political statement in favor of the European position. On August 20, 1971, for instance, Emminger had written to Volcker that a general correction of parities would require an alteration of the dollar price of gold. Connally, who instinctively suspected international civil servants, bitterly resented Schweitzer's similar comments on the value of the dollar in the wake of Nixon's August 15 announcement. Schweitzer seemed to be
saying, however diplomatically and cautiously, that the dollar should be devalued.

He made this point in private meetings with Volcker. On September 9, 1971, Schweitzer told Volcker that “speaking frankly, he felt that the present situation was a bit the fault of the United States which seemed to be saying that we could let nature take its course. Now on all sides there seemed to be a relaxed attitude, and this might be due to the U.S. reluctance to negotiate. . . . the United States was boxing itself in, and was ignoring the political problems faced by other countries. It was the first case in which a country had said it would not change its rate.”

The Managing Director of the IMF also made these points in public. On August 23, 1971, Schweitzer gave an interview to NBC, in which he said: “What one wants is a new pattern of exchange rates. The result of the sacrifice will be that the value of the dollar, compared to other major currencies, will be reduced. So you might call it a devaluation of the dollar. You might call it a realignment of other currencies. The result is, of course, the same.” The next day, the BBC showed a recorded interview, with a similar message: “If you were to have a new pattern of exchange rates then each currency will have to be redefined in terms of gold. And that might be true of the dollar too.”

Such a statement shocked Americans who were not used to being told what to do by a multilateral institution, even though a congressional subcommittee had just publicly emphasized that this was precisely the IMF’s duty. For Connally, who had told a press conference on August 15 that the gold value of the dollar would not change “one iota,” the IMF Managing Director’s intervention was a personal rebuke. But Schweitzer went on to repeat the same message in a speech to the United Nations Economic and Social Council. “In particular, the international community should cooperate with the United States in the task of achieving a fundamental improvement in its balance of payments. It was agreed that there should be a realistic new structure of exchange rates for the major currencies. It was also agreed that this currency realignment should take place as expeditiously as possible, and should be accompanied by some temporary widening of the permissible margins of fluctuation around parity.”

Doubts about the intervention of an international institution in the debate about U.S. problems were not confined to political concerns about the effects of a television lecture on devaluation. Similar problems about the nature of advice from multilateral institutions occurred at the technical level of calculating a new structure of exchange rates that might promote a general balance of payments adjustment. The IMF had developed models in 1968
and 1969 in response to the European currency crises, in which new parity structures for the deutsche mark, the French franc, and the British pound were worked out in an attempt to forestall the widespread adoption of floating in a crisis. But by the time any crisis came, the parity question had become so politicized that a statistical presentation could no longer be regarded as neutral and simply technical. On the evening of August 15, Schweitzer had told Volcker about the Fund's calculation on relative exchange rates. On August 17, 1971, the Federal Reserve Board had been given a calculation of rate changes by the IMF's Research Department on the basis of its Multilateral Exchange Rate Model (MERM), and its staff used these figures as a basis for their own parity calculations. Perhaps inevitably in the case of a document so sensitive, the IMF table was leaked, and inevitably became the focus of bitter controversy. It was based on the assumption of a gold price of $37.50, or a 7.1 percent appreciation of gold relative to the dollar.

The basis for this calculation had been the view that, as J.J. Polak, the author of the paper, told the IMF Executive Board, "a satisfactory new pattern of exchange rates could not be found by letting all currencies float for a certain period. Quite apart from the profound uncertainty that such a situation would create, a regime of many floating currencies cannot even in theory be expected to lead to a viable system of rates." Politicians, however, were unwilling to put up with such a neutral, depoliticized approach to the exchange rate issue. After the debacle of the leak, by the time of the 1971 IMF Annual Meeting, the Wall Street Journal reported that "almost everyone agreed that there should be a relatively free market in currencies for a while."

The sensation caused by Polak's calculation, as well as of the experience of August 15, led the IMF to develop a much more explicit criticism of the international reserve role of the U.S. dollar. The previous system had failed because of a mistaken assumption: "The convertibility into gold of the currency of a reserve center was considered in theory to be a deterrent to an excessive use by the reserve center of the leeway provided by its ability to finance deficits with its own currency." The fixed par value system could be rescued by the replacement of national currencies as reserves by the international SDR. Such a scheme was described as "internationally Friedmanesque" in that it would provide through control of the growth of international reserves a growth path for the international monetary supply.

In the fall of 1971, the major international discussions that occurred within the framework of the G-10 centered on ways of achieving a general balance of payments adjustment. The United States argued that it needed an improvement in the current account of $13 billion, that is, some combination of trade measures and adjustment of monetary policy that would lead
to $13 billion staying in the United States. In meetings of the G-10 deputies, other countries offered measures that would lead to an adjustment of only $2–3 billion. The Organization for Economic Cooperation and Development supplied calculations indicating that the sum required for international stability amounted to $8–10 billion. The IMF also put it at $8 billion. At the G-10, the U.S. representative, Paul Volcker, "made a strong plea in favor of floating, in view of the evidence that it had not proved possible to reach agreement on the size of the necessary balance of payments adjustment, on its distribution, nor perhaps on the exchange rates that would bring about these changes." Only the adoption of floating at least as a temporary measure could allow the large fluctuations in capital movements to be financed without risking a breakdown of the system.

This view eventually became the prevailing intellectual orthodoxy in both the United States and Germany, but at the beginning there was a great deal of hesitation. Even convinced theoretical floaters such as Otmar Emminger were fearful about what might happen to inflation internationally if countries departed from the discipline imposed by fixed parities. Increasingly, however, it appeared that the gigantic capital movements of 1971 imposed a stark choice: either let the exchange rate float (which in Germany proved a quite effective mechanism for discouraging speculative inflows) or impose direct controls of the French type.

In early 1971, before the final crisis of the Bretton Woods system, Volcker had spoken of some control of the Euromarkets, though he had been opposed to a general control of all capital flows. On September 13, 1971, after the crisis, a communiqué of the European Community ministers of finance referred to "appropriate measures to discourage destabilizing short-term capital movements," while reaffirming the principle of fixed parities. But at the G-10 ministers meeting at Lancaster House in London on September 15–16, 1971, both Connally and the German Economics Minister Schiller agreed freedom of capital movements to be in principle "highly desirable." This phrase was so contentious at the meeting that it was removed from the official text released to the press. The only agreement that could be presented as the result of the meeting lacked any specifics: "a substantial adjustment is required . . . of the present payments imbalance in the world . . . and that measures to bring about this adjustment should be taken on a wide front and should include an appropriate realignment of currencies." The American experience of applying capital controls to nonbanks in the mid-1960s had been unhappy, and Nixon in the 1968 presidential campaign had promised a substantial liberalization. Once steps toward liberalization had come to be
regarded as desirable or even inevitable, the logic of the situation pointed inexorably to floating as the only answer to the systemic crisis of world currencies.

Giscard d'Estaing, spoke on the other side, for the necessity of "regulation" of capital flows. The political heart of the European Community, the Franco-German relationship, was severely strained by the extent of the capital movements, and it appeared to France and to those politicians in Germany concerned with Europe that some control was needed in order to preserve the beginnings of a regional approach to international currency issues. Two years later, Karl Schiller was forced to resign after the German cabinet unanimously rejected his opposition to the imposition of capital controls.

The public position of the IMF remained at this time against the "market" solution to the world balance of payments problem. In his controversial television interview, Schweitzer had said: "In my opinion there is not the slightest chance that from the way markets are likely to operate there will emerge anything which will either achieve what is needed to put the U.S. balance of payments in order, or what would constitute a satisfactory exchange rate pattern. I do not think that you can rely on market forces to achieve that. In my opinion, it needs, with the guidance and participation of the Fund, an international negotiation."

Such a negotiated solution was obstructed by the United States. At the London G-10 meeting, a three-phase plan for negotiations proposed by Schweitzer was rejected on the grounds that Connally considered it as exceeding his instructions to make a U.S. commitment. Schweitzer had suggested that a currency realignment should come first, and be accompanied if necessary with wider margins (a scheme supported vigorously by the Europeans); that the United States should then correct its balance of payments; and as a final stage that the issue of international reserves should be tackled. Toward the end of the meeting, on September 16, 1971, Connally had said that there was no possibility of changing the U.S. position "one iota." Most participants concluded that there had been no real dialogue in London, and that any negotiation had become impossible.

Should or could the Fund persuade or control in these circumstances? In 1971 either course looked highly precarious. The Fund's function lay in providing guidance to, and influencing the policies of, countries vigorously engaged in the pursuit of power politics and disinclined to pay attention to the advice of international institutions. It also believed that it should act in order to restore order to the international markets. But any conceivable instrument for exerting control over the system—parity changes or controls
on capital movements—had become much too controversial. The changes in fiscal or monetary policy that would have been required to achieve any adjustment had become so dramatic as to be politically quite unrealistic.

As a consequence, it appeared increasingly that the "market" might offer an escape from the political constraints, and that "floating" would become a means of avoiding the intractable political obstacles standing in the way of an abstract articulation of a more desirable parity structure. This already appeared at some moments to be the U.S. position in the wake of the August crisis. Volcker, for instance, told Schweitzer that "he was not sure how much the dollar would depreciate. There would have to be general agreement on rates and the United States could not be satisfied with an inadequate set of measures. There would be too much danger of the system breaking down again." On an earlier occasion, he had made the same point when he "warned that the objective of orderly rates alone was not the overriding U.S. concern. The U.S. would not buy short-term order at the cost of a recurrence of difficulties and was ready to live with disorder." 65

Three features had characterized the evolving international financial system in the 1960s:

- Increasing freedom of capital movements.
- An insistence on autonomy and growth-orientation in the national policy setting.
- A fixed exchange rate system.

The development of the second half of the decade showed that these characteristics were mutually incompatible.

The original vision of Bretton Woods had included a substantial and long-term control of capital movements across national frontiers. By the end of the 1960s such regulation was unthinkable to the major players in international finance. Critics pointed out how the operation of the international monetary system in the 1950s and 1960s had allowed the United States to pile up assets throughout the world. In a discussion of the repercussions of the Nixon shock, one Executive Director of the IMF referred to the $166 billion of U.S. assets throughout the world as "greater than the total amount of the Marshall Plan and U.S. foreign aid combined." 67 Capital movements had become not only one of the features of the international market, but also came to be widely regarded as one of the tools of power politics.

Perhaps the system could have worked longer if countries had been willing or able to accommodate themselves to the system by undertaking adjustment
(if there had been any willingness to compromise on the second feature listed above). For almost every major country, domestic politics mattered much more and much more immediately than the hope of maintaining the international system. In particular, the United States after 1969, instead of working within the system, pursued a policy calculated to show up its weaknesses.

Since the first two objectives were by and large maintained internationally, the third element of the 1960s system had to give. But it took some time before participants realized this, and longer before they discovered that abandoning rules meant not just accepting the superiority of "the market," but also living with a fair measure of anarchy.