Bretton Woods 1971–2021

By David C. Mulford

The birth of the new age of modern markets.

Closing the U.S. gold window and scrapping fixed exchange rates happened in August 1971. It was bound to happen eventually—and it did, later than it should have. The writing was on the wall at least three years before the event.

Wage and price controls were also introduced at the same emergency monetary meeting at Camp David and this was a significant mistake by President Nixon and the Federal Reserve. These actions did not contain inflation as hoped nor did they help generate growth.

To understand why closing the gold window and scrapping Bretton Wood's fixed exchange rate regime were not mistakes, and wage and price controls were a mistake, one has only to look at the history of the times before and after each of these policy events.

Abandoning the Bretton Woods fixed exchange rate system and terminating the U.S. dollar's link to gold proved to be an historic regime change that influenced world economic developments and the evolution of global markets for the rest of the century. Essentially, over these years the world moved from a system of pervasive capital controls to the free movement of capital which today is taken for granted in world markets. Wage and price controls, on the other hand, was simply a damaging policy mistake that was overcome by new policies in a few years.

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By the mid-1960s, the United States was suffering from a sharply rising balance-of-payments problem. This was due to the economic recovery of Europe and Japan after the destruction of World War II, and accelerated by the costly U.S. military buildup in Vietnam and President Johnson's simultaneous commitment of resources to his Great Society programs. U.S. companies were also investing heavily overseas in these years and American tourists were flooding to Europe to spend their new savings.

The fixed exchange rate system as advertised was not for real. Instead, it was a fixed system which from time to time, without warning, was adjusted by individual players deciding suddenly under duress to devalue their currencies, such as the United Kingdom devaluing sterling by 14 percent in November 1967. These mini-crises themselves defined the reality of the fixed exchange rate system, making the Bretton Woods system appear more like a large-scale stop-and-start exercise, with no predictive order or consensus.

What was significant at the time was the combination of these forces. The outflow of U.S. dollars taken as a whole was creating and fueling the popularly known Euro bond and Euro currency markets in London from 1963 onwards. Although relatively small at the time, these were by and large unregulated, cross-border markets that provided an important source of financing to companies and governments. They were supra-national in nature, spread across and over national, still-closed, and regulated European markets, which continued to follow the regulatory habits of the post-war period. U.S. policy actions helped fuel this growing market initially, first by imposing the U.S. interest equalization tax in 1963, effectively closing the U.S. market to foreign borrowers for the next ten years. A policy response that closed off the U.S. capital market to foreign borrowers was entirely consistent at the time with a global capital controls mentality.

On top of this prohibition, the United States also imposed a restriction on its own companies seeking to invest overseas. This was known as the Office of Foreign Direct Investment program, which forced U.S. companies expanding overseas to raise financial resources outside the United States. These two actions had the effect of further stimulating and expanding the Euro markets, introducing dozens of major U.S. corporations for the first time to a new offshore financial market.

A New First—The Saudi Loan

In early 1981, there was a new first for G-5 cooperation which resulted from Saudi Arabia's willingness to make the largest private placement loan ever to the International Monetary Fund. The loan of $10 billion (SDR 12 billion) enabled the funding of the IMF's new Enlarged Access Supplemental Financing Facility, which was complementary to its Supplemental Financing Facility for developing countries. The new loan would also serve as the key building block for other countries to come together to provide yet additional funds to the IMF's total resource base for addressing the critical balance-of-payments challenges of developing world.

By early March, SAMA had completed the negotiations with the IMF on the terms and conditions of the new loan, which was set to close on May 1 at the time of the spring ministerial meetings of the IMF and the World Bank in Washington, D.C. I had been in charge as SAMA's senior adviser of the loan negotiations with the IMF and was surprised to be called by the governor of SAMA to be given new directions regarding the completion of the loan, which were not a part of the already-completed documentation. This was that I was to go to Washington to meet privately with President Reagan's new Secretary of Treasury, Donald Regan, to place before him two additional conditions that would not be part of the loan documentation, but would have to be agreed for the loan to close on May 1.

The first condition was that Saudi Arabia's quota position in the IMF would have to be lifted from position number thirteen to position number six. The second condition was that Saudi Arabia would have to be given its own permanent seat on the IMF's formal Executive Board of Directors, making Saudi Arabia the unofficial leader of the developing world. Both conditions represented unprecedented changes in the IMF.

My instructions were to go to Washington to present these conditions to Secretary Regan, and to remain in Washington for additional personal meetings with the secretary until agreement was accomplished. It was explained that I was being asked to carry out this delicate and complex mission because it was known that I had a longstanding personal/professional relationship with Secretary Regan.

I returned to Saudi Arabia two weeks later when Secretary Regan had concluded his discussions with the IMF leadership and the G-5. On March 28, the *Washington Post* reported the IMF's version of the new agreement between the IMF and Saudi Arabia.

—D. Mulford

It was the perfect storm for expanding the Euro dollar and the Euro bond markets to break free from controls and become engines for promoting free capital flows. I was there in London at the time as a young investment banker enjoying the creative surge of new financing.

By dithering for years over closing the gold window in the United States and abandoning fixed exchange rates, the United States had actually helped expand and deepen the fledgling, unregulated Euro markets, and taken the first step to expanding international cross-border capital markets. By the time the United States acted to close the gold window in 1971–1972, it and other leading countries in the financial system found that they had already inadvertently laid the foundation for the modern, sophisticated, truly global financial markets of today.

This revolutionary transition took a little time to mature—only twelve months, to be exact. All of a sudden, in December 1973, the OPEC states led by Saudi Arabia suddenly introduced a nearly four-fold increase in the price of oil. What followed may be described as the largest, most abrupt transfer of liquid financial assets ever experienced in the modern world. In the short space of a few months, the world of developed industrial nations was cast into recession and inflation. Gasoline prices skyrocketed. Lines at filling stations became hours long, foreign exchange markets were highly volatile, interest rates and inflation both rose sharply. The flow of liquidity to OPEC states and the Euro markets became a flood.

This I also know because once the flows had gained momentum, I was in Jeddah instead of in New York or London, serving for the next nine years as senior advisor of a small team of investment bankers hired by the Saudi Arabian Monetary Agency in late 1974. We were the very challenged few, three from White, Weld & Co. in New York and three from Baring Brothers in London who were hired to advise SAMA on managing and deploying these massive flows of liquidity.

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Open markets prospered, regulated and closed markets did not. At SAMA, new funds in excess of $100 million arrived every day to be invested consistently and responsibly into what was rapidly becoming a global market. This transformation was nothing like that of 1971–1972, except that at first it took place mainly in U.S. dollars, into open markets like the United States, not into the still heavily regulated markets which remained restricted for the time being.

Currency volatility became a regular feature of markets and "imbalances" in global trade and payments began to dominate policy dialogues between the major nations. So too did concerns about "stagflation" and rising interest rates.

During the tenure of U.S. Treasury Secretary George Shultz (1972–1974), he gathered together an informal group of the world's five leading-country finance ministers (the United States, the United Kingdom, Germany, France, and Japan) in the library of the White House to discuss key macroeconomic and monetary policy issues and challenges in the world's newly transformed global economy and financial system. The "Library Group" later became the G-5, the most important international policy group for the balance of the twentieth century.

Meanwhile, global markets continued to globalize. SAMA and other OPEC funds recycled vast amounts of dollars through the global banking system, which due to excess liquidity in the banks from lower economic activity in the industrial nations, resulted in significant new direct bank loan flows to developing nations in central and south America. This laid the basis for the Latin American debt crisis of the 1980s.

SAMA avoided lending directly to developing countries, and had become the largest holder of government fixed-income securities in the United States and all other developed country bond markets. SAMA also opened another multibillion-dollar private placement business directly with a large group of industrial country governments, international financial institutions, and high-quality multinational corporations.

As SAMA was the central bank of issue in Saudi Arabia, it also established access to major government markets in all significant currency markets. This was central to the opening and deregulation of markets in countries whose priority was accessing new sources of finance for restoring their recession-hit countries. This also offered SAMA the critically important opportunity to diversify away from its almost exclusive dependence initially on a weakening U.S. dollar. This was followed by creating large managed equity portfolios in all the major currency markets, another important diversification of risk and possibly higher returns.

Currency volatility and misalignment were to become increasing challenges in global markets. So also were President Jimmy Carter's economic policies which led to higher inflation and rising interest rates. SAMA now had an investment portfolio of some $200 billion and new monthly revenues exceeding $3 billion.

One outcome of SAMA's currency diversification policy, which avoided the limitations of operating in narrow currency markets, was to broaden the mix of currencies used to denominate at issue SAMA's now-large flow of private loans to national governments and the International Monetary Fund. This achieved instant large-scale currency diversification. It also saved the costs of moving large dollar amounts through sometimes narrow or volatile foreign exchange markets, and freed up SAMA's daily demand for non-dollar currencies to settle foreign currency bank deposit transactions and purchases of non-dollar bonds and securities.

Gradually markets "globalized." By the early 1980s, the main markets around the world were fully open, far bigger in size, more diverse, and cross-border investment was easier.

With the strengthening dollar, the challenge of potentially destabilizing global imbalances returned with a vengeance, along with growing political support in Congress for enacting protectionist trade legislation. Rising tensions with Germany and Japan added further heat to protectionist forces.

Not surprisingly, initiatives for more formal economic dialogue and even closer economic policy coordination among the G-5 countries became a new international policy focus of ministers and officials across the global economy, who judged that open trade and financial markets were vital to maintaining world growth and stability. By now, I was serving as undersecretary of the U.S. Treasury for international affairs for nine years in the Reagan and George H.W. Bush Administrations.

Once Fed Chairman Paul Volcker restored disciplined U.S. monetary policy and began bringing dollar interest rates down, and President Ronald Reagan restored strong U.S. growth, the global evolution of financial markets continued. The strengthening dollar picked up momentum and the G-5 became more prominent as a forum for discussing and negotiating tensions related to the strengthening dollar, global trade and payment imbalances, and the then-rising threat of protectionism.

Over the next twenty years, G-5 (later G-7) cooperation deepened, growth in the world economy improved, and millions escaped poverty. The G-20 also emerged as a force in global affairs. The Plaza Accord of 1985 broke new ground in economic policy cooperation, as did later international coordination on the Baker and Brady plans for resolving the Latin America debt crisis. The U.S.-Japan yen/dollar negotiations (1984–1988) completed the cycle of opening national markets around the world, and the collapse of the Soviet Union in 1991 was handled without a crisis in global financial markets thanks to G-5 shared efforts. Next came the movement to create the euro in the 1990s and the rise of the emerging market economies. Clearly, we had experienced a thirty-year "historic economic and financial regime change" for the world, which has taken us from a Bretton Woods world of regulation-dominated financial markets to a world of open global markets and free capital movement. ◆

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