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Weaponizing the Dollar: Part I

In July 1944, 44 allied nations gathered at the Mount Washington Hotel in Bretton Woods, NH to develop the structure for the economic and financial systems for the postwar world. The Bretton Woods agreement established a system of fixed exchange rates. Exchange rates were pegged to the U.S. dollar and the dollar could be swapped for gold at a fixed price of $35 per ounce. As part of this system, capital controls were widely deployed placing restrictions on the ability of investors to move funds overseas. In the wake of the Great Depression, international bankers were held in low regard so international transactions were mostly to facilitate current account (trade) activity, while capital account transactions were restricted.

A large enough number of nations adopted the plan and the system lasted from 1945 until August 1971, when President Nixon ended the ability of foreign dollar holders to swap for gold. Since 1971, most developed nations have adopted floating exchange rates and, over time, open capital accounts.

There is growing evidence that some policymakers in the U.S. are rethinking Nixon's break with the Bretton Woods system and are considering a return to fixed exchange rates. In Part I of this report, we will introduce the Mundell Impossible Trinity, which will provide the framework of discussion for the three historical models and the potential change. In addition to the Impossible Trinity, we will discuss the gold standard and the Bretton Woods system. In Part II, we will examine the Treasury/dollar standard and introduce what could be called Bretton Woods II. We will discuss the strengths and weaknesses of each model. As always, we will conclude with market ramifications at the end of Part II.

The Impossible Trinity

In 1960, Robert Mundell postulated that a country can only implement two of these three policies:

1. A fixed exchange rate
2. An independent central bank
3. An open capital account

For example, if a nation has a fixed exchange rate and an open capital account, then its central bank will conduct policy to maintain the exchange rate peg which will be affected by capital inflows and outflows. As such, it will not be independent. On the other hand, if the central bank is independent and the capital account is open, then the exchange rate will be required to float.

There are implications for each policy choice. A fixed exchange rate forces adjustment to other parts of the economy whereas a floating exchange rate mitigates pressures through currency appreciation and depreciation. An open capital account subjects an economy to the whims of foreign capital flows. High levels of inflows can lead to asset bubbles or excess productive capacity, while outflows can lead to debt crises and banking problems. However, a closed capital account will restrict available

investment liquidity to domestic sources. Central bank independence is only possible under conditions of floating currencies and an open capital account or a fixed currency with a closed capital account.

The Gold Standard

Using the Mundell Impossible Trinity, the gold standard generally had fixed exchange rates (currencies were pegged to a gold volume) and open capital markets. Under this model, central banks did not actively conduct independent monetary policy; historically, the central banks facilitated payments and would act as lender of last resort during bank runs. But, these central banks did not engage in discretionary monetary policy because, for the most part, it wasn't necessary. The flows of gold, tied to trade and investment, interacted with domestic supply and demand, leading to a "natural" adjustment of prices.

For example, if demand rose in a country due to rising population, inflation would tend to rise. As price levels rose, domestic goods would become relatively dear compared to foreign goods. Imports would rise; if this rise in imports was not offset by rising exports or investment inflows, the resulting deficit would be met by outflows of gold. The outflows of gold could not be met indefinitely; action would need to be taken to reduce inflation. The outflow of gold would tend to lift interest rates, as the higher interest rates would encourage gold inflows. The increase in interest rates would depress economic activity and lead to falling prices through higher unemployment or falling wages. In this particular example, the equilibrium outcome would likely be lower wages until investment capacity rises to accommodate the rise in population.

The gold standard worked quite well mostly because of limited suffrage. In many European nations, voting was limited to propertied white males, the primary owners of capital. The structure of the gold standard limited the other avenues of adjustment; devaluations against gold were relatively rare because it would have been unpopular with the propertied class which had political power. Closing capital markets was also considered "poor form" because it denied the economy the access to foreign investment and it might also restrict available imports. The gold standard, enforced by the global hegemon of the time, Great Britain, fostered globalization.

The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend.

He could secure forthwith, if he wished it, cheap and comfortable means of transit to any country or climate without passport or other formality, could despatch his servant to the neighbouring office of a bank for such supply of the precious metals as might seem convenient, and could then proceed abroad to foreign quarters, without knowledge of their religion, language, or customs, bearing coined wealth upon his person, and would consider himself greatly aggrieved and much surprised at the least interference.

***But, most important of all, he regarded this state of affairs as normal, certain, and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable.*[1]**

This quote from John Maynard Keynes, written in *The Economic Consequences of the Peace*, described the world in 1914. This world essentially unraveled after WWI; the industrialized nature of that world war required the mass induction of citizens into the military and, due to their sacrifices, they demanded the vote after the war. In addition, women also agitated for suffrage. Once voting expanded, it became impossible to force the economic adjustment on labor; this fact undermined the gold standard and during the Great Depression the gold standard as it was practiced was steadily abandoned.

The Bretton Woods Standard

During the 1930s, as British hegemony waned, the power vacuum that developed was a contributing factor to the Great Depression. The weakening of the global hegemon led to deglobalization; nations engaged in "beggar thy neighbor" devaluations in an attempt to prevent foreign nations from capturing domestic demand and as a way to "steal" domestic demand from others. This state of affairs led to weak global growth and increasing international rivalry. As a result, overall foreign trade declined.

As nations gathered for the Bretton Woods meeting, the goal was to create a stable global trading system that would be politically sustainable in ways that the gold standard was not. In other words, the negotiators wanted to build a trading system that would operate under conditions of universal suffrage. The Bretton Woods standard, in terms of the Impossible Trinity, worked as follows:

1. Fixed exchange rates
2. Central bank independence
3. Restricted capital account

Under the Bretton Woods system, nations would use the dollar as the reserve currency with the proviso that a holder of dollars could exchange them at a fixed rate of $35 for an ounce of gold from the U.S. Treasury. Central banks would be independent in that their policy goals would be established by their respective governments. For this to work, the capital account would be used primarily to facilitate trade but would be generally restricted for investment.

The Bretton Woods system emphasized national sovereignty. Nations could run independent fiscal and monetary policies. If there were problems with trade imbalances, the IMF stood ready to offer short-term financing to allow for rebalancing.

However, the system had two serious flaws. First, there were clear problems with large current account deficits; the IMF would provide funding but also require policy austerity which, in some respects, resembled the gold standard. Developing nations became increasingly jaded toward the IMF. John Maynard Keynes wanted a symmetric system of penalties that would force adjustment on nations with either large current account surpluses or deficits. The U.S., which was a surplus nation before WWII, had no interest in creating a system that would lead to such penalties.

The second flaw was perhaps worse because the first flaw had an obvious remedy, while the second one didn't. The problem for the reserve currency nation was that it had to

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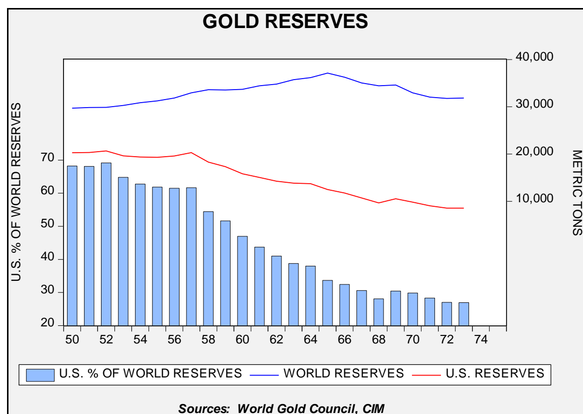
[1] https://fee.org/articles/quote-of-the-day-keynes-on-trade-migration-globalization/

run persistent current account deficits to supply the world with its currency which was used to conduct trade. If the current account deficits of the reserve currency nation became large enough, the world could lose faith in the reserve currency which would trigger a crisis and force devaluation, then shifting the burden of adjustment on the non-reserve states or policy austerity on the reserve nation that would reduce global liquidity. This problem was known as the "Triffin dilemma," named for the economist Robert Triffin, who first described it.

At the Bretton Woods meeting, Keynes was concerned about this problem developing and suggested the IMF should issue a form of world currency, or "paper gold" he called the "bancor." This would eliminate the Triffin dilemma but substitute another one – the IMF would become a global central bank and undermine national policy independence.

Because the U.S. had substantial gold reserves after WWII, the Triffin dilemma was not seen as a big problem. However, by the mid-1960s, the drain on U.S. gold reserves was becoming a serious problem.



The upper lines on the chart show gold reserves for the world and the U.S. The lower bars show the U.S. percentage of world gold reserves. In the early 1950s, the U.S. held nearly 70% of the world's gold reserves. However, as the chart shows, there was a steady drain of reserves out of the U.S. and into the world, leading to a precipitous decline in U.S. gold reserves.[2]

There were other issues as well. Investors chafed at capital controls. Milton Friedman concluded that the British pound would be unable to maintain its peg to the dollar and gold in 1971 and wanted to short the currency.

> *The concept of a market in currency itself was not new. A forward currency bank market, known as the Interbank Market, an outgrowth of the Bretton Woods Agreement, was in existence. But as its name implied, the* ***Interbank Market was limited to banks acting for themselves or their global institutional clients. An individual, regardless of his standing, purpose, or wealth, or businesses that did not measure up to the "international commercial" standards demanded by the banks, were barred from participation.*** *In a well-publicized story, in 1971 when Milton Friedman attempted to go short the British pound, banks refused him the right to do so on the basis that "****Friedman did not have the necessary commercial interest to deal in foreign exchange****."*[3]

Another example was the Eurodollar market. Currently, the Eurodollar market is simply dollar deposits that are not government-

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[2] In what was perhaps one of the oddest episodes in American policy, the Johnson administration embarked on a program to extract gold from unconventional sources. The program was called "Operation Goldfinger." Although the program failed to find new ways of sourcing gold in seawater, for example, it probably had some propaganda value.

[3] http://www.chongcapital.com/Documents/CME_BirthOfFXFutures.pdf, page 4.

guaranteed. But, until the early 1980s, Eurodollars were U.S. dollar deposits held by offshore entities that usually acquired them because of American aid (e.g., the Marshall Plan) or the U.S. trade deficit. Because these deposits were outside the U.S. banking system, they weren't regulated by the Federal Reserve. Regulation Q of the Federal Reserve set the maximum deposit rate on dollars in the U.S. banking system. Eurodollars were not subject to Regulation Q and usually carried a higher interest rate, especially in the 1970s when inflation was rising in the U.S. American investors would participate in a form of regulatory arbitrage, moving dollars offshore to capture a higher interest rate, leading to the disintermediation of deposits from the U.S. banking system.

Part II

Next week, we will complete this report with a discussion of the Treasury/dollar standard and the potential framework for a new model called "Bretton Woods II." We will conclude the report with market ramifications.

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