Breton Woods

- System planned during World War II
  - Named after hotel in New Hampshire
  - Lasted until 1971

Breton Woods

- Fixed rates desirable, but gold standard impractical

The Plan

- All currencies pegged to the dollar. Nations pledged to maintain exchange rate.

The Plan

- All currencies pegged to the dollar. Nations pledged to maintain exchange rate.
  - This rate keeps supply and demand of (say) £ in balance.
The Plan

- All currencies pegged to the dollar. Nations pledged to maintain exchange rate.
- In these conditions, lower price level to $P_{Peg}$.

Backup

- Each nation had a central bank, a bank's bank.
- The International Monetary Fund (IMF) would be their bank of last resort.

The Plan

- Adopt monetary and fiscal policies to shift Y and M curves.
- Alternatively, restrict trade and impose currency controls.

The Extreme Backup

- The foreign government could devalue (say from £1 = $4.80 to £1 = $2.80).
- If the demand for £ temporarily exceeded the supply of £, the IMF would lend $.
- It would insist on domestic reforms to drive P to $P_{Peg}$.
- The US would often help out.
The Extreme Backup

• The foreign government could devalue (say from 1£ = $4.80 to 1£ = $2.80).
• When devaluation looked likely, there was a lot of exchange speculation.

Borrow £100,000,000, exchange it for $300,000,000.

If £ devalued, exchange the $300,000,000 for £150,000,000; Profit = £50,000,000.

If £ not devalued exchange the $300,000,000 for £100,000,000. Profit = Loss = 0.

Heads I win, tails you reimburse me for my losses.

The Flaw

• Suppose $P_f > P_{peg}$
The Flaw

- Suppose $P_f > P_{peg}$.
- More people would want to purchase $ for £ than people wanted to purchase £ for $.
- The British would have a difficult choice.

They could tighten their belt, much as a household facing bankruptcy might.
- A recession would result.

The Consequences

- This was not a difficult choice
  - When choice was between using monetary policy to fight unemployment or to meet obligations to IMF, the IMF was the loser.

Ignore their commitments to the IMF and fixed exchange rates.
The Consequences

• This was not a difficult choice
• In 1971, President Nixon put the fixed exchange rates out of their misery and started floating the dollar.

Why did Fixed Exchange Rates Fail?

• Independent Monetary Systems
• End of US Dominance
  – United Kingdom wants to sell more £ than foreigners wanted to buy. For a long time, the US bailed them out.
  – That is $D_S > S_S$
  – But when $D_S < S_S$, we were forced to devalue.

Why did Fixed Exchange Rates Fail?

• Independent Monetary Systems
• End of US Dominance
• Ease of Speculation
  – Heads I win, tails you reimburse me.

Fixed Rates Today

• Many nations follow this system today.
  – US
  – Canada
  – United Kingdom
  – Japan
  – Europe

Are there Alternatives?

• Managed Floats or Crawling Pegs
• Currency Boards
• Monetary Unions

End