Bretton Woods: Keynes versus White

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Thank you, Kurt. I do not have a hand-out, and I am just going to make some very brief remarks.

I want to start out by asking the following question: What problem did they think they were trying to solve at Bretton Woods? Now, Bretton Woods emerged out of two years of negotiations between two men: John Maynard Keynes and Harry Dexter White. So I believe to understand Bretton Woods, you have to understand what problems each of them was trying to solve.

Let me start with what they both agreed on. Both believed that the key to an open multilateral trading system was to get the international financial system working properly. They viewed the protectionism of the 1930s as essentially a product of currency problems. Essentially, the trade wars were the consequence of currency wars. Secondly, both believed that the excessively free capital flows of the 1920s and 1930s had been destabilizing. And so both endorsed some form of controls on short-term capital flows. Thirdly, both recognized that some mechanism for providing temporary financing to countries running balance of payments deficits – was necessary. And it was necessary because in the 1930s, countries had not had access to short-term assistance and therefore had to impose highly deflationary policies on themselves.

But the two men also had major differences. These differences in part stemmed from their different national interest. The U.K. was a deficit country and a major international debtor after the Second World War; the U.S.A. was a surplus country and the biggest creditor in the world. But it also, I think, emerged from their different experiences. Keynes had been deeply affected by the problems of the 1920s for Great Britain. By contrast, White was more concerned about the problems of the 1930s.

So, what did Keynes see as the key problem? He saw the key problem in the 1920s as insufficient global liquidity, and secondly, as a misallocation of global liquidity. During the First World War, between 1913 and 1920, even after the

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deflation of 1920, there had been a 75% increase in U.S. dollar prices. Meanwhile, total gold reserves held by the four major countries, Britain, France, the U.S.A., and Germany had gone from USD 5 billion to USD 6 billion. So, in effect we had had a 30% fall in the value of global reserves. Secondly, there was the misallocation of reserves. Before the war, the U.S.A. had about 40% of global reserves; after the war, it had close to 75%. Keynes believed that it was this combination of inadequate reserves and their misallocation that had been responsible for the deflationary policies forced upon the U.K. and Germany when international borrowing dried up in 1931. So the Keynes plan essentially involved creating USD 26 billion in additional global reserves with the stroke of a pen. Now, what is USD 26 billion in 1944? U.S. GDP at the time was about USD 250 billion. So Keynes's plan would have handed out de novo the equivalent of 10% of U.S. GDP in additional global reserves. The equivalent today would be about USD 1.6 trillion.

The second key problem of the 1920s, he believed – and in this regard he was heavily influenced by British experience – was the problem of rigid exchange rates. Britain had gone back to the gold standard in 1925 at an overvalued exchange rate and had never been able to adjust to that overvalued exchange rate and had forced upon itself deflationary policies. Interestingly enough, in the U.K, the 1920s were almost as bad as the 1930s. So, Keynes was determined to introduce a mechanism for greater exchange rate flexibility at Bretton Woods.

Here he ran up against White. Harry Dexter White believed, as did most of the American delegation, that the big problem was the competitive devaluations of the 1930s. Britain had gone off the gold standard in 1931, followed by the U.S.A. in 1933. Thereafter, had followed a period where exchange rate instability had led to trade restrictions. After Great Britain and the U.S. A. went off the gold standard and devalued, the countries of Europe including Germany and France faced a major problem. They did not believe they could follow and go off the gold standard, because having experienced hyperinflation during the 1920s, they were terrified that were they to go off gold, there would be a massive collapse of confidence in their currencies. So the only way they could reconcile their decreased competitiveness from the depreciation of sterling and the U.S. dollar and the fact that they felt compelled to tie themselves to gold was to impose heavy protection. Germany became the most autarkic country in the world, France resisted for a long time, imposed protection, but eventually went off gold in 1936.

The irony, actually, is that the U.S.A. was one of the worst culprits in the initiation of this currency war. The devaluation of the U.S. dollar in 1933 was viewed by every country in Europe as an incredibly selfish act . After all the U.S.A. was running a significant trade surplus. The comparable step would have been if China in 2008 had devalued its currency. Within the U.S.A., the perception was that in order to deal the very high unemployment they needed to be able to ease monetary policy and to do that they felt compelled to break from the gold standard.

Why was there so much focus in 1944 on the problems of currency instability and competitive devaluations? I think the U.S.A. was mainly worried that it was the main surplus country and feared that everyone would try to devalue against it. And so Bretton Woods was an attempt to ensure that what countries could do with their exchange rates were heavily circumscribed. Initially, White's proposal included a clause that in order for a major currency change the country had to get approval of 75% of the IMF's quota. But Keynes believed that was totally unacceptable because that would have completely tied Britain's hands. And more importantly, the U.S., both the State Department and the Treasury, were committed to re-establish an open trading system. And they believed that putting constraints on what countries could do with their currencies was the key to that.

In the short run, White won. The IMF, when it was actually formed, got the total resources White had proposed, Keynes had proposed USD 26 billion, White had proposed USD 5 billion; they ended up with a number much closer to White's. I think it was USD 8 billion. The irony, I suppose, is that when we look now at the size of the IMF and other sorts of international firewalls, we are actually at numbers much closer to the ones that Keynes had recommended. The question remains: are those still inadequate for the modern day financial system?

On exchange rates, White's win was short lived. He tried to impose restrictions on what Great Britain could do with pound sterling. Three years later, sterling devalued by a major amount. Eventually the IMF ended up permitting a lot more exchange rate flexibility than White had wanted at the beginning. The ultimate irony is that we now have a system where exchange rate flexibility is the norm. So, the story of Bretton Woods, I think, is that White may have won in the short run, but Keynes won in the long run. Thank you.