When the Bretton Woods system collapsed

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Yesterday marked the 30th anniversary of one of the most significant turning points in the history of post-war capitalism. On August 15, 1971, without prior warning to the leaders of the other major capitalist powers, US president Nixon announced in a Sunday evening televised address to the nation that the US was removing the gold backing from the dollar. The commitment by the US to redeem international dollar holdings at the rate of $35 per ounce had formed the central foundation of the post-war international financial system set in place at the Bretton Woods conference of 1944. Nixon's unilateral announcement dealt it a fatal blow.

To gauge the impact of Nixon's decision and the significance of what followed it is necessary to consider the historical background to the Bretton Woods system. The agreement arrived at in the New Hampshire township in the summer of 1944 was the outcome of a protracted series of discussions and arguments between the leading economic and financial figures in the US and British governments over the preceding three years.

Within the Roosevelt administration the conviction had developed, particularly in the State Department under Cordell Hull, that the root cause of the economic and political crises of the 1930s lay in the growth of protectionism as national governments sought to defend their immediate domestic interests at the expense of the functioning of the global economy as a whole. Furthermore, it was felt that one of the contributing factors to this turbulence was the free movement of capital around the world which destabilised national economies and set in motion the competitive devaluation of national currencies that played such havoc with international trade.

Consideration of the shape of post-war international economy was very much to the fore when Roosevelt met British Prime Minister Winston Churchill in 1941 to discuss the terms of Lend Lease (the process through which the US provided financial and material assistance to the British war effort). Somewhat to the surprise of the British side, however, the US insisted on the insertion of a clause in the Atlantic Charter guaranteeing free trade and access to markets. Both governments committed themselves to "further the enjoyment by all States, great or small, victor or vanquished, of access, on equal terms, to the trade and raw materials of the world."

The US was determined that the trading bloc, which Britain had formed on the basis of its old empire, would have to be destroyed in the post-war world. As Robert Skidelsky puts it in his biography of John Maynard Keynes, Britain's chief negotiator at Bretton Woods: "To condense a complicated story, the Americans tried to use Lend Lease as a lever to destroy Britain's pre-war financial and trading system, based on the sterling area and imperial preference." While as far as Britain was concerned, the chief aim in negotiations with the US was, in Keynes' words "the retention by us of enough assets to leave us capable of independent action."

Whatever the issues which divided them, the British and US officials were agreed on one thing: there could not be a return to the pre-World War I situation where capital was free to move all over the world. International trade had to take place without the constrictions that had bedeviled the world economy in the 1930s. But this could only take place if the movement of capital was not allowed to disrupt trade and currency relationships.

How far removed the policymakers of that time were from today's prevailing orthodoxy can be seen in the remarks of US treasury secretary Henry Morgenthau to the Bretton Woods conference. The aim of the agreement, he told the assembled representatives of 45 nations, was to "drive the usurious moneylenders from the temple of international finance."

Keynes had made clear that if free capital movements were allowed then it would not be possible to establish the kind of regulated capitalism at which the new agreement was aimed. "Freedom of capital movements," he insisted, "is an essential part of the old *laissez-faire* system and assumes that it is right to have an equalisation of interest rates in all parts of the world. ... In my view the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world. Capital control is a corollary to this."

The issue of capital controls was directly connected to the political situation which confronted the capitalist class after World War II. The eruption of World War I had brought the Russian Revolution of 1917 and the series of revolutionary upheavals that had convulsed Europe in the period 1918-23. With the end of war now in sight, every capitalist government was aware that a return to the condition of the 1930s would bring no less explosive struggles.

It was against this background that Keynes explained the necessity for capital controls. Unless they were put in place any government that attempted to make social reforms in the form of unemployment benefits and other social welfare measures would find its program immediately sabotaged by capital flight organised by the "wealthier classes." In other words, in order to allow governments to tack and weave and make concessions to the demands of the working class, it had to be protected from the destabilising effects produced by an exodus of capital.

Foundations of the postwar expansion

The Bretton Woods Agreement of 1944, with its system of fixed exchange rates between currencies and support for countries that ran into balance of payments difficulties, together with the Marshall Plan (1947-50) for the economic reconstruction of Europe which followed it, laid the foundations for a quarter century of capitalist expansion the like of which had not been seen. Neither before nor since has there been a period where the global economy has grown as rapidly and the living standards of the working class, at least in the major capitalist countries, advanced as much.

But the Bretton Woods system did not overcome the essential contradictions of the capitalist economy. In fact, the very economic expansion it helped to produce brought them to the surface and eventually led to the demise of the regulated post-war order.

It is necessary to emphasise this point in the face of claims by proponents of Keynesian regulation that there can be a return to the stability of the post-war period and the social reformist policies which accompanied it, if only agreement can be reached on some kind of revived Bretton Woods Agreement. The advocates of this program, however, never examine why the original system collapsed.

The history of this breakdown involves two interconnected processes—the development of an increasingly global system of production and finance, and the relative decline of the US within the Bretton Woods order and its move towards a new regime based on the free movement of capital in order to maintain its position of global hegemony.

The first cracks in the economic order were quite small, arising from the emergence of what was called the Euro dollar market at the end of the 1950s. The initial agreement on currency values had provided for free convertibility. But that proved to be impossible until 1958. The approach of the free conversion deadline saw the development of a crisis of sterling in 1957 to which the British government responded, as it was entitled under the Bretton Woods setup, with restrictions on capital movements.

This decision, however, cut across the operations of the British banks. Fearful of being eclipsed by their trans-Atlantic rivals if the measures of their government forced them to cut back on international lending, they moved to circumvent the restrictions. Instead of using sterling to finance international transactions, they used the dollars deposited with them instead and found a way to continue their international operations despite the sterling controls.

For its part the British government had an ambivalent attitude to the development of this new financial market. On the one hand national policy dictated the need for financial controls, while on the other it was keen to ensure that London remained a centre of international finance.

By this time another contradiction, rooted in the very structure of the system, was starting to emerge. Under the agreements of 1944 the American dollar functioned as a virtual world currency, conferring great advantages on the US vis-à-vis the other capitalist powers. These advantages were limited, at least in theory, by the provision that the US dollar could be redeemed in gold at the rate of $35 per ounce.

As is often the case with financial arrangements, the gold backing system functioned very well so long as it was not actually tested. But it was founded on a contradiction. The system would continue to operate while the mass of US dollars circulating in the rest of the world was backed by gold held in the US. But the very expansion of the international economy tended to increase the need for international liquidity in the form of US dollars. That is, the more the global economy expanded, the shakier became the relationship between the dollar and gold.

In the 1960s, the dollar overhang—the difference between the dollars in international circulation and the value of the gold backing held in Fort Knox—began to grow as a result of increased US investment abroad and military spending. US administrations imposed policies aimed at restricting capital movements and like their British counterparts before them, US financial interests found the Euro dollar market a useful means for circumventing the actions of their own government.

US administrations also had an ambivalent attitude to the Euro dollar market. While trying to restrict capital outflows to counter the balance of payments deficit, the existence of the Euro dollar market meant that foreigners would be more likely to keep their holdings in dollars, thereby easing the pressure on the US currency.

However, the growth of the Euro dollar market had exactly the effect that Keynes and Harry Dexter White, the chief US negotiator at Bretton Woods, had foreshadowed. Growing amounts of finance capital were now able to move around the world outside the control of governments. The system of fixed exchange rates could not be sustained. The pound came under pressure in 1967, followed by the dollar in 1968. In 1971, a qualitative change took place as the US, for the first time since before World War I, experienced a balance of trade deficit, leading to the Nixon announcement on August 15.

In the immediate aftermath of the decision there were attempts by Japan, as well as the European powers, to resurrect the Bretton Woods system, at least in some form, through the exercise of capital controls. The US opposed all such measures because they would have restricted its freedom of operation both internationally and at home.

Under Bretton Woods, or any other system of regulation, the US would have had to take action to rectify the imbalances in its international position. One method would have been to cut back military spending, particularly on the Vietnam War. But this would have meant weakening the position of the US vis-à-vis the other major powers. In 1971 an administration grouping under the leadership of Paul Volcker (later to become chairman of the US Federal Reserve Board) concluded that financing for US deficits has "permitted the United States to carry out heavy overseas military expenditure and to undertake other foreign commitments" and that an important goal was to "free ... foreign policy from constraints imposed by weaknesses in the financial system." Looking back from the 1990s, Volcker commented that "presidents—certainly Johnson and Nixon—did not want to hear that their options were limited by the weakness of the dollar."

Another way to reduce the balance of payments deficit, ease the pressure on the dollar and so maintain a system of regulation would have been to cut spending in the United States. But the consequences would have been to induce a severe recession. Facing a rising tide of militancy in the working class, the student radicalisation produced by the Vietnam War, and the rebellion of black youth in the cities, this was not considered an option.

Moreover, there was considerable support for the view within US ruling circles that if the system of controls on capital movements were scrapped, the US would be able to maintain its hegemonic position because of its weight within the world economy. Other nations would want to hold dollars because of the role it played in the international monetary system. This outlook was summed up by the treasury secretary in the Nixon administration, John Connally, in remarks to a European audience as follows: "The dollar may be our currency but it's your problem." Or, as he told an American audience: "Foreigners are out to screw us. Our job is to screw them first."

No return to Bretton Woods system

Those advocates of a return to regulation of the world capitalist economy, and a policy of social reforms, as an antidote to the economic and social devastation being caused by the domination of global financial markets, will no doubt argue that the collapse of the Bretton Woods system was the outcome of policy decisions.

Of course, had other policies been adopted, then events may have taken a different course. But alternative policies would not have prevented the demise of the Bretton Woods system, for its collapse was rooted in objective tendencies of development. As one recent major study has noted: "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" [Harold James, *International Monetary Cooperation Since Bretton Woods*, page 207].

The collapse of the Bretton Woods system was an initial expression of the deepening contradiction between the inherent tendency of the productive forces to develop on a global scale and the nation-state system.

The removal of the gold backing from the US dollar was rapidly followed by the abolition of fixed currency relationships and the lifting of restrictions on the movement of capital throughout the 1980s, as one country after another was forced to abandon national controls under the pressure of international markets.

The result has been a series of storms of mounting amplitude within the international financial system. In 1987, differences between US and German authorities over interest rate policies directly contributed to the October stock market collapse. In order to prevent a global collapse, financial authorities, led by the US Federal Reserve pumped liquidity into the international financial system. These actions prevented a financial meltdown. But they helped boost a financial bubble in Japan which eventually collapsed at the beginning of the 1990s, dragging the economy ever deeper into an ocean of bad debt.

The decade of the 1990s saw the sterling crisis of 1992, followed by the turbulence in bond markets in 1994 and the Mexican bailout of 1994-95. Then came the Asian crisis of 1997, followed by the Russian default of 1998 and consequent threat to the US financial system in the wake of the collapse of Long Term Capital Management in September 1998—a threat described by president Clinton as the most serious financial crisis in 50 years.

These dangers seemed to disappear behind the hype of the "new economy". But not for long. The underlying tendencies in the global economy have re-emerged with the collapse of the hi-tech finance bubble in the US and the growing signs of world slump.

The Bretton Woods system was established in 1944 as the major capitalist powers initiated a program of national regulation aimed at containing the contradictions of the world economy and preventing the development of socialist revolution.

Its demise in 1971 inaugurated a new stage, characterised by the development of globalised production and the domination of an international financial market. When the US pulled the rug from under the previous system it did so in order to maintain its position of global hegemony in the new economic order which was beginning to emerge. It managed to do so but at great cost.

The free market program it has so strenuously promoted over the past 30 years has intensified all the contradictions of the capitalist mode of production.

At the same time, starting with the unilateral decision of August 15, 1971, the basis for collaboration between the major capitalist powers has been narrowing. The combined impact of these two processes has created the conditions for major economic, social and political upheavals in the world capitalist economy in the period immediately ahead.