No system of currency exchange will work forever because the world is always changing.

**Brettonwoods Agreement**

At the end of 1945, the Brettonwoods system was implemented and used the dollar as a pivot because the US as producing ~75% of the world GDP at the time. Major points of the system:

1. The US owns gold to back the dollar at a fixed rate of $35 per oz.
2. Every other currency is backed by the dollar at a fixed exchange rate.
3. Individuals not allowed to own gold – only countries are.

There are many disadvantages to owning gold (no interest, selling and transportation is expensive) so this was mainly a symbolic thing (all the gold was stored in New York).

They established fixed exchange rates because they were worried about the competitive devaluation that led to the Great Depression. The question was how do you decide where to set the rates. They went back to rates similar to that of 1929 as this was perceived as the ‘Golden Age’ (as an example - $5/£).

During this summit, they also created the International Monetary Fund (IMF) and the World Bank (WB). These were not, however, designed to help in a crisis (contrary to how they are used today). At the time, no one believed there would be crises because of the prevalence of colonialism. The WB dealt with infrastructure and the IMF was for short term loans to underdeveloped countries during a BOP crisis. Today, we use them much differently than they were intended.

**Fallout from the system**

During the 1940s and 1950s, there was a dollar shortage as a result of low productivities in the rest of the world compared to the relatively high productivity in the U.S. This meant that the exchange rates were way off.

Other developed countries at the time started low in productivity but had a high rate of growth of productivity because they already knew how to manufacture and produce things – their low productivity was caused by missing pieces and things that were critical to production. Once these pieces were replaced, productivity skyrocketed. This coupled with fixed exchange rates led to a dollar surplus by the 1960s. So the rest of the world has surpluses while the US is running a deficit.

Even though, economically, it is better for surplus countries to adjust (increase imports; increase GDP), the deficit countries are always the ones adjusting (cut exports, smaller GDP).
Ending the gold standard

So how does the US adjust? Since everything was pegged to the dollar, they changed to value of gold (from $35 to 38 to 42+) in the 1970s. This move increases US liquidity (by allowing more money to be printed) but doesn’t solve the deficit problem – just delays its demise.

This causes demand for gold to increase as it is now a better investment. This prompted many countries to ask for a gold guarantee (a promise of payment to foreign countries if the price of gold increases). However, Nixon could never do this so he delays the gold guarantees (Thursday to Monday) and in the interim (on Sunday), he announced that the US was abolishing the gold standard – the US government refused to buy and sell it at set price. Effectively, gold had been phased out of the international monetary system.

Should we go back to gold?

Many people now want to return to the gold standard. Economically, there is no reason to believe that the change in the supply of gold has anything to do with the change in the money supply. Also, it is unattractive politically. In 1985, gold was mostly mined in South Africa and the Soviet Union (US supply was only 2%). Who wants to give these countries control over world money supply? In the 1990s, there was an enormous increase in gold technology and now the US produces about 15% of the world supply. Additionally, if gold is falling in value, then there is a potential for a large dump on the market by countries that still have reserves left over from ’72-3.

European exchange rate system

For a while, Europe had a fixed exchange rate system. This was good for BOP accounting and led Europe halfway to a common currency. Inherently, a flexible exchange rate lead to inefficient companies and national, instead of European, companies.

But at the end of the cold war, German reunification really messes things up. To absorb the East, Germany raises interest rates to attract capital inflow and increase investment in East Germany. Additionally, the Germans don’t care about unemployment because of the prevalence in Germany of guest workers (which they can send home) and a low population growth. West Germany does experience a slight slowdown but they didn’t worry about it.

This is fine for Germany. But this leads to lower investment and lower consumption in the rest of Europe and plunges them into a recession (or slow growth). To drive growth, they start to increase their trade deficits, but because of the fixed exchange rates, their currencies become overvalued. This leads to a speculative attack on the currencies of Britain, Italy, and France in 1992 and they withdraw from the fixed rate system, thereby defeating the whole purpose of it in the first place.

So Europe realized that there had to be a common currency or there would be no ‘Europe’.
Country exercises

Country A: Has a current account deficit with a recession – warning light should go off.
Country B: Overvalued currency with a currency board can lead to a crisis. You either have to change your currency or have a recession.
Country C: People don’t make portfolio investments in poor countries. This situation is impossible because small countries don’t get enough attention to cause a crisis.
Country D: No red lights in this scenario – could be South Korea.
Country E: Probably Israel – lots of money parked (maybe illegally) in the country. This money may leave as mysteriously as it came which could cause a crisis.

Conflict to think about

What should the trading economy do about genetically modified food? There are very different attitudes on both sides of the Atlantic Ocean with Americans pressing ahead and Europeans being cautious. Europe is trying to prove scientifically that there’s a danger but that hasn’t happened yet. However, you can’t prove something doesn’t exist without a little exploration. How do we solve this problem?