Bretton Woods and Financial Liberalization

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Abstract

The creation of the Bretton Woods system (1945-1971) and the evolution of the financial liberalization that characterized the last quarter of the 20th century and resulted in the contemporary international monetary system remain the most important developments in the international monetary system over the last century. What were the reasons for and structure of the Bretton Woods system, and what was the intellectual reason for the international monetary system moving towards liberalization in the 1970s? A historical review of the evolution of the international monetary system during the 20th century finds that the development and structure of Bretton Woods can be explained by a collapse of the international monetary system in the interwar period (1918-1939) and state-interventionism, while Ronald I. Mckinnon’s work on financial repression and liberalization provided the intellectual support for liberalization, neoliberalism, and financial globalization.
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I. Introduction

The international monetary system is rarely talked about outside of economics and political economy, but the international monetary system’s effects are far-reaching and potent. The international monetary system is the set of rules and regulations that govern international economic and financial transactions (Solomon, 1982). Well-functioning international monetary systems have promoted economic prosperity while others have caused painful financial crises and economic strife (Solomon, 1982). Following World War II, the international monetary system was not well functioning. World War I created large debt burdens and fractured international trade (Eichengreen, 1996). The international trade regime collapsed further during the interwar period (1918-1939) due to the failure of the price-specie flow mechanism, a mechanism inherent to the gold standard that theoretically facilitates fair international trade (Eichengreen, 1996). The interwar period was also characterized by currency crises, painful economic crises caused by speculative capital flows (Kindleberger, 1986). By the end of World War II, the international monetary system was in disarray (Eichengreen, 1996).

In 1944, economic policymakers met in Bretton Woods, New Hampshire to develop a well-functioning international monetary system (Helleiner, 1994). John Maynard Keynes of Britain and Harry Dexter White of the United States served as the architects of the new international monetary system (Helleiner, 1994). After intense negotiations, Keynes and White created an international monetary system of fixed international exchange rates and stringent capital controls, and created the International Monetary Fund (IMF) to referee the system (Helleiner, 1994). The design of the Bretton
Woods system was laid out in the International Monetary Fund Articles of Agreement, ratified in 1945 (“Articles of Agreement of the International Monetary Fund,” 1944). While the Bretton Woods system did not specifically mandate state-interventionist policies outside of capital controls, the Bretton Woods period was characterized by state-interventionist policies (Reinhart & Sbrancia, 2011).

In 1973, Stanford economist Ronald I. Mckinnon provided the intellectual foundation for the neoliberal movement that put an end to the Bretton Woods system. Mckinnon considered state-interventionist policies like capital controls and developed a theory of “financial repression” (Mckinnon, 1973). Mckinnon (1973) said state-interventionist policies were inefficient and a detriment to economic growth and development. Mckinnon (1973) argued in favor of “financial liberalization” instead. Financial liberalization is the deregulation of the financial sector (Reinert, 2010). Mckinnon (1973) argued financial liberalization would create a more efficient international monetary system and create economic growth.

The creation of the Bretton Woods system (1945-1971) and the evolution of the financial liberalization that characterized the last quarter of the 20th century and resulted in the contemporary international monetary system remain the most important developments in the international monetary system over the last century. What were the reasons for and structure of the Bretton Woods system, and what was the intellectual reason for the international monetary system moving towards liberalization in the 1970s?
II. International Monetary System

The international monetary system is “the set of arrangements, rules, practices, and institutions under which payments are made and received for transactions carried out across national boundaries [and] is concerned not only with the supply of international money but with the relationships among the hundred or so currencies of individual countries and with the pattern of balance-of-payments relationships and the manner in which they are adjusted and settled” (Solomon, 1982, p. 5). The international monetary system therefore describes more than just monetary arrangements; the international monetary system describes trade regimes, fiscal policies, and other domestic economic policies (Solomon, 1982). An international monetary system should, at the very least, manage three processes: “the adjustment of balance of payments positions, including the establishment and alteration of exchange rates, the financing of payments imbalances among countries by the use of credit or reserves, and the provision of international money reserves” (Solomon, 1982, p. 6). The rules and regulations governing the international monetary system have taken many forms as the international monetary system has evolved to meet different economic needs and thought (Solomon, 1982). For example, the current international monetary system is governed by an international organization of 189 countries called the International Monetary Fund (IMF), which was originally created as a part of the Bretton Woods system in 1944. The IMF conducts day-to-day management of the international monetary system, a contrast to previous international monetary systems, namely the original gold standard, which had no international oversight (Solomon, 1982).

The international monetary system is not truly international, nor is it a clearly
defined system. While 189 countries are currently members of the IMF, there are countries, for example North Korea, that are not participants in the international monetary system – and the major countries Russia and China barely participated in the international monetary system until the 1990s (Solomon, 1982). Furthermore, developed Western countries, i.e. the United States, the United Kingdom, France, and Germany, have mostly dictated the structure of the international monetary system during recent history (Solomon, 1982). The international monetary system is also convoluted. The international monetary system is foremost regulated by the IMF, but also conforms to other agreements between countries such as “the General Agreement on Tariffs and Trade (GATT), the Organization for Economic Cooperation and Development (OECD), the United Nations Conference on Trade and Development (UNCTAD),” and other regional agreements such as in the European Union (Solomon, 1982, p. 5-6). There are complex layers of rules and regulations to the international monetary system, but the IMF and the IMF Articles of Agreement primarily organize the international monetary system.

The international monetary system plays an essential role in daily economic life. “International monetary developments affect individuals as workers, consumers, travelers, businessmen producing goods for domestic or foreign markets, and investors at home or abroad. The channels which transmit the impact of monetary events to people in their various roles in society are numerous” (Solomon, 1982, p. 2). The importance of the international monetary system rests in the increasing interdependence of international economic and financial systems. International trade, travel, investment, and finance have increased to a level thought unimaginable at the end of World War II (Solomon, 1982). “Living standards and employment have come to depend on the ability to export and to
import and to provide the capital flows that help finance such trade and the stock of capital on which it is based” (Solomon, 1982, p. 7). “In these circumstances, a strike, a bank failure, an increase in interest rates, a recession, inflation...can have a significant impact on other nations” (Solomon, 1982, p. 7). Economic and financial interdependence mean that economic variations in one country or region affect economic conditions in another country or region, for better or worse. The international monetary system is the framework that governs the complex economic and financial relationships and transactions between countries and regions (Solomon, 1982). A well-functioning international monetary system can promote economic growth and development while a poorly functioning international monetary system can do the opposite or worse (Solomon, 1982).

In the late 19th and early 20th centuries, the international monetary system was organized under the gold standard – an arrangement in which national currencies were fixed to gold and international payments were made with gold (Eichengreen, 1996). In the period between World War I and World War II, called the interwar period, the international monetary system became dysfunctional. Following World War II, economic policymakers met in Bretton Woods, New Hampshire, to reorganize the international monetary system. The Bretton Woods conference reorganized the international monetary system into the “Bretton Woods system,” which lasted until 1971. Since the 1970s, the international monetary system has been moving towards “financial liberalization.”
III. Reasons for Bretton Woods

“The Bretton Woods agreements negotiated at the United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire, in 1944 laid the groundwork for the creation of the International Monetary Fund (IMF)” (Reinert, 2010, p. B). The IMF provided the framework for the postwar international monetary system that came to be known as the Bretton Woods system. Between the end of World War I and the end of World War II (1918-1944), international trade, and the international monetary system became dysfunctional and characterized by collapsing international trade, currency crises, balance of payments disequilibria, and large debt burdens. These were the reasons for the creation of a new international monetary system, called the Bretton Woods system. John Maynard Keynes of Britain, Harry Dexter White of the United States, and other economic policymakers met at the Bretton Woods conference in the hopes of creating a functioning international monetary system (Eichengreen, 1996).

Trade

Immediately following World War I, there was an American and European debt crisis regarding wartime loan repayments (Eichengreen, 1996). Hudson (2003) argued the persistence of creditor nations such as the United States, Britain, and France in pursuing repayment of war-related loans disrupted and uncoupled the global financial system. Following the war, the allies that received British loans during the war were unable to meet debt obligations, causing Britain to fail to meet debt obligations to the United States (Eichengreen, 1996). The war-related loan repayment dilemma culminated in the Treaty of Versailles which required that Germany pay immense reparations to the allies, especially France, amounting to $402 billion in today’s money, in the hopes that it would
be enough to resolve the loan repayment crisis (Suddath, 2010). Keynes insisted that the amount was too large and would ultimately cripple Germany’s economy (Suddath, 2010). Because reparation payments were so burdensome for Germany, Germany resorted to printing money, which led to hyperinflation, and defaulting on payments entirely (Suddath, 2010). Germany’s inability to meet its debt obligations meant that the wartime loan repayment crisis persisted (Keynes, 1920). At the same time, economic strain created a bitter political and economic environment in post-war Germany – resulting in the rise of Adolf Hitler and World War II (Castillo, 2003).

Germany’s debt problem led to a chain reaction that forced countries to leave the gold standard, an exchange rate regime that facilitated international trade. “With Germany unable to meet her short-term obligations…the government declared a standstill on foreign payments and imposed exchange restrictions in July 1931” (Ghosh & Qureshi, 2016, p. 13). A run on the British Pound Sterling ensued due to British banks’ exposure to German and Eastern European markets forcing Britain off the gold standard in 1931 (Ghosh & Qureshi, 2016). “What ensued was a decade of almost dizzying capital flight, hot money flows, competitive devaluations, exchange restrictions and capital controls (nearly all on outflows), protectionism, and imploding global trade” (Ghosh & Qureshi, 2016, p. 13). The Pound sterling’s devaluation immediately put pressure on the US Dollar, and in 1933, the United States was forced to devalue the US Dollar (Ghosh & Qureshi, 2016). The devaluation of the US Dollar triggered “speculative pressure on the Dutch Florin and the Swiss Franc—both of which were still pegged to gold at their pre-war parities—as well as on the French Franc, the largest economy still on gold, and on the other gold bloc countries…in sequence, countries abandoned the gold standard”
The “gold bloc” countries, France, Switzerland, Belgium, Luxembourg, the Netherlands, Italy, and Poland, were the only countries to remain on the gold standard through the Great Depression (Eichengreen, 1996). The collapse of the gold standard resulted in imploding global trade (Ghosh & Qureshi, 2016).

International trade was further disrupted by the Great Depression (1929-1939), which affected both the United States and Europe (Eichengreen, 1996). The response to the high levels of unemployment that characterized the Great Depression was “the introduction of policies to protect domestic producers by restricting imports, placing controls on the access to foreign exchange used to purchase imports, introducing preferential tariffs…national import restrictions, export subsidies, and agricultural price supports” (Reinert, 2010, p. B). International trade restrictions only exacerbated the deterioration of international trade and the international financial system (Eichengreen, 1996).

Currency Crises

An additional reason for the development and structure of the Bretton Woods system was the persistence of currency crises in the United States and Europe during the 1920s (Kindleberger, 1986). Currency crisis are caused by speculative international capital flows (Kindleberger, 1986). A currency crisis occurs when foreign investment, unmitigated by capital controls, flows into a country, generally stimulating economic growth, and then exits rapidly, usually due to some economic indicator that is perceived as unfavorable to investors (Reinert, 2010). Mass capital outflows cause major devaluations in the domestic currency, which can be problematic for the local economy.
because 1. The nation’s central bank will deplete its reserves trying to stabilize the
domestic currency on the foreign exchange market and 2. If currency stabilization fails,
people and businesses have to pay off debt denominated in foreign currency with
domestic currency, and because the domestic currency depreciated, the debt burden
becomes relatively larger (Feenstra & Taylor, 2011). Large debt burdens stunt economic
growth and development (Feenstra & Taylor, 2011). US Treasury Secretary Henry
Morgenthau later said at Bretton Woods that he wanted to “[drive]...the usurious money
lenders from the temple of international finance” (Department of State, 1944, p. 9).

In order to combat currency crises countries attempted to implement measures to
stop speculative capital inflows (Kindleberger, 1986). However, attempts manifested as a
chaotic system of protectionist and neo-mercantilist policies that limited beneficial
foreign investment, curtailed trade, and did little to prevent speculative attacks
(Kindleberger, 1986). “For the principal architects of the Bretton Woods system - John
Maynard Keynes and Harry Dexter White - the lesson of the interwar period was that free
capital mobility and free trade in goods and services are incompatible: destabilizing
capital flows will result in calls for protectionism” (Ghosh & Qureshi, 2016, p. 4).
Keynes and White viewed capital controls as a permanent part of the international
financial landscape (Ghosh & Qureshi, 2016). “It was in this environment that the
Bretton Woods arrangement of fixed exchange rates and tightly controlled domestic and
international capital markets was conceived” (Reinhart & Sbrancia, 2011, p. 19-20).

**Balance of Payments Disequilibria**

The balance of payments “is an international accounting record. It records the
economic transactions of the residents of one country with the residents of other countries
during a fixed period…payments are broken down into categories – goods, services, transfers, investments, and official reserves” (Reinert, 2010, p. B). The balance of payments is divided into the current account, “goods, services, income, and transfers,” and the financial account, “direct investment…portfolio investment…trade credit, bank loans and deposits…currency exchanges…[and] reserve assets,” and in the long-run, deficits and surpluses added should equal zero – indicating a balanced balance of payments (Reinert, 2010, p. B). In the interwar period (1918-1939) however, the global economy was characterized by imbalanced balance of payments, or balance of payments disequilibria (Eichengreen, 1996). Some countries were plagued by consistent balance of payments deficits, depleting gold and foreign-exchange reserves (Eichengreen, 1996). Britain was a deficit country every year from 1927 to 1931, while the French experienced surpluses every year for the same years (Eichengreen, 1996). Meanwhile the United States ran surpluses for almost the entire 1920s (Eichengreen, 1996).

The price-specie flow mechanism was at fault for the global balance of payments crisis (Eichengreen, 1996). The price-specie flow mechanism is an adjustment mechanism inherent to the gold standard that theoretically equalizes the balance of payments between nations (Reinert, 2010, p. G). It works in the following way: A balance of payments surplus results in excess gold inflows that get monetized by a central bank; by the quantity theory of money (QTM), the price level increases and makes domestic goods less competitive internationally, which moves the balance of payments towards deficit (Reinert, 2010). A balance of payments deficit results in gold outflows, and by the QTM, deflation; the lower price level makes good more competitive internationally, which moves the balance of payments towards surplus (Reinert, 2010).
The price-specie flow mechanism failed during the interwar period (Eichengreen, 1996).

The mechanism is predicated on surplus countries monetizing excess gold reserves to become less competitive. Without an international referee during the interwar period, surplus countries, primarily the United States and France, often failed to monetize their gold inflows (Irwin, 2012). “France increased its share of world gold reserves from 7 percent to 27 percent between 1927 and 1932, and failed to monetize most of this accumulation. This created an artificial shortage of gold reserves and put other countries under significant deflationary pressure…the United States and France shared the blame (in a 60/40 split) for the withdrawal of gold from the rest of the world and the onset of worldwide deflation in 1929” (Irwin, 2012, p. 1). The 1929 deflation was a leading cause of the Great Depression (Irwin, 2012). Creating an international referee to moderate the international payment system was therefore a main objective of the Bretton Woods conference.

Debt Burdens

Following World War II, Western economies had large debt burdens (Reinhart & Sbrancia, 2011). Many governments implemented “financially repressive” policies to control the allocation of credit in the economy, keeping interest rates lower than in a competitive environment, allowing government to reduce outstanding debt more quickly (Reinhart & Sbrancia, 2011). For governments, controlling the allocation of credit in the economy can be less burdensome than other debt reduction methods such as default, austerity, and inflation (Reinhart & Sbrancia, 2011) “One of the main goals of financial repression is to keep nominal interest rates lower than would otherwise prevail. This effect, other things equal, reduces the governments’ interest expenses for a given stock of
debt and contributes to deficit reduction (Reinhart & Sbrancia, 2011, p. 19). Financial repression was therefore an appealing tool for Western governments looking to reduce debt following World War II. “It thus appears...that the widespread system of financial repression that prevailed for several decades (1945-1980s) worldwide played an instrumental role in reducing or “liquidating” the massive stocks of debt accumulated during World War II in many of the advanced countries, United States inclusive” (Reinhart & Sbrancia, 2011, p. 3).

Outside of capital controls, the International Monetary Fund Articles of Agreement established at Bretton Woods did not explicitly mandate financially repressed policies, but many countries independently pursued such policies during the Bretton Woods period (Reinhart & Sbrancia, 2011). For example, the United States Federal Reserve pegged interest rates low to finance government debt repayment after World War II, and the US Treasury extended the peg until 1951 (Hetzel, 2013). One cannot help [but] think that part of the design principle of the Bretton Woods system was to make it easier to work down massive debt burdens” (Reinhart & Sbrancia, 2011, p. 46).

**Summary**

Deteriorating international trade and financial relationships caused by the collapse of the gold standard and Great Depression protectionism, currency crises caused by speculative international capital flows, and balance of payments disequilibria caused by surplus countries violating the price-specie flow mechanism characterized the interwar period. Western economies also had large debt overhangs in the wake of World War II. Therefore, policymakers at the Bretton Woods conference met with four main objectives in mind: reestablish international trade and financial relationships, restrict capital
mobility to thwart currency crises, create a referee for the international monetary system, and reduce war-related debt. The structure of the new international monetary system created at the Bretton Woods conference, called the “Bretton Woods system,” was necessitated by these four reasons, and designed with these four reasons in mind.
IV. Structure of Bretton Woods

The main goal of the Bretton Woods system was to create a new international monetary system that facilitated trade, prevented speculative attacks from international capital flows, prevented balance of payments disequilibria, and helped governments reduce war-related debt. In addition, policymakers wanted to ensure countries retained monetary policy autonomy and control over other macroeconomic planning measures such as tax policy (Helleiner, 1994). John Maynard Keynes and Harry Dexter White, the chief policymakers at the Bretton Woods conference, designed an international monetary system with the structure of stringent capital controls, fixed exchange rates, and domestic monetary policy autonomy (Helleiner, 1994). The Bretton Woods conference created the International Monetary Fund to implement the Bretton Woods system, referee the international monetary system, and provide other support functions (Solomon, 1982). All of these policies and functions are outlined in the IMF Articles of Agreement.

The fixed exchange rate regime facilitated international trade, capital controls rendered capital largely immobile to stave off speculative attacks, the IMF prevented balance of payments imbalances and provided other economic support, and nations maintained control over domestic money supplies and most domestic economic policies (Feenstra & Taylor, 2011). The Bretton Woods agreement is often vague and the architects of the Bretton Woods system, John Maynard Keynes and Harry Dexter White, never said exactly how the system was supposed to work (calling it a system may imply undue formality), but analysis of the Bretton Woods negotiations and the IMF Articles of Agreement reveals salient features of the system (Bordo, 2007).
Structural Considerations for International Monetary Systems

The trilemma of international finance, also called the impossible trinity, is central to understanding the logic behind the structure of monetary regimes such as the Bretton Woods system. This theory can be used to understand the creation of the Bretton Woods system as well as the reasons Bretton Woods unraveled. “The impossible trinity describes an apparently inescapable constraint faced by policymakers, namely the impossibility of simultaneously fixing an exchange rate, permitting full capital mobility,” and retaining monetary policy autonomy (Reinert, 2010, p. T). Policymakers construct monetary regimes with three policy goals in mind and have three regime types to choose from; each regime type achieves one pair of policy goals, and no regime type achieves all policy goals simultaneously (Feenstra & Taylor, 2011).

The three policy goals are achieving fixed exchange rates, free capital mobility, and monetary policy autonomy (Feenstra & Taylor, 2011). A fixed exchange rate is a foreign exchange rate regime in which a currency trades at a set parity to a commodity, commonly gold, or a reserve currency; this regime facilitates international trade (Feenstra & Taylor, 2011). Free capital mobility is the ability for capital to flow freely into and out of a country; these flows consist of transactions like foreign direct investment, and even payments necessary for international trade (Reinert, 2010). Monetary policy autonomy is the situation in which a country’s central bank or other government agency maintains control over the country’s money supply, and can independently exercise monetary policy. No monetary regime achieves all three goals simultaneously. If a country decides to achieve a different pair of goals, it must change its monetary regime.

There are three monetary regimes to choose from referred to as policy choices:
floating exchange rates, capital controls, and absent monetary policy autonomy (Feenstra & Taylor, 2011). A floating exchange rate is a foreign exchange rate regime in which a currency “floats” on the foreign exchange market and the forces of supply and demand determine the currency’s value; there is no government effort to artificially set value (Feenstra & Taylor, 2011). Capital controls are government policies that restrict cross-border financial transactions (Feenstra & Taylor, 2011). An absence of monetary policy autonomy means that a country and its central bank or other government agency do not have control of the country’s money supply and cannot exercise independent monetary policy; developed countries with strong institutions prefer to maintain monetary policy autonomy because monetary policy is a tool for managing the economy (Feenstra & Taylor, 2011).

Each one of the policy choices achieves a pair of the three policy goals (Feenstra & Taylor, 2011). Under a system of floating exchange rates, a country has monetary policy autonomy and free capital mobility, but not a fixed exchange rate (Feenstra & Taylor, 2011). In a system of absent monetary policy autonomy, the country has a fixed exchange rate and free capital mobility (Feenstra & Taylor, 2011). Finally, under a system of capital controls, the country has a fixed exchange rate and monetary policy autonomy, but not free capital mobility (Feenstra & Taylor, 2011). The final policy choice of capital controls with a fixed exchange rate and monetary policy autonomy fit Brett Woods policymaker objectives and were the largest structural elements of the new international monetary system.

**Fixed Exchange Rates and International Trade**

The Bretton Woods system created a fixed exchange rate regime built on the US
Dollar and US Treasury Bond (Solomon, 1982). The fixed exchange rate regime, commonly called “the modified gold standard” fixed the US Dollar to gold, and fixed other currencies to the US Dollar in an arrangement called the par-value system, outlined in Article IV of the IMF Article of Agreement (Bordo, 2007). Under the par-value arrangement, all members declared an exchange rate parity and currencies had to remain in a 1% band of the official par-value, with the exception of cases of “fundamental disequilibrium,” a term never formally defined, in which exchange rate parities could be modified once by up to 10 percent if approved by the International Monetary Fund, the rulekeeper of the international monetary system (Ghosh & Qureshi, 2016). The adjustment of the fixed parity could be larger if approved by more than three-fourths of the International Monetary Fund’s members (Ghosh & Qureshi, 2016). Exchange rate manipulations or failure to maintain par-value could result in the expulsion of a member country (Bordo, 2007). The fixed exchange rate regime made the US Dollar the world’s reserve currency and made US Treasury Bills the world’s central risk-free financial instrument, making the United States the center of the international monetary system (Solomon, 1982). The United States was put at the forefront of the international monetary system because of the superior condition of the US economy following World War II, but later resulted in an overvaluation of the US Dollar, causing President Nixon to suspend the system in 1971 citing concerns of US economic competitiveness (Solomon, 1982).

The fixed exchange rate regime promoted international trade and was the leading cause for the ratification of the agreement by the United States (Eichengreen, 1996). American industry supported the conference’s focus on international trade, and “saw export markets as vital to postwar prosperity and Britain’s system of imperial preference
as hindering its market access” (Eichengreen, 1996, p. 99). US politicians did not care for the complicated rules and regulations outlined in the agreement for the new international monetary system, but the promise of international trade and the continued success of American manufacturing in the post-war period was alluring for American businesses and government officials (Eichengreen, 1996). The “provisions for the reestablishment of multilateral trade the Americans attached great importance, believing such importance to be the raison d’etre of the Fund, equal in importance to its stabilization functions” (Eichengreen, 1996, p. 99).

**Capital Controls**

The Bretton Woods negotiations are often seen as an intense debate between policymakers John Maynard Keynes of Britain and Harry Dexter White of the United States, but both representatives agreed on the implementation of stringent capital controls (Helleiner, 1994). Keynes and White argued in favor of capital controls for two reasons. First, according to White, “flights of capital, motivated either by prospect of speculative exchange gain, or desire to avoid inflation, or evade taxes,” would disrupt government control over monetary and tax policies (Helleiner, 1994, p. 33). Keynes added, “short-term speculative movements or flights of currency…would impose undue balance-of-payments constraint on domestic macroeconomic objectives” (Helleiner, 1994, p. 34).

Second, Keynes and White believed that free capital mobility was incompatible with stable exchange rates and international trade, as suggested by the trilemma of international finance (Helleiner, 1994). White noted that “speculative capital movements were one of the chief causes of foreign exchange disturbances,” and Keynes argued “capital controls would be needed to prevent capital flows from strangling international
“trade” (Helleiner, 1994, p. 35). “Keynes and White thus envisaged capital controls as a structural element of the international financial landscape, rather than as just temporary or transitional measures” (Ghosh & Qureshi, 2016, p. 15). However, “members of the New York financial community…worried…any US obligation to control speculative flows would remove what had been a lucrative business for New York banks…[and] prevent the rebuilding of an open, liberal international financial system from which they…would derive considerable benefit” (Helleiner, 1994, p. 48). Late in negotiations, elite New York bankers lobbied against capital controls and had success watering down capital controls proposals (Ghosh & Qureshi, 2016). In the final version of IMF Articles of Agreement “capital controls were not included as a permanent feature of the international financial landscape” (Helleiner, 1994, p. 50). Instead, Article VI.3 of the IMF Articles of Agreement only said, “members may exercise such controls as are necessary to regulate international capital movements” (“Articles of Agreement of the International Monetary Fund,” 1944). Under the IMF Articles of Agreement, capital controls were not mandated, but were strongly recommended and encouraged (Helleiner, 1994).

Despite resistance from New York banking and financial interests, “the Bretton Woods era was characterized by widespread use of restrictive measures” (Ghosh & Qureshi, 2016, p. 16). The Bretton Woods system retained the restrictive approach to international capital movements favored by Keynes and White (Helleiner, 1994). Capital controls primarily focused on capital outflows rather than inflows (Ghosh & Qureshi, 2016). Although the Bretton Woods system promoted capital movements in some specific cases, the overriding theme was restriction and states were given permission to
control all capital movements (Helleiner, 1994). In addition, the two mechanisms Keynes and White designed to make capital controls more effective, cooperative capital controls and exchange controls for preventing illicit capital movements, were included in the final system (Helleiner, 1994). “In the early years of the Bretton Woods era, capital controls thus remained widespread—more so in advanced economies than in emerging markets, and (much) more so on outflows than on inflows. Inflow restrictions were initially directed mainly at limiting foreign ownership of “strategic” industries, but in later years, prudential measures to restrict speculative flows became more prevalent” (Ghosh & Qureshi, 2016, p. 4).

The International Monetary Fund

The Bretton Woods conference established the International Monetary Fund and outlined its resources, powers, and organization in the IMF Articles of Agreement (Bordo, 2007). International Monetary Fund resources are outlined in Article VII: Replenishment and Scarce Currencies of the IMF Articles of Agreement (“Articles of Agreement of the International Monetary Fund,” 1944). Under Article VII, the Bretton Woods system created a monetary fund to finance short- or medium-term balance of payments imbalances (Bordo, 2007). The fund was set at a value of $8.8 billion and “could be raised every five years if the majority of members wanted to do so” (Bordo, 2007). The fund was financed and replenished by member countries according to individual quotas and paid with 25% gold and 75% currency (Bordo, 2007). Quotas were determined by the economic size of a member measured by GDP (Bordo, 2007). The IMF’s powers are outlined in Article V: Operations and Transactions of the fund (“Articles of Agreement of the International Monetary Fund,” 1944). In the final version
of the Articles of Agreement, the IMF was granted considerably less power than Keynes and White hoped, but it did retain the ability to approve or disapprove changes in parity, the use of multiple exchange rates and other discriminatory practices, and the conditionality that was implicit in members’ access to fund resources (Bordo, 2007). The IMF could make members ineligible to use its resources and expel members from the fund (Bordo, 2007). Article XII: Organization and Management outlines the structure of the IMF (“Articles of Agreement of the International Monetary Fund,” 1944). The IMF is governed by a board of governors, appointed by member nations, in charge of major policy decisions, such as approving a change in parity (Bordo, 2007). Directors, also appointed by member nations, managed fund operations (Bordo, 2007).

Other Restrictive Measures

Although outside of capital controls few restrictive measures were mandated by the Bretton Woods agreement, the Bretton Woods system symbolized an ideological shift towards repressive liberal policies and a restrictive financial order (Helleiner, 1994). The interventionist policies of the Bretton Woods period were a stark contrast to the laissez-faire policies of the 1930s and earlier (Helleiner, 1994). In fact, “financial repression was…the norm for advanced economies during the post-World War II period and in varying degrees up through the 1980s” (Reinhart & Sbrancia, 2011, p. 6). Examples of financial restrictions or financially repressive policies in the Bretton Woods period include Regulation Q in the United States, a restriction on banks paying interest on certain types of bank deposits, and the US Federal Reserve’s decision to maintain artificially low interest rates until 1951 to accelerate the reduction of World War II debt (Hetzel, 2013). Other financially repressive measures common during the Bretton Woods
period included “capital account restrictions and exchange controls…in the portfolio of financial institutions and individuals…high reserve requirements…‘prudential’ regulatory measures requiring that institutions…hold government debts in their portfolios…and transaction taxes on equities…to direct investors toward government…debt instruments” (Reinhart & Sbrancia, 2011, p. 6). Financial repression made private banking interests less profitable, so banking and financial interests in both the United States and Britain opposed such measures, a fact that would undermine the Bretton Woods system (Helleiner, 1994).

Summary

In 1944, economic policymakers led by John Maynard Keynes and Harry Dexter White met in Bretton Woods, New Hampshire, at the Bretton Woods conference. The Bretton Woods conference created a new international monetary system called the Bretton Woods system, the structure of which was outlined in the IMF Articles of Agreement. The Bretton Woods system’s structure was that of a fixed international exchange rate, capital controls, and the establishment of an international referee called the International Monetary Fund (IMF). While not explicitly mandated by the IMF Articles of Agreement, the Bretton Woods system marked a shift towards restrictive economic policies and government interventionism. In 1973, Ronald I. Mckinnon developed the theory of financial repression and financial liberalization. Mckinnon argued that restrictive international monetary systems were inefficient and stunted economic growth. Mckinnon provided intellectual support for financial liberalization, and the forces that undermined the Bretton Woods system.
V. Theory of Financial Repression

Financial repression “refers to the notion that a set of government regulations, laws, or other non-market restrictions prevents an economy’s financial intermediaries - such as banks and security markets - from functioning at their full capacity” (Reinert, 2010, p. F). “The policies that cause financial repression include interest rate ceilings, liquidity ratio requirements, high bank reserve requirements, capital controls, restrictions on market entry into the financial sector, credit ceilings or restrictions on directions of credit allocation, and government ownership or domination of banks” (Reinert, 2010, p. F). Ronald Mckinnon and Edward Shaw developed the concept of financial repression in 1973 in their works Money and Capital in Economic Development, and Financial Deepening in Economic Development. Mckinnon (1973) and Shaw (1973) studied why growth was stagnant in less developed countries (LDCs) in the face of large foreign aid transfers, capital inflows, and subsidies from industrialized nations, and why economic growth in the post-World War II period was unequal between similar countries like Mexico and Colombia, Japan and India, and Taiwan and the Philippines.

Mckinnon (1973) and Shaw (1973) discovered that stagnation and unequal growth could largely be explained by a concept they termed “financial repression.” Rejecting previous explanations for stagnant and unequal growth, Mckinnon (1973) turned the focus towards the organization of financial systems. Mckinnon (1973) argued that certain government interventions in the financial sector prevented financial intermediaries from working at full capacity and channeling saving into investment efficiently, stunting growth. While Mckinnon (1973) used financial repression to describe LDCs, Reinhart
and Sbrancia (2011, p. 6) claimed “financial repression was also the norm for advanced economies during the post-World War II period and in varying degrees up through the 1980s.” Financial repression is now applied widely and describes any financial system hindered by “interest rate ceilings, liquidity ratio requirements, high bank reserve requirements, capital controls, restrictions on market entry into the financial sector, credit ceilings or restrictions on directions of credit allocation, and government ownership or domination of banks” (Reinert, 2010, p. F).

McKinnon (1973) originally defined financial repression as an arrangement in which the government controlled the price and allocation of credit in the economy. “The main motive behind financial repression is fiscal. The government wishes to promote development, but lacks the resources to do so. Through imposition of large liquidity and reserve requirements, it creates a captive demand for its own interest bearing or non-interest bearing instruments, respectively, and uses it to finance its own priority spending” (Agenor & Montiel, 1996, p. 95). According to McKinnon (1973) the government controls the price and allocation of credit in three main ways: first, it strictly regulates financial institutions and their business operations, second, it puts tight controls on international capital flows, and third, it takes ownership of banks and various other financial intermediaries. Carmen M. Reinhart and M. Belen Sbrancia (2011, p. 6) provided “The Pillars of Financial Repression,” the most comprehensive academic definition of financial repression:

“(i) Explicit or indirect caps or ceilings on interest rates, particularly (but not exclusively) those on government debts. These interest rate ceilings could be effected through various means including: (a) explicit government regulation (for instance, Regulation Q in the United States prohibited banks from paying interest on demand deposits and capped interest rates on saving deposits). (b) In many
cases ceilings on banks’ lending rates were a direct subsidy to the government in cases where the government borrowed directly from the banks (via loans rather than securitized debt); (c) the interest rate cap could be in the context of fixed coupon rate nonmarketable debt; (d) or it could be maintained through central bank interest rate targets (often at the directive of the Treasury or Ministry of Finance when central bank independence was limited or nonexistent).

(ii) Creation and maintenance of a captive domestic audience that facilitated directed credit to the government. This was achieved through multiple layers of regulations from very blunt to more subtle measures. (a) Capital account restrictions and exchange controls orchestrated a “forced home bias” in the portfolio of financial institutions and individuals under the Bretton Woods arrangements. (b) High reserve requirements (usually non-remunerated) as a tax levy on banks. (c) Among more subtle measures, “prudential” regulatory measures requiring that institutions (almost exclusively domestic ones) hold government debts in their portfolios (pension funds have historically been a primary target); and (d) transaction taxes on equities also act to direct investors toward government (and other) types of debt instruments. (e) prohibitions on gold transactions.

(iii) Other common measures associated with financial repression aside from the ones discussed above are, direct ownership (China or India) of banks or extensive management of banks and other financial institutions (i.e. Japan). Restrictions of entry to the financial industry and directing credit to certain industries are also features of repressed financial markets.”

**Inefficiency**

Mckinnon (1973) postulated that economic growth in LDCs was stagnant because of financial repression - an inefficient system that stunts economic growth because it limits the amount of credit in the economy and creates inefficient allocation of capital. In financially repressed systems, bank credit remains a financial advantage of the elite and crony capitalists and the rest of the economy must look to pawnbrokers and moneylenders (Mckinnon, 1973). Mckinnon (1973) gives the example of a farmer who would see a 60 percent return on investment from building additional irrigation, but can only borrow from a moneylender at 100 percent interest so foregos the investment to illustrate the inefficiency. Mckinnon (1973) details how crony capitalist relationships in
credit allocation eliminate opportunities for innovation and entrepreneurship for the non-elite. Furthermore, traditional banks cannot earn high rates of return from lending to elite and creditworthy borrowers, resulting in a correspondingly low rate of return for depositors (Mckinnon, 1973). As a result, depositors reduce their holdings in banks below the social optimum, and further reduce the amount of money available for lending (Mckinnon, 1973). In sum, in a financially repressed economy, credit is scarce and financial intermediaries do not perform at their full capacity, failing to channel savings into investment efficiently (Mckinnon, 1973). Scarce credit and inefficient allocation of capital inhibit economic growth (Mckinnon, 1973).

**Trade Restrictions**

Governments often couple financial repression with trade restrictions such as tariffs and quotas (Mckinnon, 1973). Trade restrictions are used to encourage domestic growth which is often anemic in financially repressed economies (Mckinnon, 1973). While in liberalized economies capital freely flows to productive business opportunities, it does not in repressed economies due to inefficiencies and credit shortages (Mckinnon, 1973). Repressive governments use tariffs and quotas as an alternate means of fundraising for domestic businesses. Tariffs and quotas reduce the supply of imported goods, raising the price of domestic goods and leaving domestic producers without outside competition (Mckinnon, 1973). Businesses see increased cash flow from charging higher prices and less international competition, supposedly substituting for investment (Mckinnon, 1973). Mckinnon (1973) points to several problems with using trade restrictions as alternative funding. First, trade restrictions subsidize efficient and inefficient businesses equally (Mckinnon, 1973). Regardless of a business’s performance,
the business will experience increased cash flow. The opposite is true in a liberalized economy in which financial intermediaries and market forces direct capital efficiently to the best businesses and to capital’s most productive use (Mckinnon, 1973). Second, prices get distorted in the economy and no longer reflect accurate information (Mckinnon, 1973). And third, trade restrictions do nothing to help “infant entrepreneurs” who do not yet have a marketable product (Mckinnon, 1973). As a result, resources are used inefficiently in repressed economies and the trend tends not to improve (Mckinnon, 1973). In addition, although trade restrictions are designed to help domestic producers, they often have the opposite effect (Mckinnon, 1973). For example, if the government were to distribute import licenses, privileged firms with crony capitalist relationships to the government would likely be the only producers to get import licenses (Mckinnon, 1973). This puts other, less privileged producers at a distinct disadvantage regardless of comparative efficiency. In some cases, cronyism can prop up inefficient businesses with elite relationships over better businesses that are less privileged. In sum, Mckinnon (1973) argues that trade restrictions are inefficient and not a substitute for efficient financial systems.

Capital Controls

Mckinnon (1973) identifies several reasons that capital controls, government restrictions on the inflow and outflow of capital in the domestic economy, are inefficient and stunt growth. First, capital controls reduce the capital supply, limiting the amount of capital available for investment and increasing the cost of raising capital (Mckinnon, 1973). In addition, in economies with capital controls, governments direct capital rather than financial markets, insulating economies from market forces and allowing
governments to allocate capital inefficiently (Mckinnon, 1973). Economic theory dictates that market forces direct capital to the most efficient use in the economy; in the best-case scenario, government cannot direct capital as efficiently as market forces and oftentimes, government capital direction has more to do with crony capitalism and corruption than efficiency (Mckinnon, 1973). Finally, capital controls can be difficult and costly to enforce, even for nations with well-established government institutions (Mckinnon, 1973). Capital controls became even more difficult and costly to enforce with the development of information technology and the use of the computers and the Internet in global finance and banking (Helleiner, 1994).

**Empirical Support**


Roubini and Sala-i-Martin (1991) provide the leading empirical evidence that financial repression inhibits growth. Roubini and Sala-i-Martin (1991, p. 1) “analyze the
relation between the trade regime, the degree of financial development and the growth performance of a large cross section of countries,” controlling for factors that made most previous studies of the Latin American experience with financial repression and liberalization. Roubini and Sala-i-Martin (1991) empirically analyze the relationship between trade regime and growth and financial development and growth in the context of financial repression theory. Roubini and Sala-i-Martin (1991, p. 30) find that “the empirical evidence is for most measures consistent with the hypothesis that trade barriers and inward-oriented trade regimes are harmful to long term growth. The evidence on a large cross-section of countries is therefore consistent with the results...on the relation between trade regime...and economic performance.” Roubini and Sala-i-Martin (1991) find the same negative relationship between financial repression and growth, echoing theory. “Controlling for other determinants of growth, a high degree of financial underdevelopment and/or financial repression will lead to lower economic growth” (Roubini & Sala-i-Martin, 1991, p. 36). Roubini and Sala-i-Martin (1991) analysis supports Mckinnon’s theory that trade barriers and financial repression lead to slower growth. However, while Mckinnon (1973) primarily focused on LDC’s, Roubini and Sala-i-Martin (1991)’s analysis included both developed and less developed countries meaning that empirically, financial repression leads to slower growth in both developed and less developed economies.
VI. Theory of Financial Liberalization

Financial liberalization is “the transition away from a financial system characterized by state intervention and ownership and toward a more market-oriented system...externally oriented financial liberalization involves lifting state controls on the flow of finance between the country in question and international financial markets, including allowing for competition from international banks operating within the country. Internally oriented financial liberalization focuses on removing restrictions on competition and other business practices within the domestic financial markets” (Reinert 2010, p. F). Due to the inefficiencies Mckinnon (1973) identified as being inherent to financially repressed systems, Mckinnon (1973) advocates for financial liberalization. The following six features characterize financially liberalized economies, according to Mckinnon (1973):

1. Elimination of credit controls
2. Unregulated interest rates
3. Elimination of barriers to entering the banking or financial sector
4. Banks are independent from the government
5. Banks are privately owned
6. International capital flows are liberalized

Mckinnon (1973) also advocated for trade liberalization, but put domestic financial markets and capital markets at the forefront of liberalization. Policy in the domestic capital market and the withdrawal of government interventionism is the key to general liberalization (Mckinnon, 1973). The logic for the preeminence of capital markets is clear. The primary reason for government trade restrictions in financially repressed economies is to funnel more money towards domestic businesses as a substitute for investment in the absence of well-functioning credit markets. Once credit markets and the
financial sector are sufficiently liberalized, capital can be allocated efficiently to its most productive use, and the need for substitute funding sources like trade restrictions is eliminated (Mckinnon, 1973). In a system of well-functioning capital markets and financial services, trade restrictions are not needed as an alternative funding source. Therefore, Mckinnon (1973) says that liberalization of financial markets will naturally lead to the liberalization of trade, eliminating both growth-inhibiting regimes.

Credit Markets

To develop domestic credit markets, Mckinnon (1973) gave five objectives: eliminating credit controls, removing caps on interest rates, eliminating barriers to entry in the finance and banking sectors, and making banks private and independent from the government. A credit control is a feature of financial repression whereby the government maintains control over the credit that commercial banks grant (Reinert, 2010). Credit controls lend themselves to cronyism, inefficiency, and slow-growth (Mckinnon, 1973). Furthermore, financially repressed institutions are costly (Zagha & Nankani, 2005). “Banks, particularly state banks and development banks, periodically required recapitalization and the takeover of their external debts by governments...loan repayments were weak because loans financed inefficient activities, because loan collection efforts were insufficient, and because borrowers tended to treat loans from the state banks simply as transfers” (Zagha & Nankani, 2005, p. 204-205). Consequently, Mckinnon (1973) advocates for eliminating credit controls entirely, making banks independent from government intervention, and opening the finance and banking sectors up to free-market competition in order to allocate credit in the economy more efficiently and reduce the costs of state-run banking. Mckinnon (1973) also argues in favor of
eliminating caps on interest rates. The logic is that higher interest yields attract more savings, which are usually lacking in financially repressed economies, and result in more funds available to lend - increasing the supply of credit in the economy (Mckinnon, 1973). In addition, the higher yields attract money away from unproductive stores like foreign currency and land, and move it into the financial sector for productive use (Mckinnon, 1973). Functioning credit markets allocate investment towards the most productive activities, resulting in economic growth.

Capital Controls

Eliminating capital controls results in many economic benefits. As explained by Forbes (2005, p. 1), “capital inflows can provide financing for high-return investment, thereby raising growth rates. Capital inflows—especially in the form of direct investment—often bring improved technology, management techniques, and access to international networks, all of which further raise productivity and growth. Capital outflows can allow domestic citizens and companies to earn higher returns and better diversify risk, thereby reducing volatility in consumption and income. Capital inflows and outflows can increase market discipline, thereby leading to a more efficient allocation of resources and higher productivity growth.” Capital controls prevent economies from accessing growth-producing benefits. However, rapid capital control liberalization caused financial crises in Latin America in the 1980s and 1990s leading Mckinnon (1993) to refine his theory. Mckinnon (1993) acknowledged the risk of liberalizing capital flows and developed an “order of financial liberalization” that helped stem the risk of liberalization-related financial crises. Mckinnon (1993) viewed capital control liberalization from a cost-benefit standpoint and argued that the benefits of
liberalizing capital flows far exceeded the risks, especially if the correct order of financial liberalization was followed during the liberalization process.

**Empirical Support**

The effects of financial liberalization have been more contentious in practice. Financial liberalization has contributed to major financial crises in Latin America and Asia, but worked as theorized in Chile, Poland, the Czech Republic, and elsewhere (Mckinnon, 1993). Financial liberalization contributed to the Asian financial crisis in the 1990s, but also provided efficiency, access to world markets, and a flexible exchange rate regime that allowed the Asian tigers to develop in the first place (Feenstra & Taylor, 2011). Larger economies have had mixed experiences with financial liberalization as well. Financial liberalization contributed to the success of US banking and financial interests, but also contributed to the lax financial regulations in the United States that contributed to the Great Recession. While Mckinnon (1993) tried to reduce the risk inherent to financial liberalization with the order of financial liberalization, financial liberalization still entails risk.

Financial liberalization should be looked at through a cost-benefit analysis. While there are definite risks to financial liberalization, studies suggest that the benefits generally outweigh the costs. While a liberalized international monetary system may not provide the same stability as the Bretton Woods system, or some other restrictive international monetary system, the consensus is that financial repression is simply too costly. Financial repression stunts growth and is inefficient at an unacceptable level. The growth and efficiency benefits unlocked by financial liberalization outweigh the risks in most cases. Economies should pursue financial liberalization, but be aware of the associated risks and try to manage them.
VII. End of the Bretton Woods System and Financial Liberalization

The Bretton Woods system ended because of the intellectual movement towards financial liberalization and ensuing political difficulties (Helleiner, 1994). The Bretton Woods agreement failed to prevent individual IMF members from unilaterally pursuing many domestic economic policies that eventually undermined the system (Helleiner, 1994). In the late 1950s, the United States and Britain began deregulating and liberalizing the financial sector to increase the international competitiveness and superiority of US and British banking and financial interests (Helleiner, 1994). Deregulation and liberalization in the United States and Britain caused a wave of competitive deregulation in other major economies (Helleiner, 1994). Foreign financial centers saw business and capital moving toward the more attractive US and British markets and were forced to liberalize and deregulate their own banking and financial sectors in a wave of competitive deregulation (Helleiner, 1994).

The neo-liberal intellectual movement, supported by Mckinnon (1973), continued the march towards financial liberalization (Helleiner, 1994). “Neoliberal advocates favored a liberal financial order on the grounds that it would...promote a more efficient allocation of capital both internationally and domestically” (Helleiner, 1994, p. 99). Neoliberals rejected the structure of the Bretton Woods system in favor of an international monetary system of floating exchange rates and no capital controls (Helleiner, 1994). In 1971, citing an overvaluation of the US Dollar that made the United States economically uncompetitive on the international stage, President Richard Nixon suspended the US Dollar’s convertibility into gold, marking the end of the Bretton Woods par-value system of fixed exchange rates (“The end of the Bretton Woods system
Attempts to repair the system of fixed exchange rates failed and all major currencies began floating against one another in 1973 ("The end of the Bretton Woods system (1972-81)," n.d.). The United States also eliminated capital controls in 1974, with other major economies following suit (Helleiner, 1994). The end of the par-value system and capital controls marked the end of the Bretton Woods system and the transition to the current liberalized international monetary system. The IMF remained, but in a different role. In addition to the new international monetary system of floating exchange rates and no capital controls, the neoliberal intellectual movement ensured that financial liberalization continued in the international economy through the 1990s (Helleiner, 1994).

While the Bretton Woods system ended in the 1970s, some remnants remain, with major implications for the United States. Through the par-value system of fixed exchange rates, the Bretton Woods system put the US Dollar and US Treasury Bond at the center of the international monetary system. The functioning of the international monetary system depended on a steady supply of US financial assets to be used in international financial transactions. As the world economy grew, the demand for US financial assets grew. Treasury bonds are debt instruments, and get produced when the United States is running budget deficits. In order to supply the US financial assets that the Bretton Woods system depended on, the United States had to continually run budget deficits. Post-World War II, the United States was in superior economic standing and agreed to sacrifice its fiscal position to reestablish international economic order.

Despite the international monetary system now being divorced from the Bretton Woods system, US financial assets are still at the center of the international monetary
system. The United States is still forced to continually run budget deficits to provide US financial assets to enable the international monetary system. The successful operation of the international monetary system is still squarely on the United States’ shoulders. The US cannot remain in this role forever. By continually running budget deficits, the United States is continually eroding its fiscal position. As the national debt grows larger, the United States has to dedicate a growing amount of the national budget to paying interest on the national debt. The United States could be reducing taxes or appropriating interest payment money to programs that would benefit US citizens instead. The United States has borne the burden of the international monetary system for long enough. In the coming decades, the United States should renegotiate the structure of the international monetary system so that other world financial powers like the European Union and Japan can share the burden. The restructuring of the international monetary system will be difficult, and mark the next great evolution of the international monetary system.
VIII. Conclusion

The Bretton Woods system was largely a consequence of the times in which it arose. Motivated by the collapse of the international monetary system between World War I and World War II, policymakers at the Bretton Woods conference established an international monetary system that promoted international trade and international financial relationships. In 1944 the Bretton Woods agreement established the International Monetary Fund, an international regime of fixed exchange rates, and a system of international capital controls. The Bretton Woods system represented a shift towards a restrictive liberal international monetary system characterized by interventionist policies.

In 1973, Ronald Mckinnon introduced the theory of financial repression and financial liberalization. Financial repression is a financial system characterized by state interventionist policies, such as capital controls. Mckinnon argued that financial repression was inefficient and stunted economic growth, which was proved correct empirically. Mckinnon argued in favor of financial liberalization, the process of deregulating financial markets and removing interventionist state policies. Mckinnon provided the main intellectual support for the neoliberal movement that eroded the Bretton Woods system and led to financial liberalization and globalization in the last quarter of the 20th century.

The Bretton Woods system was flawed in that it allowed individual countries to unilaterally adopt certain economic policies that threatened the integrity of the entire system. In the late 1950s both the United States and Britain launched neoliberal efforts to deregulate the financial sector to benefit domestic banking and financial interests.
Deregulation in the United States and Britain made other countries less competitive causing other major countries to deregulate in a wave of competitive deregulation. President Nixon suspended the US Dollar’s convertibility into gold in 1971, and put an end to the par-value system of fixed exchange rates. The world’s major currencies began floating in 1973, the United States and other major economies eliminated capital controls soon after, and the neoliberal ideals supported by Mckinnon resulted in waves of financial liberalization through the 1990s.

The waves of financial liberalization that characterized the 1970s, 80s, and 90s were not without incident. Countries in Latin America and Asia endured painful financial crises as a result of speculative international capital flows and liberalizing incorrectly in the context of Mckinnon’s order of financial liberalization. However, financial liberalization has been mostly positive. Financial liberalization created the current international monetary system, which is stable, efficient, and encourages economic growth. However, the United States still plays too great a role in the operation of the international monetary system, and will need to restructure the international monetary system once again in the coming decades.
References


