Breton Woods

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  - Named after hotel in New Hampshire
  - Lasted until 1971
- Fixed rates desirable, but gold standard impractical

The Plan

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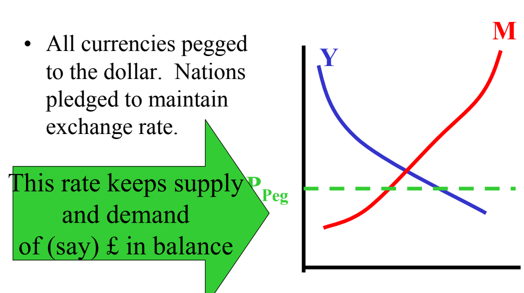

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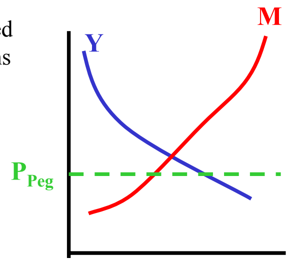
- In these conditions, lower price level to P_{Peg}



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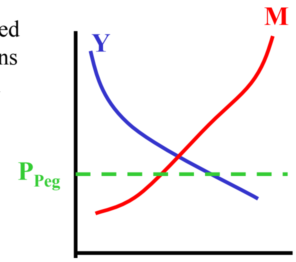
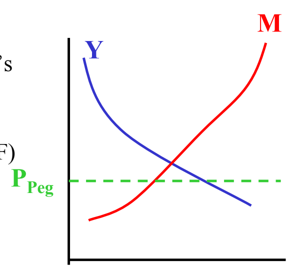


Backup

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

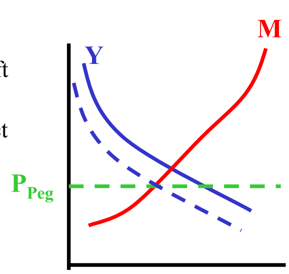


Backup

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

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



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

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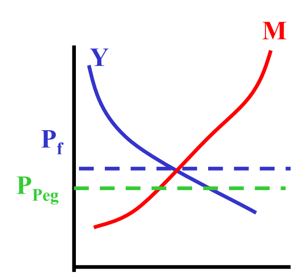
The Flaw

- Suppose $P_f > P_{peg}$.



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The Flaw

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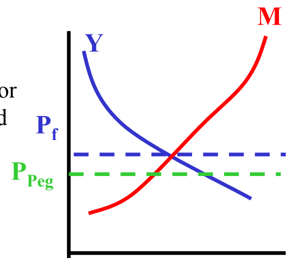
- More people would want to purchase \$ for £ than people wanted to purchase £ for \$.



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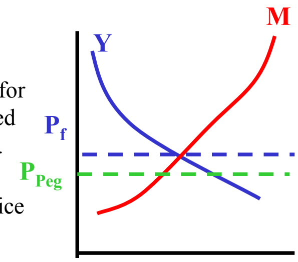
- Suppose $P_f > P_{peg}$.
- More people would want to purchase \$ for £ than people wanted to purchase £ for \$.
- The British would have a difficult choice



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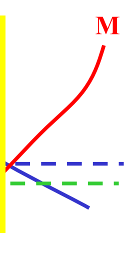
They could tighten their belt, much as a household facing bankruptcy might.

–A recession would result.



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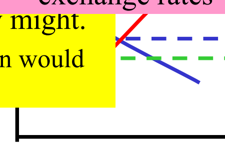
Ignore their commitments to the IMF and fixed exchange rates



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.

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  - When choice was between using monetary policy to fight unemployment or to meet obligations to IMF, the IMF was the loser.
  - Speculation was rampant.
  - Devaluations became more and more common.

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 $D_\$ > S_\$$
  - But when $D_\$ < S_\$$, 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