FEDERAL RESERVE BANK *of* CLEVELAND

# FEDERAL RESERVE POLICY AND BRETTON WOODS


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18 September 2014

# Introduction

- The Bretton Woods system was designed to correct the perceived problems of the interwar
- Competitive devaluations, free falling exchange rates, protectionism, unemployment and deflation
- It established an adjustable peg system with capital controls
- This allowed members to pursue domestic stabilization goals
- It was a compromise between the gold standard and floating and between the US and the UK

# Introduction

- The system which emerged in the late 1950s began to confront persistent problems with macroeconomic adjustment, exchange rate credibility and adequate liquidity
- The US dollar became the key international reserve and vehicle currency.
- This required a credible commitment by the U.S. to price stability– a necessary condition to sustain the system

# Introduction

- In the early years persistent U.S balance of payments deficits supplied the world with the dollar and gold reserves needed to maintain their parities in a growing economy.
- But by 1960 , just as Bretton Woods was becoming fully functional concerns over whether the U.S. had sufficient gold reserves to back the ever expanding dollar liabilities held by the rest of the world began to surface
- There was now concern over the dollar's convertibility and some European countries resented the dollar's "exorbitant privilege"
- This put great pressure on U. S. monetary authorities to attach high importance on external objectives
- This conflicted with the prevailing Keynesian paradigm to maintain full employment

# Introduction

- In this global environment we ask how international considerations may have affected U.S. monetary policy.
- Between 1960 and 1973 Federal Reserve policy makers often mentioned balance of payments concerns in their deliberations and policy statements
- On a few occasions, especially during crises they adjusted policy slightly and temporarily because of international considerations

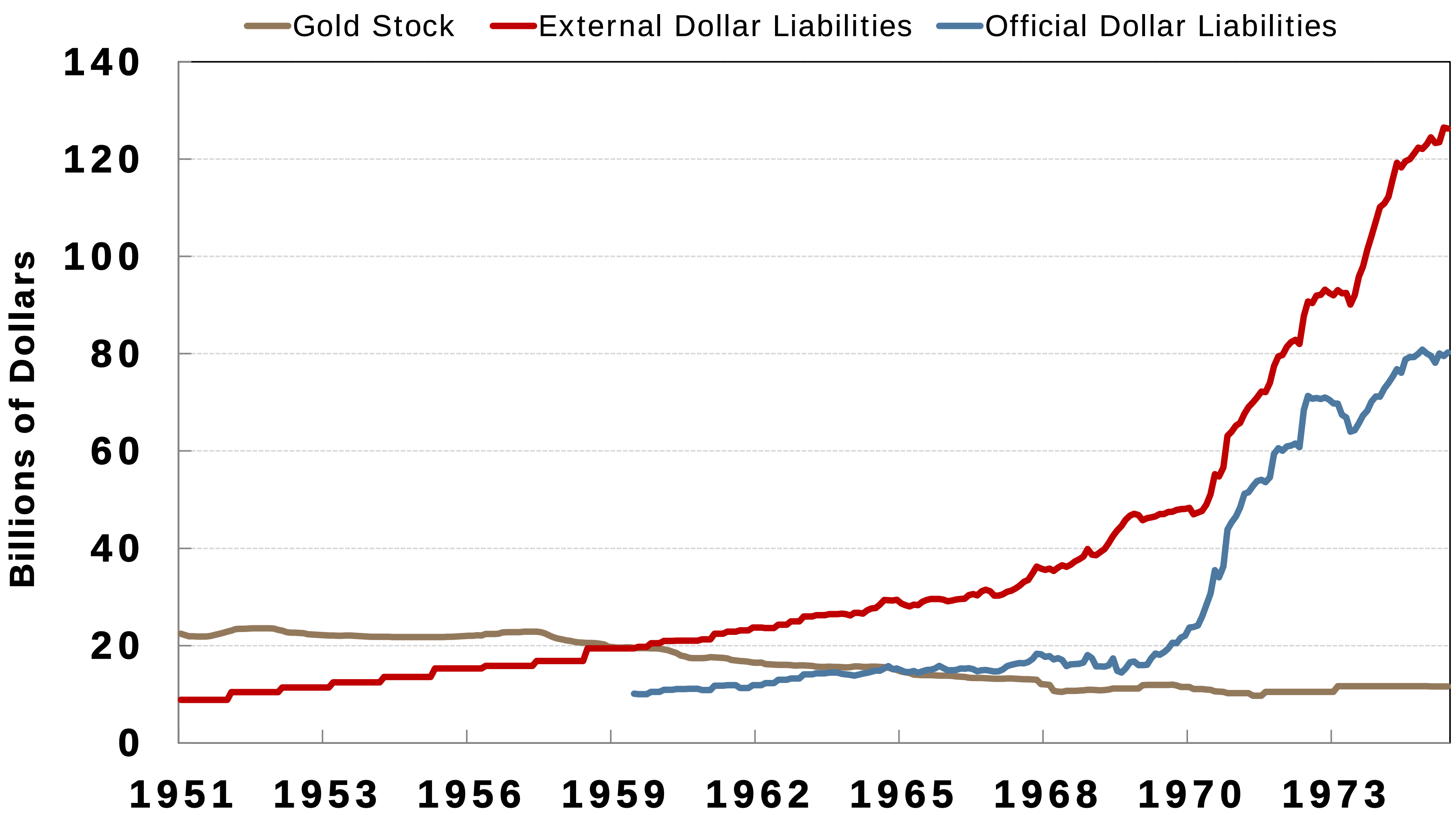
# Introduction

- But overall U.S. monetary policy focused primarily on the state of the real economy and unemployment
- Fed policy makers typically treated balance of payments objectives as superfluous.
- This attitude was possible because the Fed viewed expanding capital constraints, efforts at international cooperation and sterilized foreign exchange operations as relieving monetary policy of responsibility for international events

# Introduction

- Also accountability for international events in the 1960s was shifted to the Treasury
- These non monetary policies were often successful in the short-term.
- But ironically by eliminating the balance of payments as a constraint on U.S. monetary policy they allowed the Fed to create the accelerating and entrenched inflation that doomed Bretton Woods
- This ultimately made the outcome worse
- These themes we develop in the paper.

# Figure 1: Gold and External Dollar Liabilities

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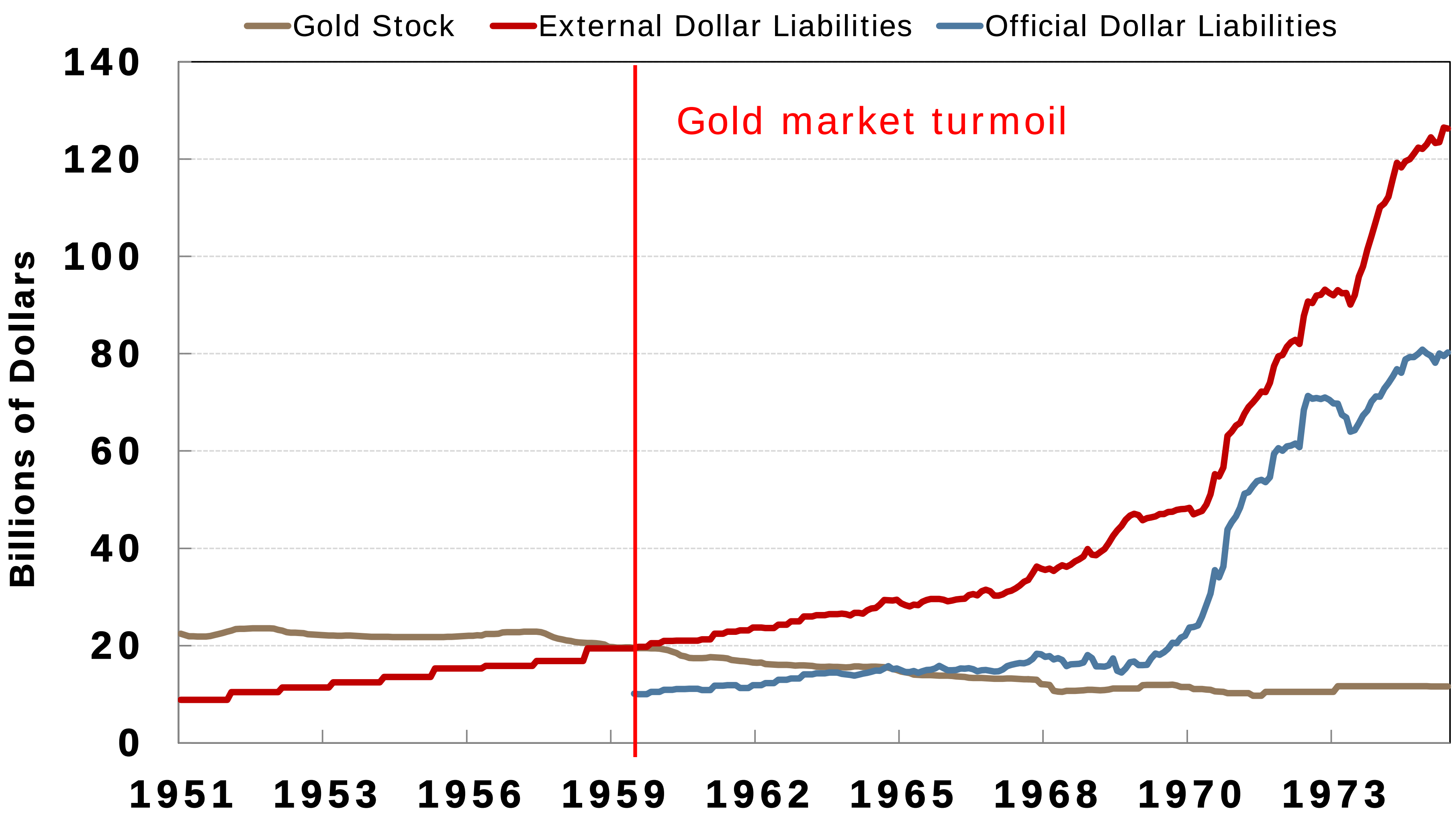


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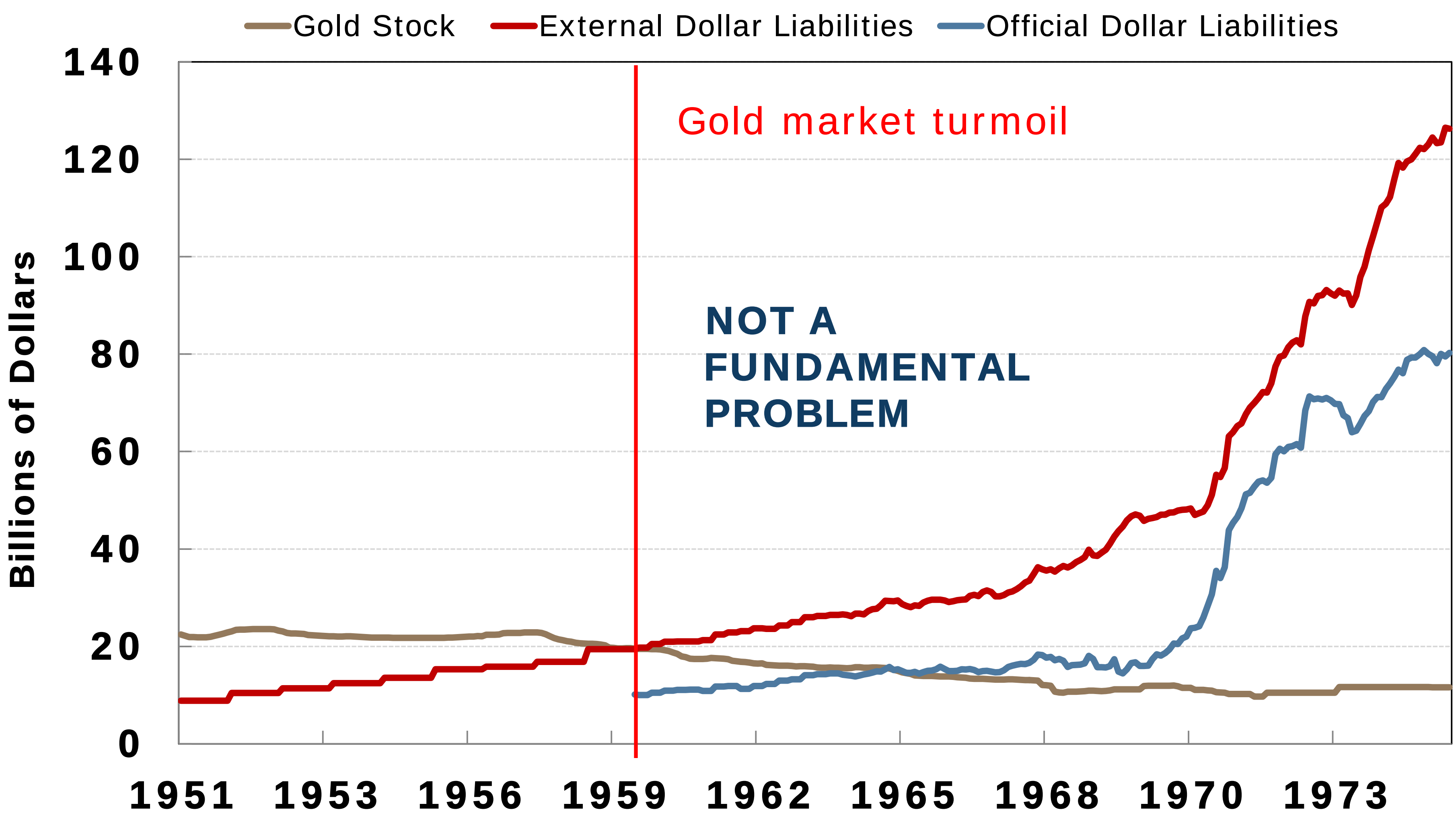


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# Stopgap Measures:

- TO IMPROVE BRETTON WOODS:
  - Gold Pool
  - General Agreement to Borrow

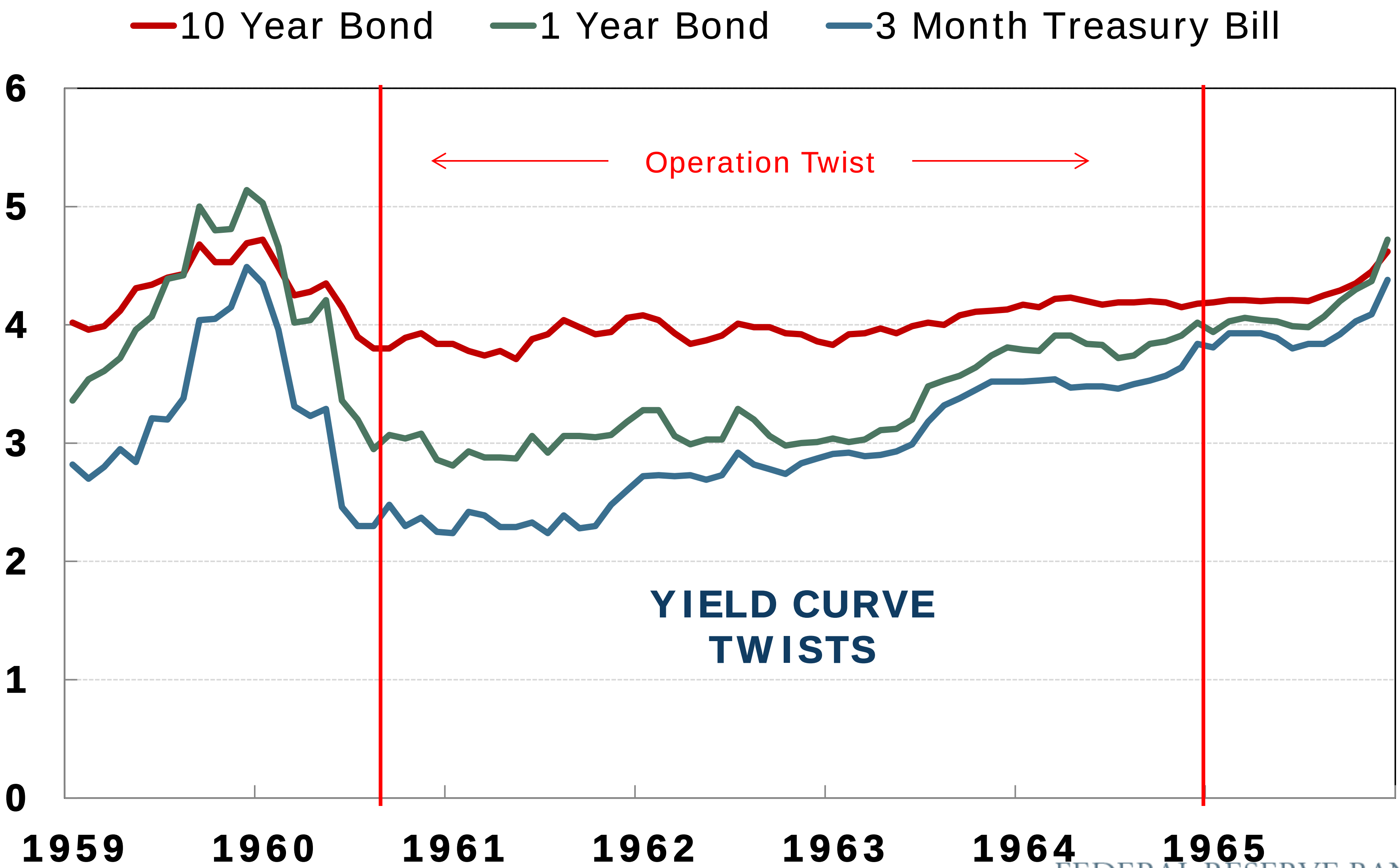
- TO IMPROVE THE US BALANCE OF PAYMENTS
  - Capital Restraints
  - Foreign-Exchange Operations

# Operation Twist: 1960 - 1964

- Simultaneously achieve internal and external policy objectives by twisting yield curve:
  - increase short-term rates & keep long-term rates from rising
  - FOMC dissents

- Augmented with: discount-rate hikes, regulation Q easing, reserve-requirement cuts

# Figure 6: Treasury Yields

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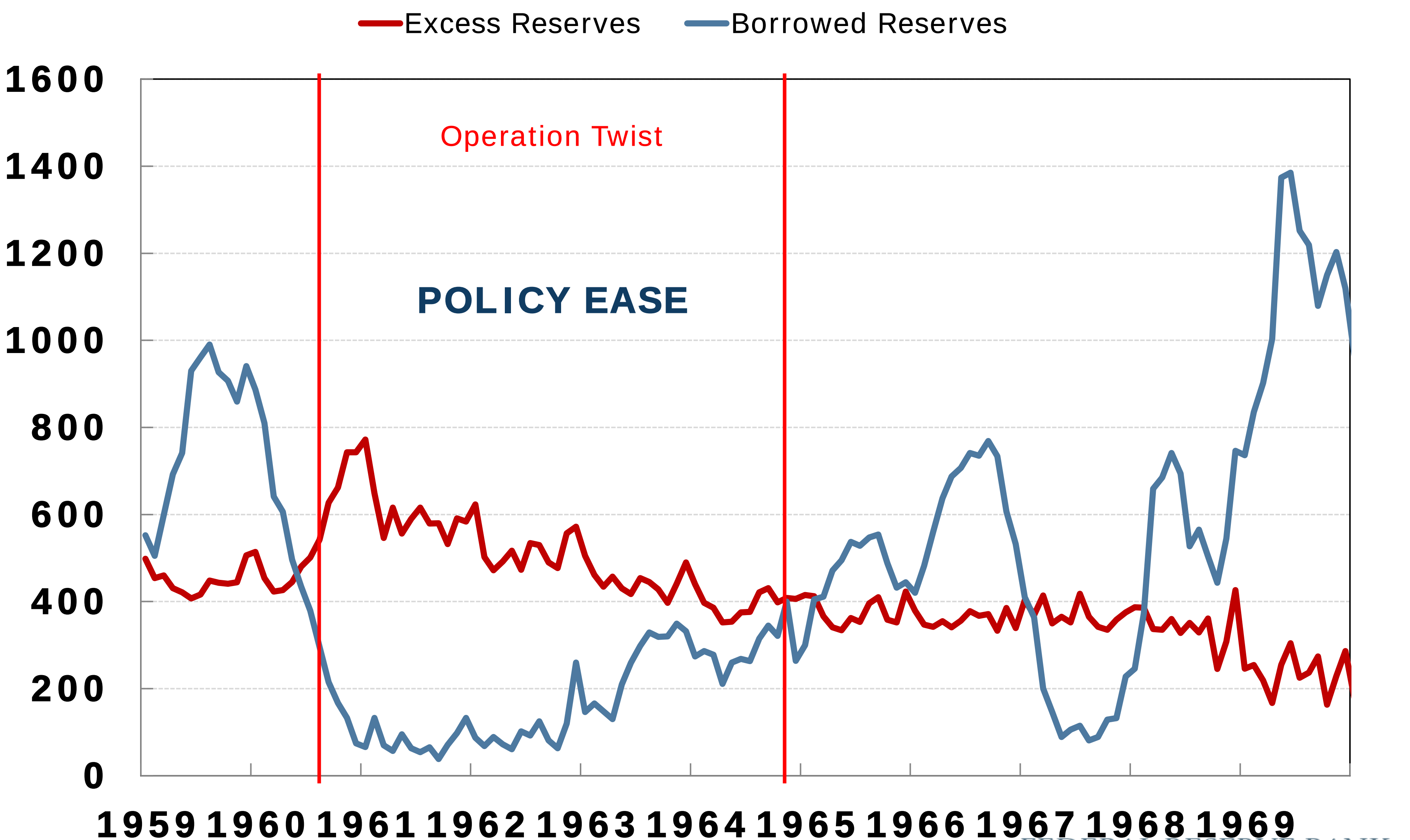
# Figure 4: Net Free Reserves

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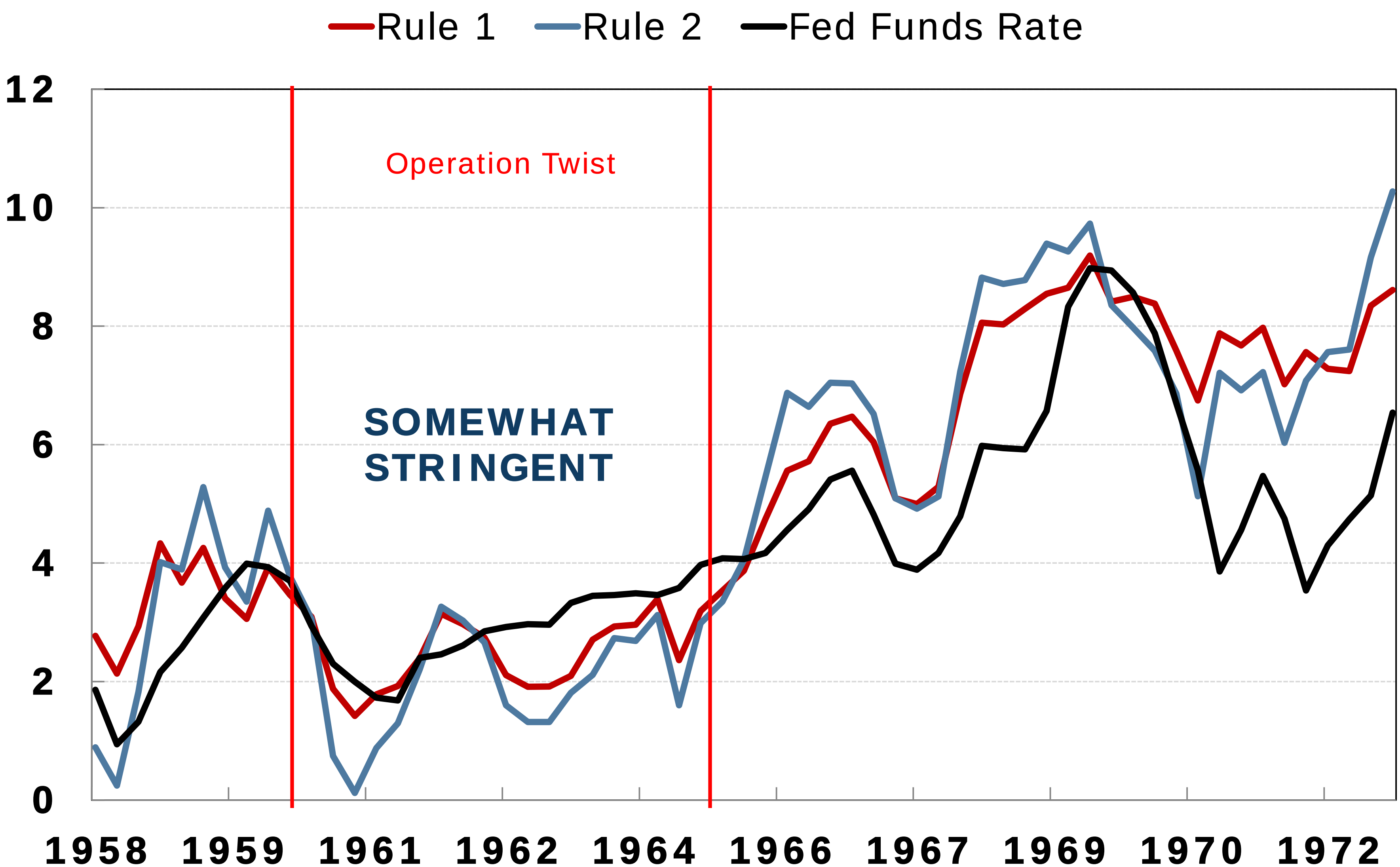
# Figure 5: Real Time Taylor Rules

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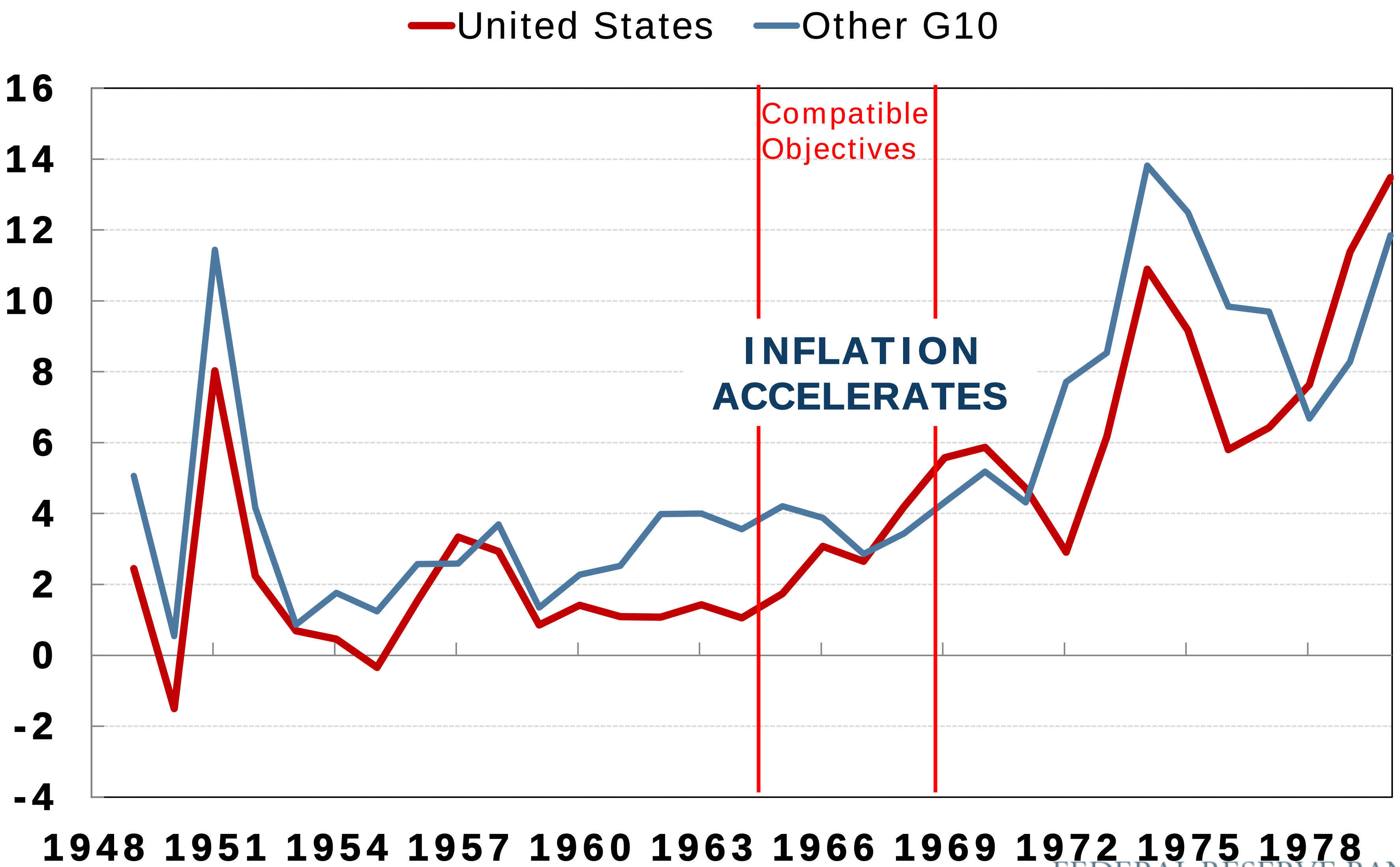
# Compatible Objectives: 1965-69

- Policy problem:  inflation & external imbalance lead to monetary tightening
  - administration & congress object
  - policy fails to be tight enough
- Capital controls ramped up
- Stop-go policy response
- Fed responds to international crises

# Figure 2: Inflation Rates

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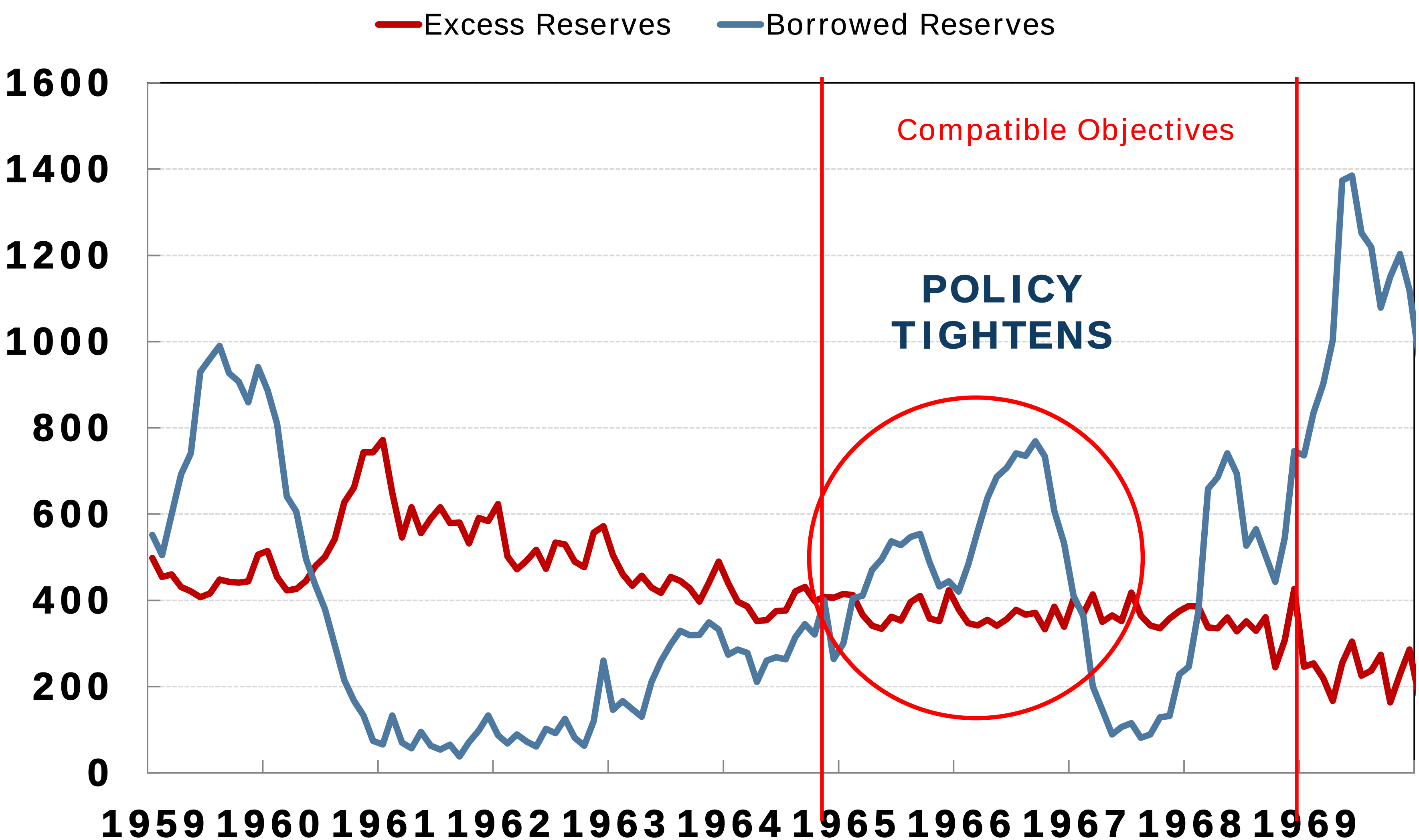
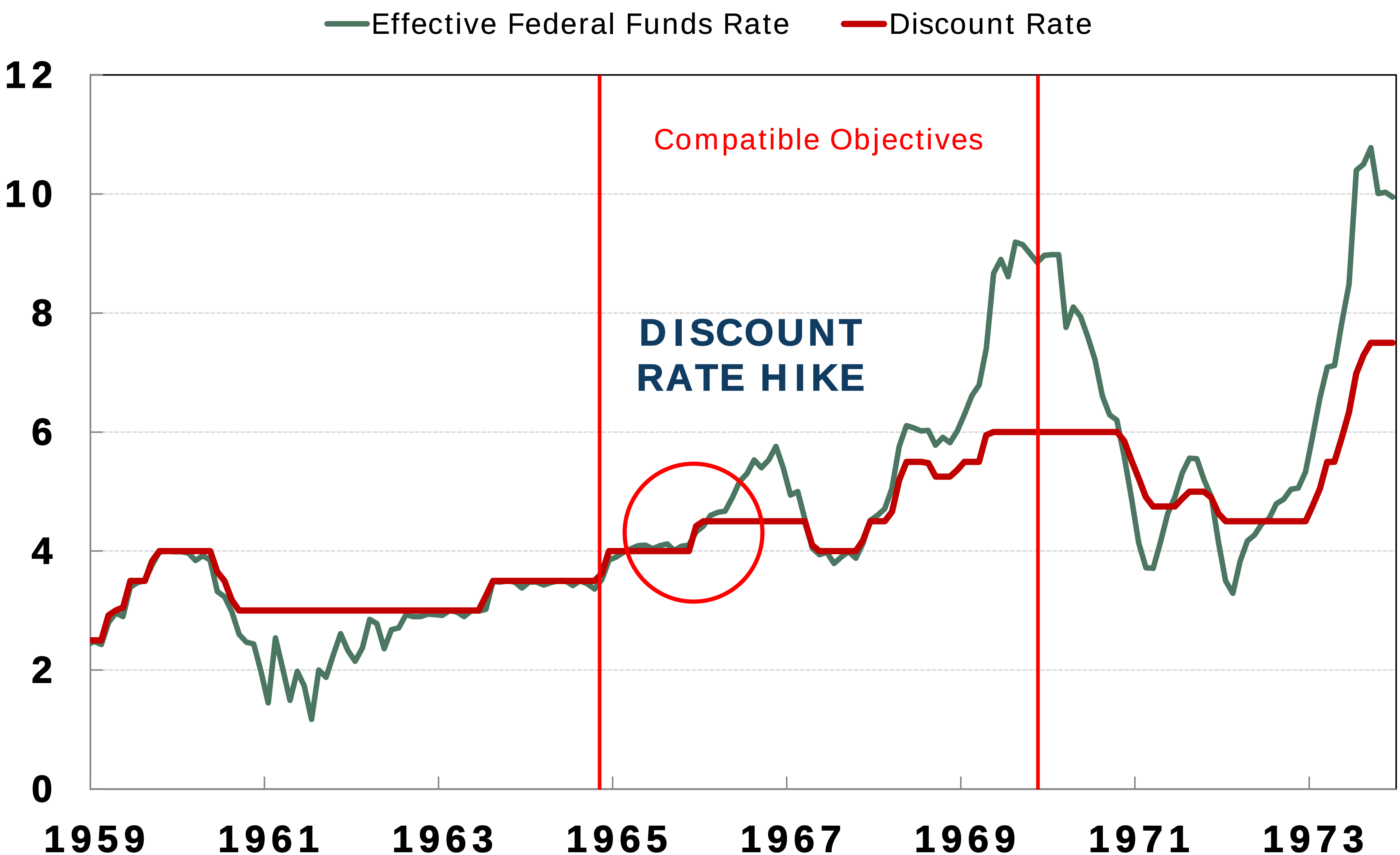


# Figure 3: Federal Reserve Policy Rates

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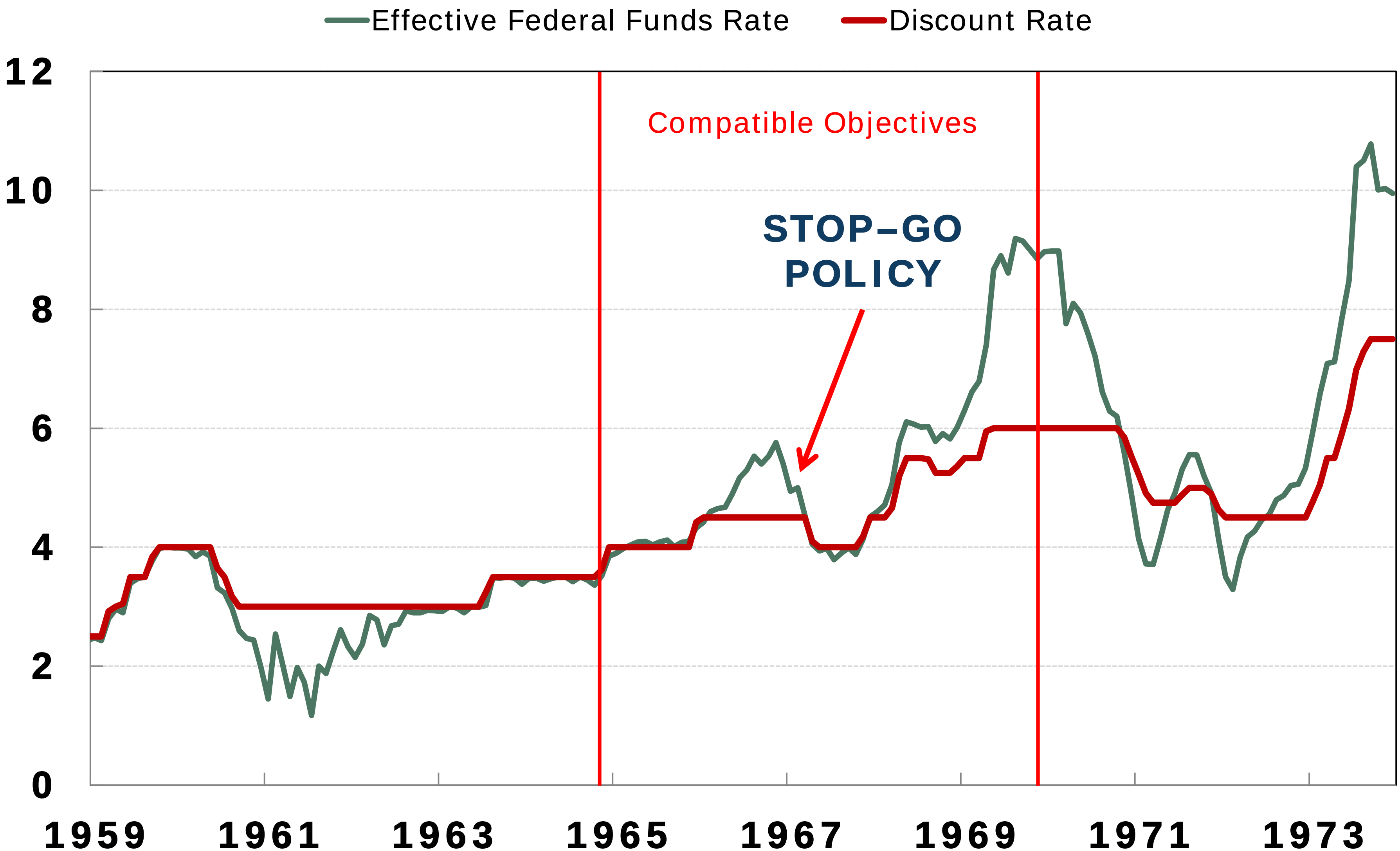


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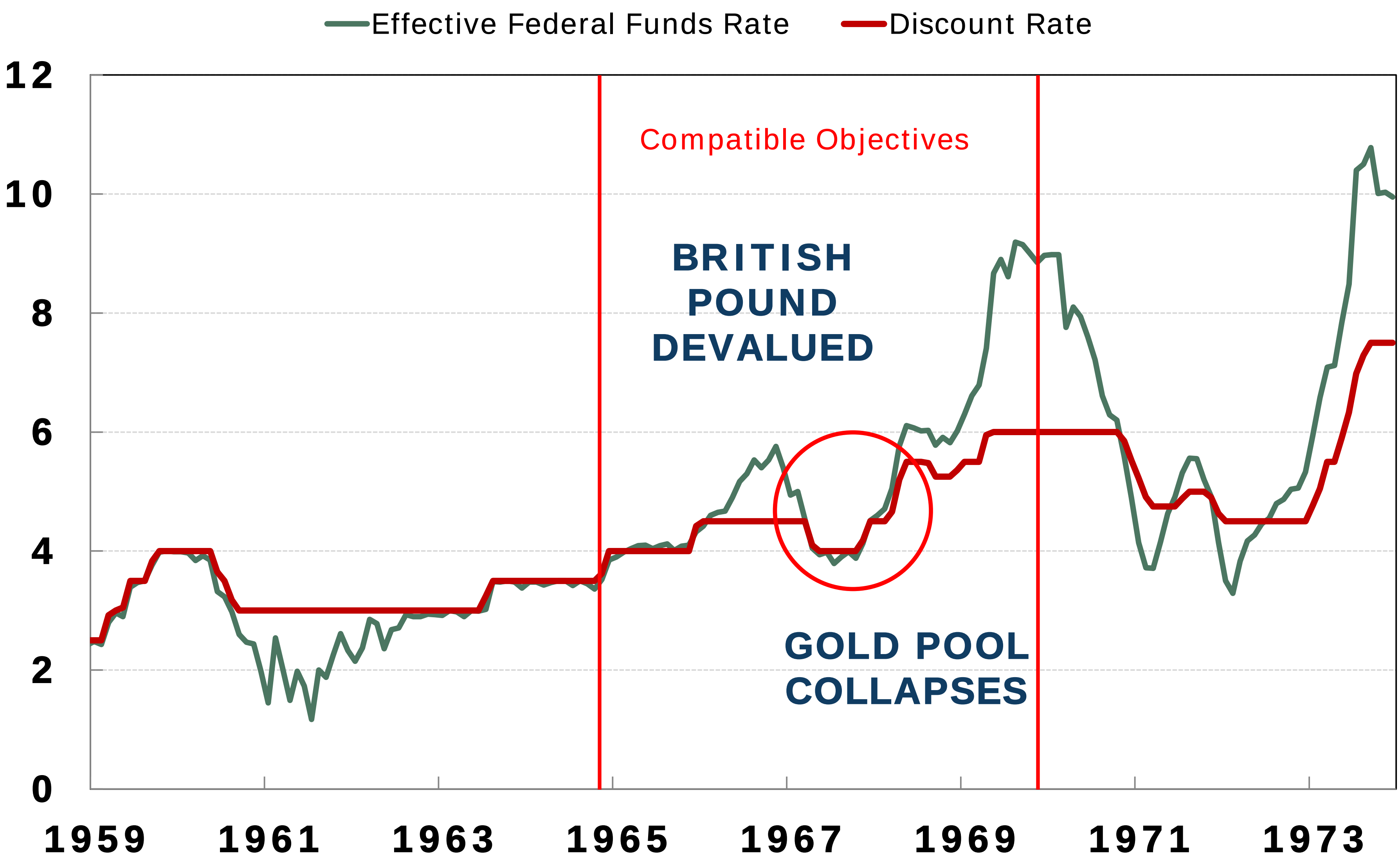


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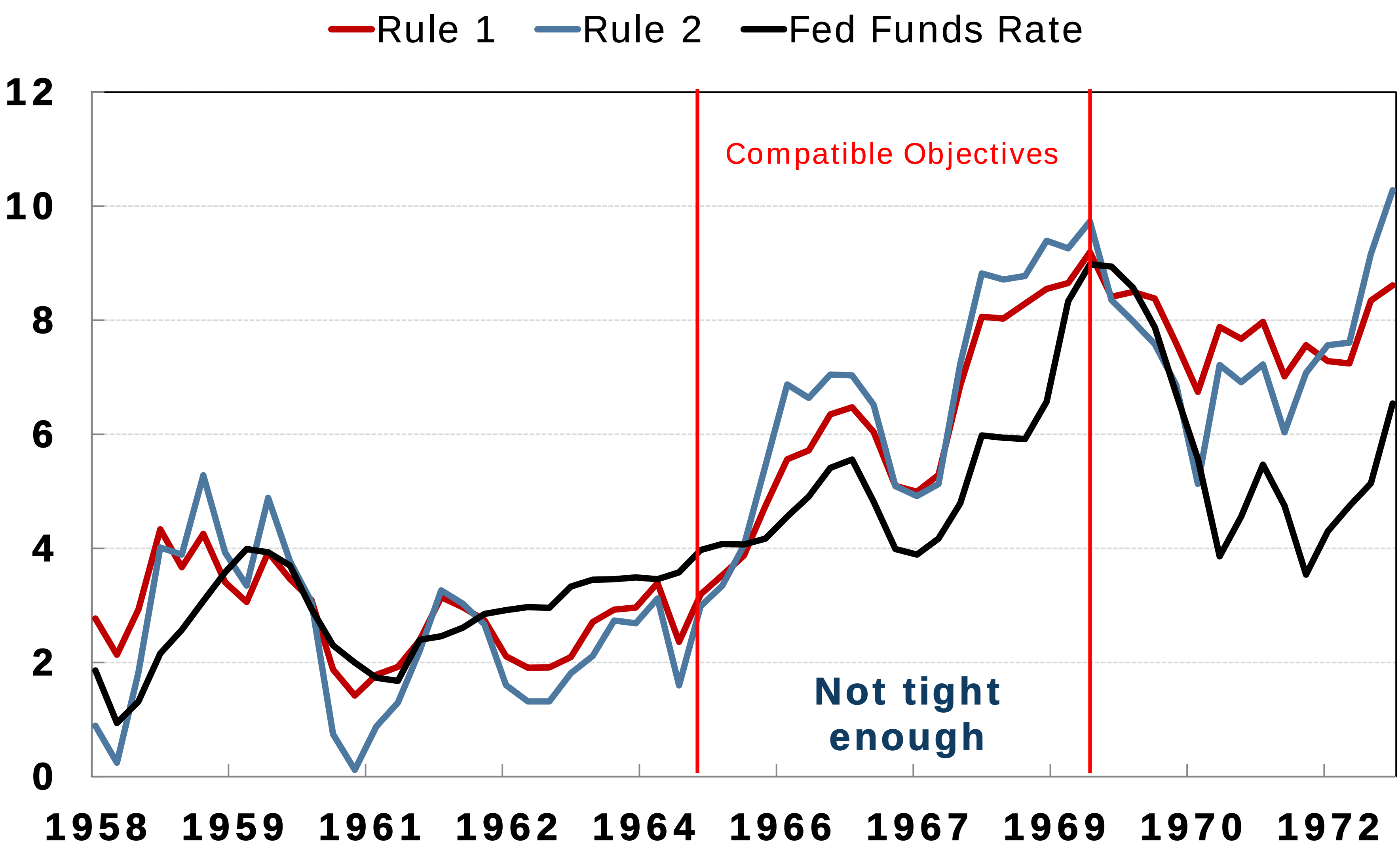


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# Benign Neglect: 1970-1973

- Policy dilemma: Internal & external objectives conflict
- Cost-push inflation
  - monetary policy promotes growth at potential
  - capital controls for balance of payment
- Stop – go policy

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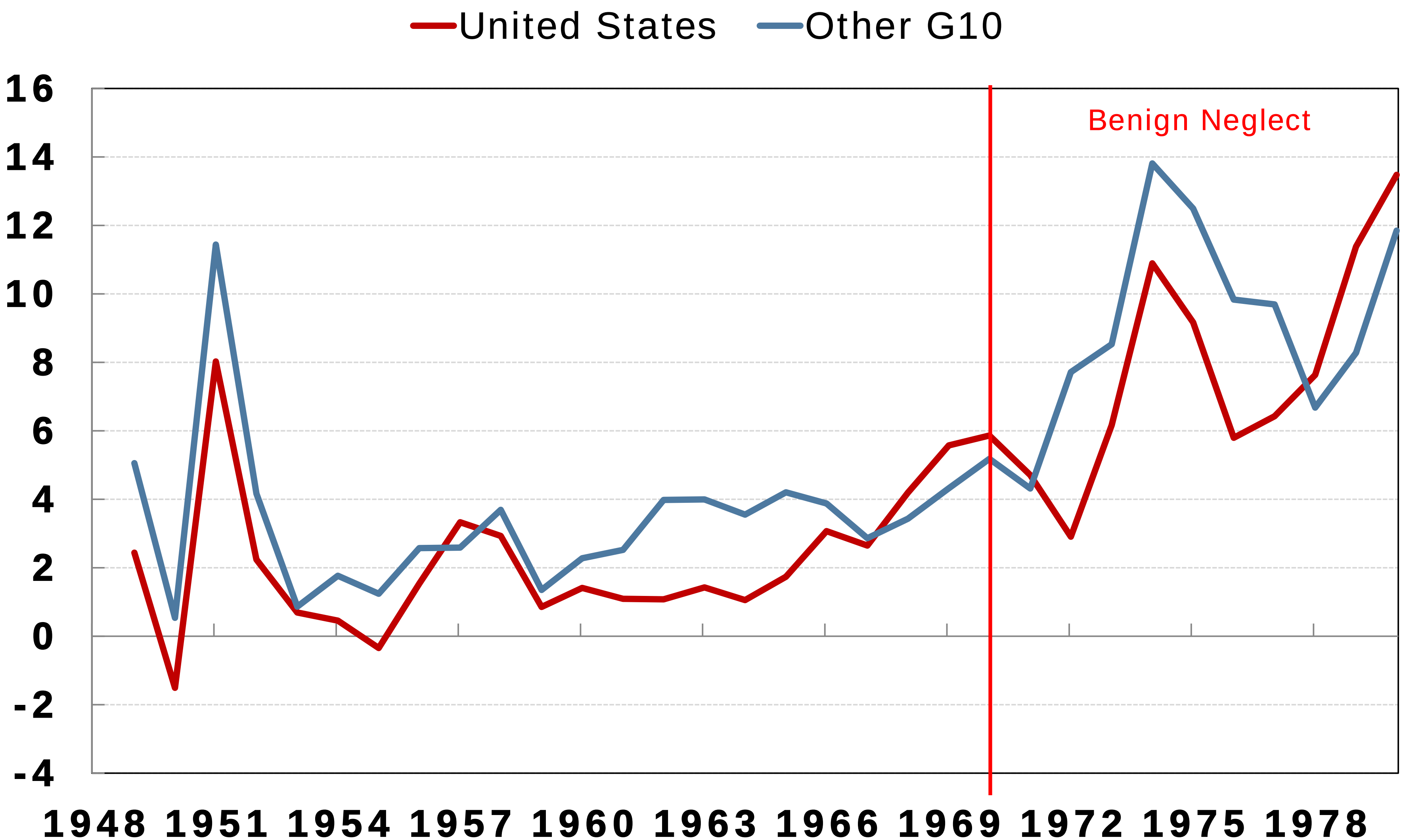


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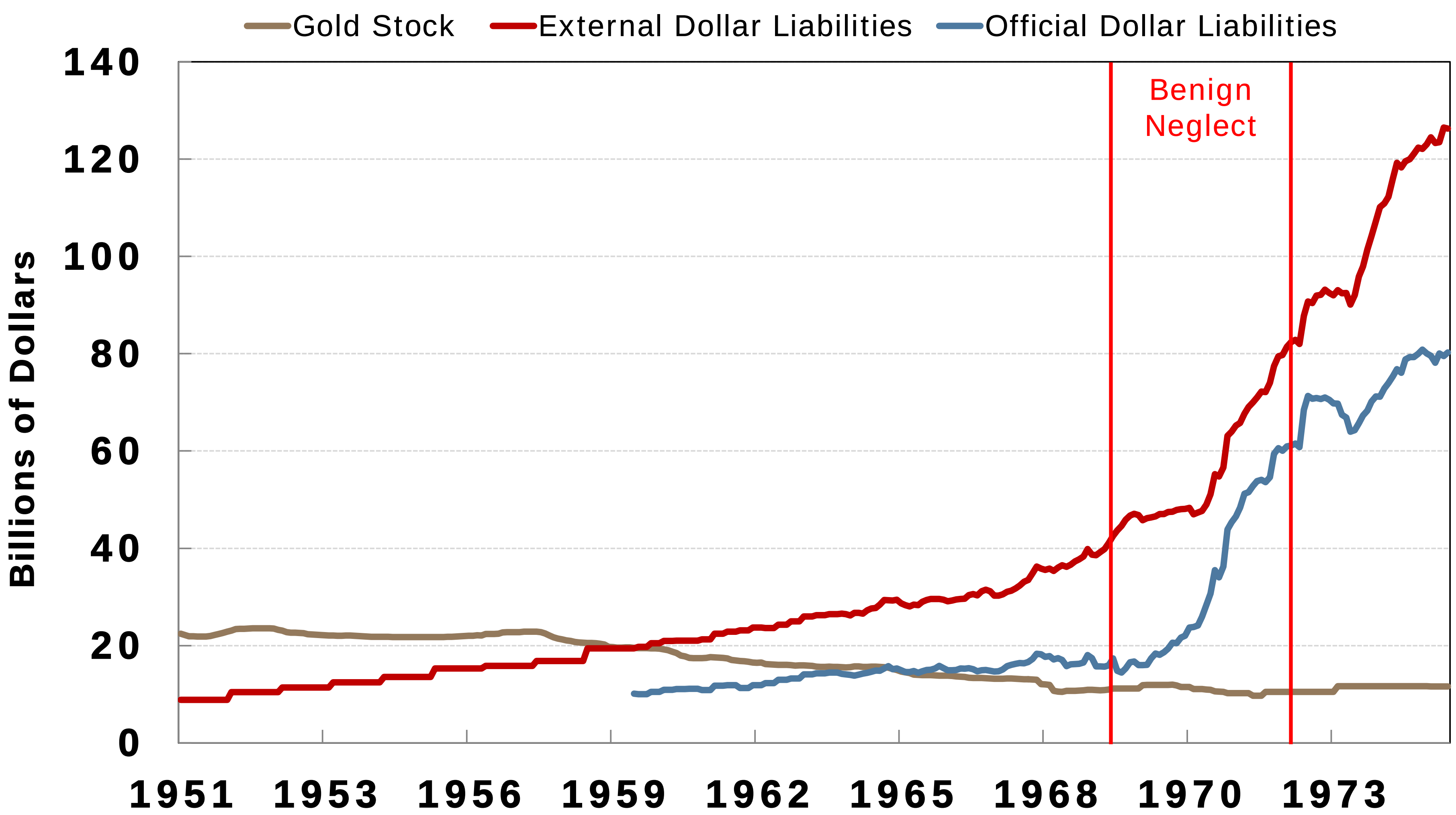


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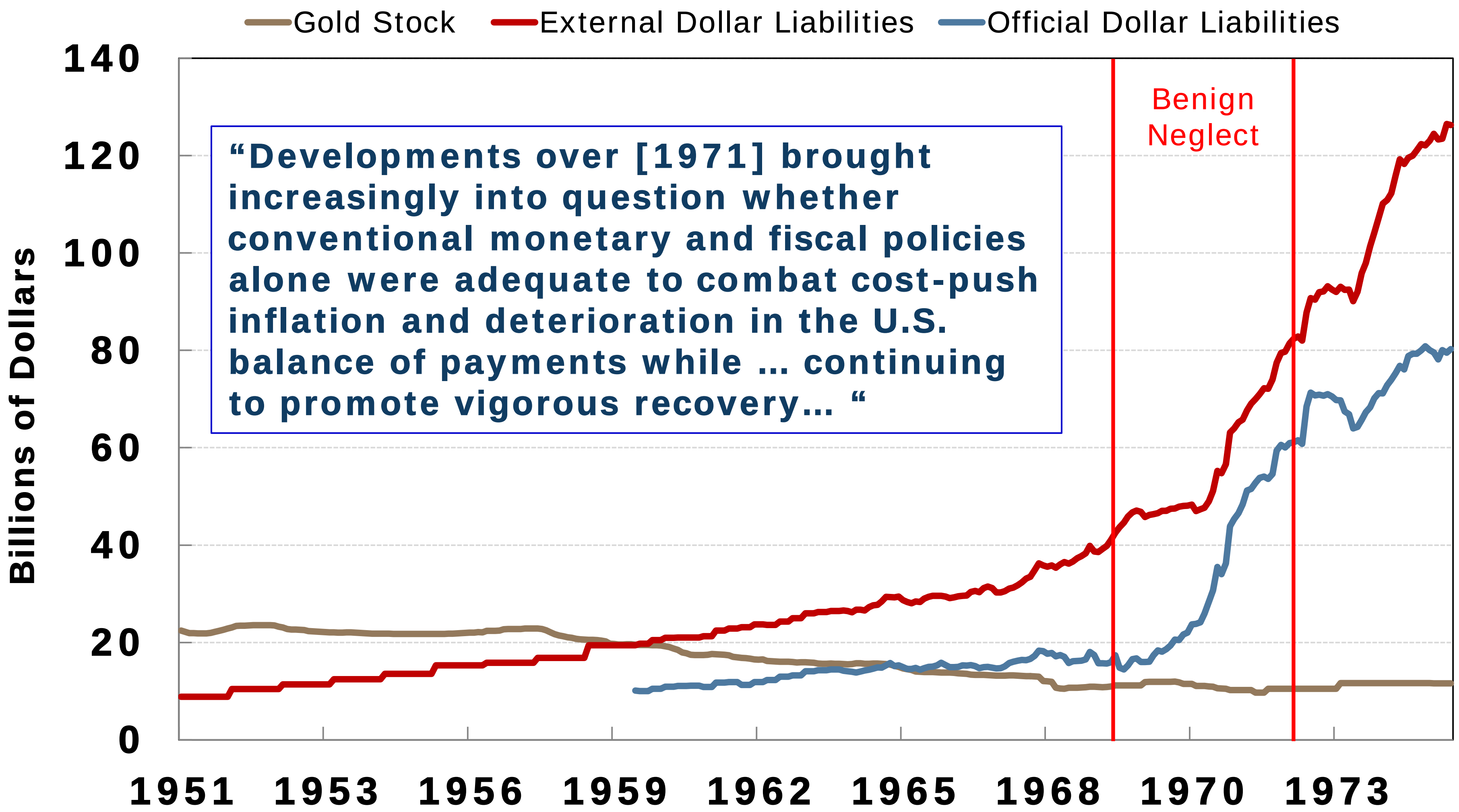


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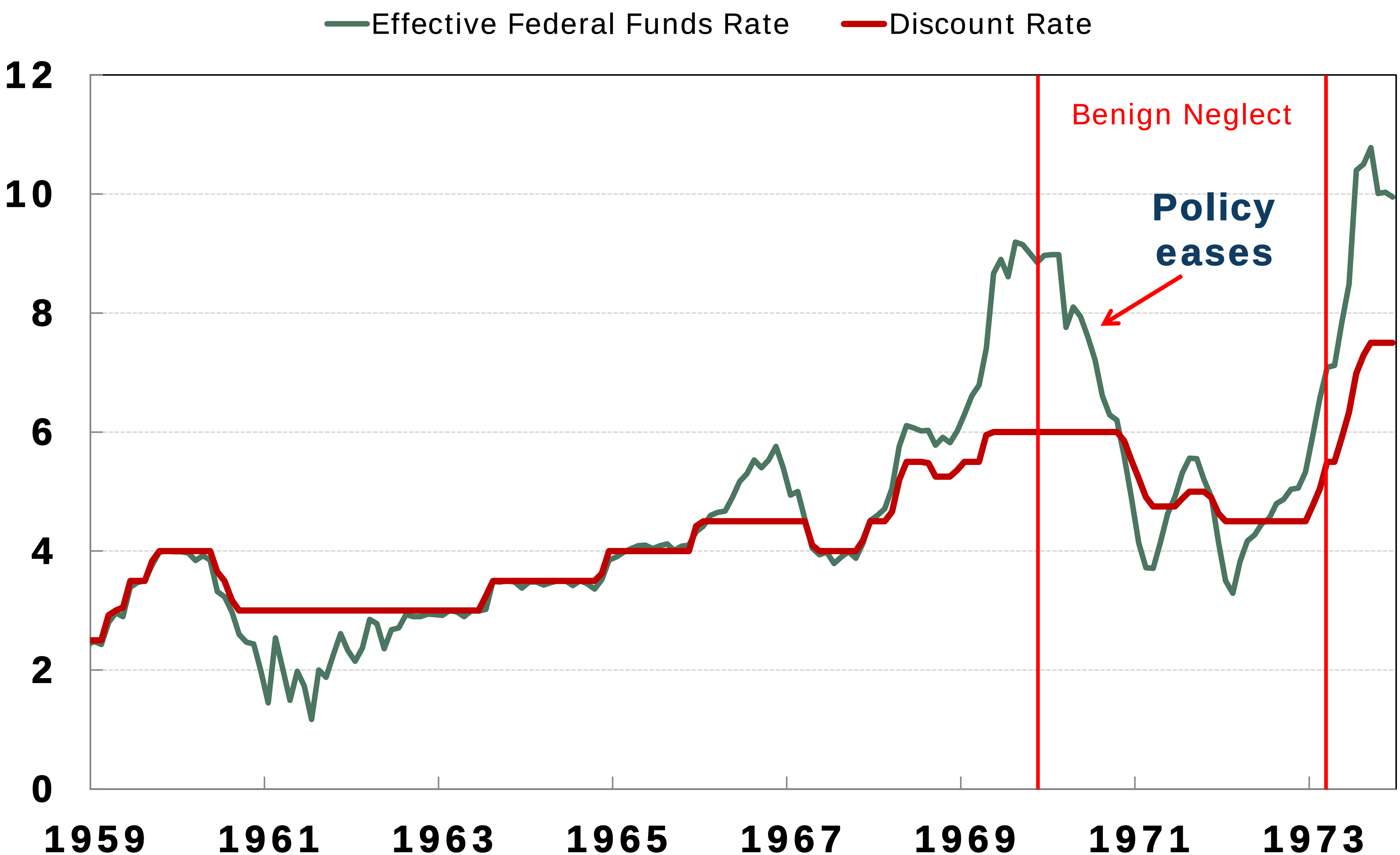


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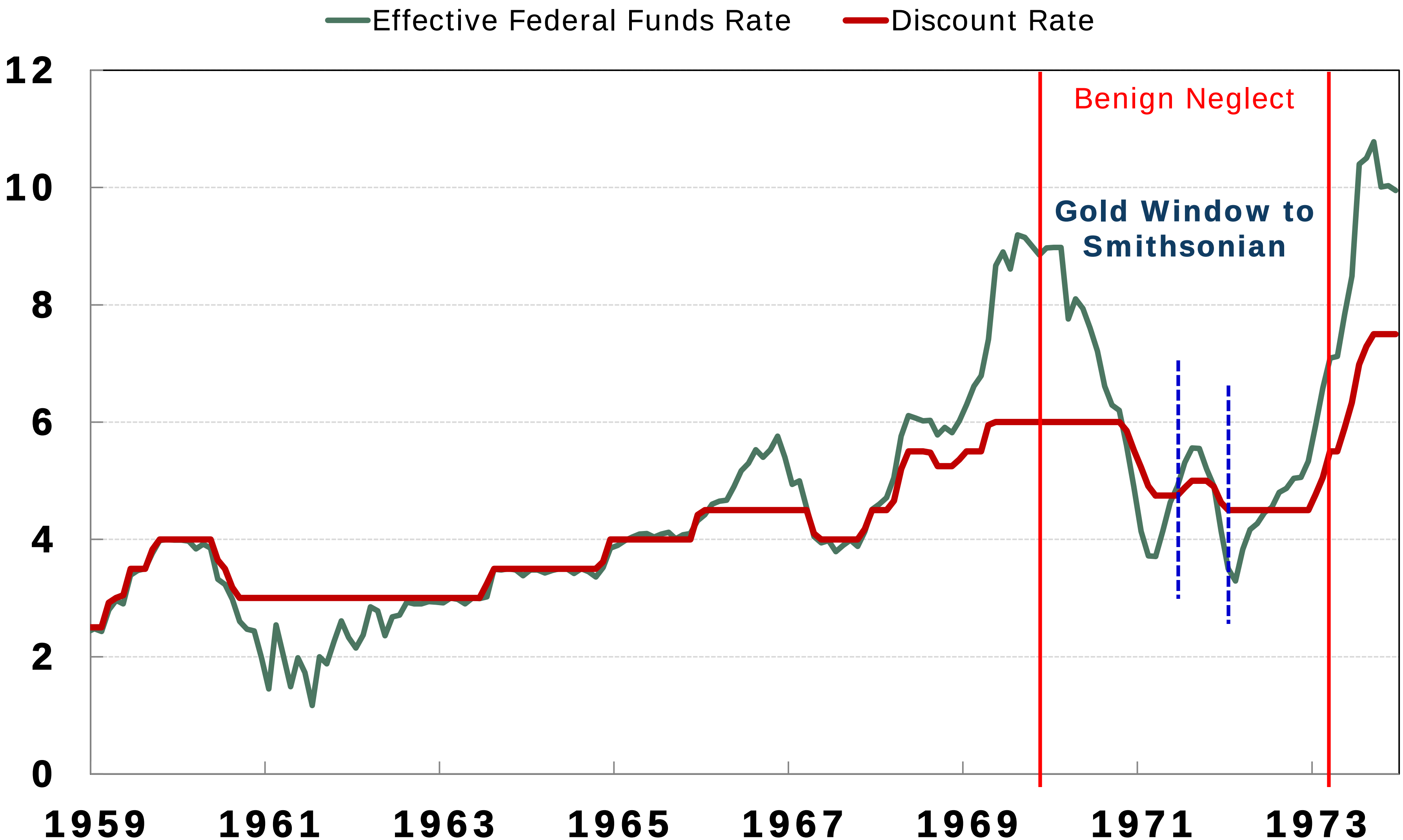


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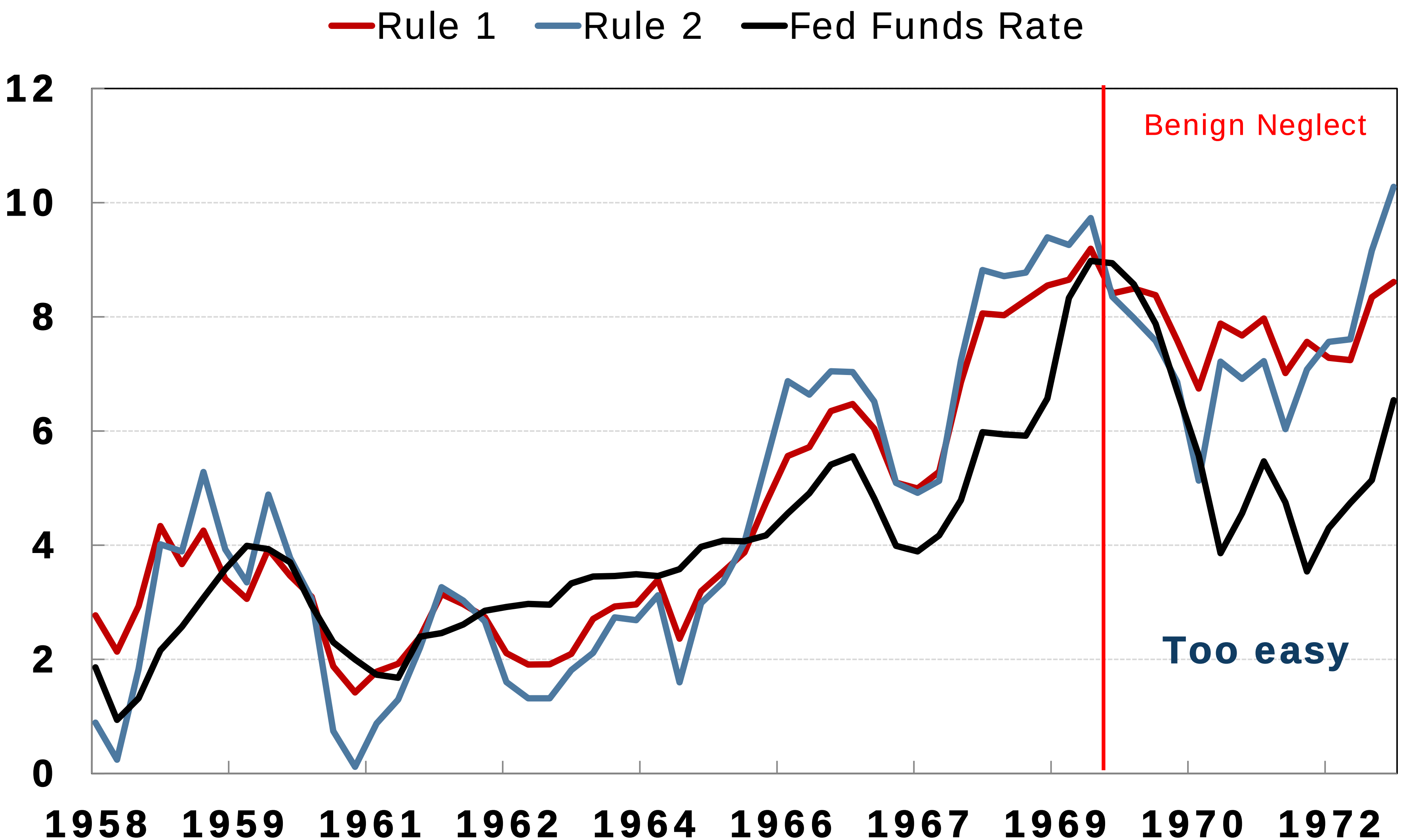


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# Conclusion

- International considerations carried little weight in FOMC decisions.
  - shaped broad contours of policy (Operation Twist)
  - responded to crises (pound devaluation)
- Stopgap policy removed the external constraint on monetary policy
- Great Inflation ended Bretton Woods
- The stopgap measures ultimately contributed to Bretton Woods demise

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