When and Why did Opinion Shift Decisively from Favoring the Bretton Woods System to Floating Exchange Rates?

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Economic opinion favoring the floating exchange rate regime was present in academic circles since the 1940s yet did not have the ideational power to become formulated as policy. The floating regime did gain ideational power once political opinion in the 1970s became more receptive to new economic thinking. In attempting to mitigate economic hardships, new economic thinking was welcomed, adopted, and soon implemented as policy. This political receptiveness was (1) paralleled by change in America's socio-political philosophy; (2) a response to the intellectual imperatives of the time; and (3) an adaption to powerful geo-political forces that were altering global perceptions of power.

This essay is theoretically supported by regime analysis, which will underpin this discussion on when and why opinion shifted from favoring a fixed exchange rate regime to favoring a floating one. In short, opinion distinctively shifted *when* epistemic consensus concerning the flexible exchange rate regime was reached in the late 1960s and early 1970s during the collapse of the Bretton Woods system. Moreover, the reason *why* opinion shifted was because events and circumstances – junctures and breakpoints in history (Ikenberry 1992) – shifted opinions and policy expectations. To establish a working definition, regimes are "sets of implicit or explicit principles, norms, rules and decision-making procedures around which actors' expectations converge; …and they are developed because actors believe that with such arrangements they will be able to make mutually beneficial agreements" (Keohane 2005, p.57).

Regime analysis offers two viable ways to account for this shift: (1) the evolutionary approach to regime change seeks to preserve norms while changing principles; and (2) the revolutionary approach to regime change overturns norms in order to change principles (Puchala & Hopkins 1997). Moreover, the former maintains that regime change is a product of new information and understanding that subsequently alters opinions and attitudes; the latter maintains that regime change is produced from alterations in structures of power (Puchala & Hopkins 1997). This paper maintains that the change in opinion concerning exchange rate regimes can be interpreted from both approaches, yet at different points in the Bretton Woods context. For instance, the Smithsonian Agreement altered opinions and attitudes rather than structures of power (the evolutionary approach), whereas the collapse of the Bretton Woods postwar economic system did alter the structures of power (the revolutionary approach).

Consideration must be given to all types of opinion instead of opinion in general. This discussion will focus on four types of opinion: political (the opinion of political actors); social (public opinion); economic (expert opinion); and global (all categories of opinion). Moreover, epistemic communities, which are groups of individuals whom hold shared beliefs about a given topic area (Puchala & Hopkins 1997), play an essential role in regime formation.

To provide context, this discussion will focus on the birth and death of the Bretton Woods postwar economic system. Looking forward, this paper first considers the inception of the Bretton Woods system and how opinion came to support a fixed regime. Secondly, this discussion focuses on the life and death of the Bretton Woods system as well as the shift in opinion to supporting a flexible regime. Within both sections, the socio-psychological and ideational factors of each period will be discussed. While it is important to consider the opinion of all politcal actors around the world, the focus of this essay will remain on American and British (social, political and economic) opinions because "…together both shaped the substantive content of the post war system" (Ikenberry 1992, p.296). Before getting into the substantive analysis, this paper opens with a brief discussion on exchange rates and why exchange rate regimes are important to consider.

Understanding Exchange Rates

An exchange rate is "the price at which one national money can be exchanged for another" (Krueger 1983, p.16). There are three systems of exchange rates: fixed exchange rates, floating exchange rates and exchange controls. For the purpose of this paper, only the first two systems will be considered. First, a fixed rate system is,

A convertible currency system in which individuals are free to undertake their desired transactions at prevailing prices and in which the government buys and sells foreign exchange in order to maintain exchange rate (Krueger 1983, p.21).

A fixed rate system would best serve the interests of internationally oriented producers because fixed rates install predictability and certainty into the international economy (Frieden 2000). Yet, at the same time, a fixed low rate of exchange will trouble the business interests of domestic producers by making imported goods more competitive. At the institutional level during the Bretton Woods fixed exchange rate system (1944-71), the IMF played an essential role in managing exchange rates by matching currencies according to their 'par values' and providing analysis of determinants for balance of payments (Frieden 2002). Moreover, under a fixed rate system, exchange adjustments could only occur in times of financial disequilibrium (Odell 1988).

A floating exchange rate system, on the other hand, is less predictable and relies upon the markets to determine rates.[1] In general, a floating exchange rate system is a "convertible currency system in which the exchange rate is market-determined and in which there can be no deficit" (Krueger 1983, p.21). Exchange rate flexibility, according to Friedman (1953), is more liberalized than the fixed rate system and is the more desirable system in a world that is becoming more integrated, both economically and politically.

In sum, exchange rate systems, whether fixed or flexible, are interconnected with, as well as dependent upon, other economic variables: capital flows and monetary policy in general, to name a few. Furthermore, exchange rate systems have become highly politicized and contentious in the international political economy (Frieden 2000). Looking forward, shifts from fixed to floating exchange rates are interconnected with changes in political and economic opinion about 'what works best' in promoting domestic and international interests as well as satisfying global utility.

The Bretton Woods System

From 1900 to 1945, the power politics of World War I, the extreme nationalism of World War II and the unhealthy economics of the Great Depression all produced an environment of economic instability coupled with political exhaustion (Odell 1988). The US, as the only nation to come out of this period in good standing, decided to lead the world with the help of Great Britain and other Western European countries into a postwar world. Their postwar plan centered around creating a system that would protect against the problems surrounding the gold standard of the 1920s as well as the competitive devaluations and beggar-thy-neighbor policies of the 1930s (Krueger 1983). Coming to the fore with answers to remedy these problems was John Maynard Keynes, the British economist. With the power of his economic ideas, US and British economists and politicians worked together to remodel the international monetary system.

After addressing the diverging trade agendas of the US State Department and British War Cabinet, US economists and British economists toiled over how best to structure the international monetary system. One the one hand, US expert economists, led by Henry Dexter White, wanted stabilized exchange rates, a stabilization fund as well as most of the burden of financial adjustments to fall on debtor countries (Helleiner 1994). On the other hand, British economists, led by Keynes, were concerned with the following: enabling exchange rate adjustment to be made in an orderly manner (Odell 1988); involving the government in markets to stabilize and provide financial confidence; and establishing an international clearing union to settle transactions that lead to surpluses and deficits (Helleiner 1994).

This team of expert economists and political negotiators, known in regime analysis as an epistemic community, eventually reconciled their differences and found common ground to craft a new monetary system. The agreement achieved between these experts is quite laudable and warrants attention. Firstly, agreement was centered on new thinking about the government's role in the economy, and reevaluating the relationship between state and society (Ruggie 1982). Moreover, to protect against speculative movements that created problems in the 1920s-30s, the experts wanted to reconcile national commitment to full employment and controls on the movement of capital (Ikenberry 1992; Volcker & Gyohten 1992). The compromise would be that, unlike the economic nationalism of 1930s, this system would be liberal, multilateral and reliant on domestic intervention at the same time. This system was conceptually grounded in what Ruggie (1982) coined 'embedded liberalism'.

Both mainstream economic and political opinion during and following the establishment of the postwar system agreed that capital controls and exchange rate stability were the most salient factors in maintaining the postwar system. Moreover, stable exchange rates and strict capital controls would allow countries to pursue independent monetary policies (Cohen 2000). This so-called trillemma only permits countries the ability to control two of three factors: capital mobility, stable exchange rates or an independent monetary policy (Cohen 2000, p.246). Exchange rates and capital controls were the factors chosen to control and thus illustrates the prevailing values, thoughts and expectations concerning economics during the period.

Fixed yet variable exchange rates were thought the most promising way of fostering stability because "currency fluctuations, exchange controls and discriminatory policies of the 1930s discredited ideas associated with floating rates" (Ikenberry 1992, p.298). In addition, mainstream economic ideas of the 1940s-50s were not in favor of floating currency because it was thought to promote damaging speculative movements (Odell 1988). With confidence that a fixed system was the best system, the dollar was fixed to gold at $35 and all other currencies were then fixed to the dollar. Moreover, the IMF was created to maintain this stable regime, to foster confidence in the system and to act as a lender of last resort.

After convergence of political and economic opinions among individuals at the Bretton Woods conference, it was time, said Keynes, "to go out of here as missionaries, inspired by zeal and faith" (Eckes 1975, p.165). The task of convincing everyone at the conference on the value of the postwar system was easy compared to the work that would be put in to convincing the rest of the world on the merits of this new type of economic internationalism. But this quest, like all else in the game of international politics, represents the two-level game that political leaders play – that is, they must sit at two different tables: one with world leaders at the international level, and the other with fellow public servants, unionists and business leaders at the domestic level (Putnam 1988).

In the US, for instance, Morgenthau went across the country and spoke of the value that the Bretton Woods system would add to global security and the international political economy (Eckes 1975). In Detroit, Morgenthau spoke of the increase foreign demand for automobiles that the system would bring; and, in Minneapolis, he spoke of the increase demand for wheat that would result from stable exchange rates (Eckes 1975, p.169). In interpreting Morgenthau's hard work, regime analysis maintains that publicly recognized individuals, who understand the technical nature of the system being promoted, will venture to traditional networks of individuals and explain to them the utility of the system through language that will foster support (Haas 1997).

Acceptance of the Bretton Woods fixed rate system did not occur uniformly across political, economic and social realms. Instead, shifts in American and British political and economic circumstances empowered this new epistemic community of experts that supported Keynesian economics. This epistemic community proposed new ways of serving national and international economic interests as well as preventing the problems of the 1920s-40s from returning. Political actors also worked hard to gain social support for new ideas that were expected to improve social conditions. At the international level, the opinions of key political actors of capitalist economies soon converged around the belief that capital controls, fixed exchange rates, and the pegging of currencies to a single commodity would fix balance of payment problems and foster a stable international monetary system. All in all, the Bretton Woods system regularized behavior; yet, as time continued and new problems unfolded, a re-analysis of 'what works best' took place.

Change of Opinion

Friedman (1953) claimed that ideas regarding what could best solve the problems of the 1930s were misinterpreted during the creation of the Bretton Woods system. While it appeared to work well for 25 years, it took some time to realize that fixed rates, impeded capital flows and the reliability of the one currency-commodity peg were not the most economically viable solutions. In general, the postwar fixed rate system lasted from 1945 to 1971 when Nixon closed the gold window (Ferguson 2008). Opinions on 'what works best', though slow moving, began to shift away from favoring the fixed exchange rate regime well before 1971. The reasons for this regime change can be linked to the changing circumstances of the 1960s-70s.

The Bretton Woods system was poorly equipped to handle the inflationary pressures of the 1960s-70s because the system was constructed to protect against the deflationary problems of the 1930s. In addition, the changing circumstances of the 1960s can be linked to three essential trends: there was a diffusion and expansion of world economic power, marked by the recovery of Europe and reduction of US and British relative power; world trade and capital movements continued to expand; and a degree of monetary and economic integration, similar to that prior to 1914, occurred (Eckes 1975). As a result of these trends, the inherent instability resulting from the gold exchange became more noticeable. Triffin explored the instability of the gold exchange system and determined that "the system's viability hinged on the willingness of foreign governments to accumulate dollars, which depended in turn on confidence in dollar convertibility" (Eichengreen 2000, p.240). Triffin's thesis illustrated how global confidence in the international system was dependent on the US maintaining a dollar deficit. This unhealthy equation was beginning to manifest and cause worries in global affairs.

Political and social opinion lagged behind and slowly evolved to meet these deteriorating circumstances. Political opinion lagged behind because Keynesian economics were so well rooted in economic institutions and powerful in political and social thinking. For instance, Keynes himself was idolized and chosen as 'Man of the Year' by *Time* magazine in 1965, and Keynesian policies were still being used during the administrations of John F. Kennedy and Lyndon B. Johnson (Volcker & Gyohten 1993). Moreover, Keynesian policies were maintained throughout the 1960s because of the large number of Keynesian economists holding influential positions. Yet, outcomes from Keynesian policies were not meeting public and political expectations like they once did prior to the mid-1960s; and the actual effort of trying to meet expectations made matters worse (Samuelson 2008). From the perspective of regime analysis, the persistence of the ideas espoused by the Keynesian epistemic community demonstrates how regimes continue to influence behavior and maintain compliance long after their norms lose capability (Puchala & Hopkins 1997).

With expectations not being met, as well as with fear and lack of confidence undermining the system, new policies were sought. Walter Heller, Kennedy's chairman on the Council of Economic Advisors, once said, "the minds of men had to be conditioned to accept new thinking, new symbols and new broader concepts of public interests" (Samuelson 2008, p.58). The implementation of new policies would not occur until political opinion was stimulated by new economic opinion. Moreover, alteration in political opinion on 'what works best' must further consider social opinion before new policies can legitimately be accepted. But political opinion was soon stimulated by the flexible exchange rate theories of a new epistemic community of experts led by Milton Friedman of the University of Chicago and James Meade, the British economist. While their proposals stem from the mid-1940s and early 1950s, the floating exchange rate regime only gained power once the policies of Keynesian economics clearly failed to meet the needs and expectations of politicians.

For the integration of the free world through multilateral trade to continue, argued Freidman (1953), exchange rate flexibility was the only natural and acceptable policy choice. In addition, while it was feared that flexible rates would cause further instability, Friedman argued that instability was not a symptom of flexible rates, but a result of inherent flaws in national economic policies (Friedman 1953). Echoing Friedman's message from across the Atlantic was James Meade, who further maintained that the current state of the international political economy was incompatible with fixed rates, and a flexible regime would provide a more viable solution to correcting balance of payment problems (Helleiner 1994).

The intellectual case for floating was gaining further support among strong social forces, such as private financial groups, as well as further acceptance and political power in Washington. Two of President Richard Nixon's key appointments, Arthur Burns as chairman of the Federal Reserve Board and George Shultz as Secretary of Treasury, represent the power that domestic political actors have in the policy environment. Both Burns and Shultz were keen on implementing Friedman's policies to manage inflationary pressure and insulate the national economy from disturbances originating in other countries (Volcker & Gyohten 1993; Cooper 1982).

The new policies advocated by Burns, Shultz and other in the administration were evidence that norm-governing changes were taking place. These norm-governing changes reflect a revision in the psychology underpinning the system rather than the collapse of the system altogether (Ruggie 1982). Furthermore, changes in the international economic environment produced a reevaluation of expectations and subsequent alterations in ideational power. For instance, the problems of the 1960s and 70s could not be managed by the prevailing ideas and opinions of the 1940s and early 1950s.

New governing strategies through the Smithsonian Agreement would have to be accepted or the entire system itself would have to be abandoned. These new governing strategies exemplify the evolutionary approach to regime change. While the flexible regime was gaining opinion power amongst political groups in Washington, attempts were made to maintain the fixed rate system, though readjusted, before doing away with it completely. This attempt at the Smithsonian Agreement is evidence that elites (the Keynesian epistemic community) were seeking to preserve their power while regimes were in transition (Puchala & Hopkins 1997).

The Collapse & Float

The postwar international monetary system was bent, broken and finally abandoned (Keohane 2005). The system was bent when a loss of confidence resulted from the British sterling devaluation; from De Gaulle's disapproval of greenback imperialism; and from German accusations that the US was exporting its inflation and disrupting German price stability (Volcker & Gyohten 1993). By December 1971, with inflationary pressure rising and the dollar deficit growing, the Smithsonian Agreement was concluded and currencies were re-pegged (Keohane 2005). This re-pegging, however, did not last, and by 1973 the system was broken. Soon after, floating currencies became a political reality with America and other major currency blocs floating against each other.

While economic opinion provided new ideas, the political decision to float was a response to both geo-political events and shifting political philosophy. Initially, political leaders were reluctant to float because of the conception that floating would encourage speculative pressure and therefore destabilize the global economy. But geo-political events, such as the Arab oil embargo crisis and Vietnam war, and economic events, such as the inability to maintain confidence in the dollar, mitigate balance of payment deficits and contain inflationary pressure, shifted the focus of analysis and forced the hands of politicians to abandon Keynesian policy options.

The shift to the floating regime, in the words of Gottfried Haberler, was a 'non-policy' option because political opinion was still much in favor of the fixed rate regime, and the adoption of the floating regime was emblematic of the defeat of the old system rather than a conscious adoption of the new (Daunton Lecture, 19 Nov. 2008). Yet, keeping in mind the shifting political philosophy of the period, particularly amongst America's conservatives, Haberler's thesis is difficult to defend. Shifts in American political philosophy represent the *conscious* adoption of new policies that would reinforce this new thinking.

While Nixon famously said "[w]e are all Keynesians now," which, again, exemplifies how well-rooted this regime was, the Republican Party was reassessing their socio-economic political philosophy (Weisbrot 2008). Although this philosophy would not become well established in the party until the Reagan-Thatcher free market revolution of the

1980s, the following points were being considered: the acceptance of competitive deregulation; adoption of more predatory policies; and the promotion of a neoliberal framework that was centered on personal freedom rather than embedded liberalism (Helleiner 1994). This philosophical component is essential to understanding the subjective dimension of regimes, which are all too often consumed by discourse on power and interests (Puchala & Hopkins 1997).

New focus on personal freedom fostered a decoupling of government involvement in the domestic economy and the acceptance that markets will determine rates. Furthermore, this new focus on market liberalism in general and exchange rate flexibility in particular altered the equation of the trilemma. With the abandonment of the fixed exchange rate regime, capital controls were (eventually) dismantled and subsequently an independent domestic monetary policy was no longer manageable. In sum, the Keynesian welfare system was eventually unseated and a new focus was placed on the promotion of personal freedom and market led economic growth.

Change in American political opinion and practice paralleled changing circumstances in international politics. The regional breakup of the international political economy, as well as shifts in global opinion concerning ways of managing the system, were evidence that America's relative economic power waned over the 1970s. Moreover, before the 1970s America was capable of unilaterally maintaining the international political economy by providing most participants of the system with a stable international monetary system predicated on stable oil prices and open markets (Keohane 2005). All of the aforementioned securities that America guaranteed, however, were eventually no longer maintained. America's change in relative economic power, therefore, produced a restructuring of both perceptions of power and global opinion concerning America's economic capabilities.

Conclusion

Shifts in opinion from favoring the fixed regime to favoring the floating regime illustrated that something fundamental changed in the 1960s and early 1970s. The fundamental change was that the international post-war economic system was on the verge of collapse. Moreover, the ideas buttressing the Bretton Woods postwar system – mainly the idea of pegging gold to the dollar – were no long economically viable given the circumstances of the period. These circumstances were the shifting relative economic power of the US; the geo-political problems stemming from the Arab Oil Embargo and Vietnam; and the inflationary pressures of the period.

Keynes once said that, "when the facts change, I change my mind" (Perry 2008, para. 1). Comparisons can be drawn from this famous quip to explain the change of opinion concerning exchange rate regimes – that is, when circumstances change, regimes change. Yet, regimes do not formally change until ideas fail to produce desired outcomes. Upon such failure, a search and acceptance of alternative ideas will empower a new epistemic community and therefore create a new regime. And this regime will retain its power until its ideas fail to produce the desired outcomes.

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[1] There is considerable debate surrounding whether floating rates create domestic economic instability as a result of being less predictable. See Friedman (1953) and various works by Dr. Mahathir Mohammed.

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