"Free-Floating Anxiety"

by Milton Friedman

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The fiftieth anniversary of the Bretton Woods conference, which created the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (the World Bank), has been the occasion for a triumph of nostalgia over reality. Nostalgia has converted the twin institutions into major pillars of postwar expansion, transformed the 1971 termination of the system of pegged exchange rates established by Bretton Woods into a major policy mistake, and produced expressions of support for the re-establishment of such a system.

Reality is very different. The IMF and the World Bank have been major failures; they have done far more harm than good and have imposed heavy costs on their members. The world would be far better off today if neither had been established. Both are excellent examples of one of my favorite generalizations: If a private enterprise is a failure, it will close down unless it can get the government to bail it out; if a government enterprise is a failure, it will be expanded.

Even the most casual empiricism suggests that the World Bank and its more recent junior accessory, a reformed IMF, have done more harm than good. They have distributed many billions of dollars of so-called loans, most of them really grants, supposedly to foster the development of poor countries. But the most successful cases of development have been in the countries that have relied least on the Bank and the Fund—the Four Tigers, and more recently Mainland China. Most of the countries that have received extensive assistance from the Bank have done very poorly—India, for example, and most African and Latin American countries.

The reason is clear. The problem with the poor countries is mostly a government sector that imposes excessive restrictions on economic activity and transfers both power and wealth unto itself—in short, too strong a government. But to whom do the World Bank and the IMF make loans? To the government. Hence they strengthen government control, providing money that the people in power can use to entrench their position, in countries where the urgent need is to reduce government power and control. They encourage the propensity of governments to construct monuments, which is indeed what the major output of the Bank has been.

The IMF's assignment was to supervise a system of agreed-on exchange rates among member countries by providing a) assistance to smooth over temporary balance-of-payments problems and b) a forum for agreeing on changes in exchange rates in response to a "fundamental disequilibrium" as judged by the IMF. The agreement linked the U.S. dollar to gold and the currency of other countries to the U.S. dollar. It provided that all members other than the United States would specify an official exchange rate in terms of the U.S. dollar, that each was free to make one change of up to 10 per cent in that exchange rate on its own, but that any other changes required the approval of the IMF; and that the United States would commit itself to buy gold from and sell gold to foreign central banks or other monetary authorities at $35 an ounce in unlimited amounts at their request. The IMF arrangements were intended to eliminate the direct exchange controls that had become pervasive ever since Hjalmar Schacht introduced them in Germany in the late 1930s.

Despite the commitment to fixed exchange rates, numerous changes in exchange rates occurred during the 25 years after the IMF began operation, including appreciation of the German mark in 1961 and 1969, and major devaluation of the British pound in 1949 and 1967, and of the French franc in 1949, 1959, and 1969. Furthermore, exchange controls continued until 1959.

All in all, the much-vaunted Bretton Woods system of pegged exchange rates operated as intended for only eight years—from 1959 to 1967—and even those years were not free from exchange-rate changes. And it worked then only because the U.S. was willing to finance the payments deficits of other member countries.

When President Nixon closed the gold window on August 15, 1971—an act which I believed then, and still believe, he should have taken immediately on his inauguration [see sidebar]—the function that the IMF had been established to perform, and hence its reason for existence, disappeared. It should have been abolished. But it was a government agency, and so instead it simply converted itself into a junior World Bank and expanded. It became an international busybody, offering under-priced loans to countries in trouble at the price of their following its advice on domestic policy—to judge by results, occasionally good, but perhaps more often bad.

True, there have been large, sometimes violent movements in exchange rates during the period since 1971 when exchange rates have been flexible. But, first, some of those are themselves attributable to government interventions, and, second, they have not led to the introduction of direct controls on imports, exports, and capital movements that it was one purpose of Bretton Woods to eliminate but that in practice it kept alive.

As to the first, the February 1987 Louvre agreement, under which Japan and Germany undertook to support the exchange rate for the dollar, bears much responsibility not only for the large exchange-rate movements at the end of that year but also for the subsequent stock-and land-price explosion in Japan (the “bubble”), which in turn led the Bank of Japan to step on the brake so hard that it produced a major depression, from which Japan is only beginning to emerge. That depression in turn played a major role in producing the sharp appreciation in the dollar value of the yen. The Japanese taxpayers have paid a heavy price for the Bank of Japan’s repeated interventions in foreign-exchange markets. Indeed, I believe that if the yen had been allowed to float freely throughout the 1980s, Japan would have avoided the bubble and the subsequent collapse.

As for pegged exchange rates, there have been repeated efforts both before and after the collapse of Bretton Woods to establish such systems. (For brevity, I start with the end of the war.) For eight years during the Bretton Woods period there was also a European Payments Union designed to foster pegged exchange rates among European countries. Like all such arrangements, it broke down, and it was terminated in 1958. The Smithsonian Tunnel, created in December 1971, collapsed in February 1973; the Snake, created by the European Economic Community in April 1972, was joined by a varying number of countries until 1979. It was then buried by the EEC and replaced by a more formal arrangement, the European Monetary System, again with changing membership. The EMS experienced no fewer than 11 devaluations or revaluations from 1979 to 1987, sometimes affecting more than one currency. A period of stability followed, much like that under Bretton Woods from 1959 to 1967, though even shorter. Both periods of stability had the same source: a major country—first the U.S., then Germany—that was willing to finance the balance-of-payments deficits of other members of the exchange agreement.

The system was doomed when the fall of the Berlin Wall and the subsequent unification of Germany made it imperative for West Germany, which had been exporting capital to other members of the EMS, to start exporting it to East Germany instead, and if possible to import capital. The agreed-on exchange rates were not consistent with the new situation, and something had to give. In late 1992, the EMS collapsed with the withdrawal of Britain and Italy.

Similarly, the nineteenth-century gold standard is repeatedly referred to as if it were a model. It did indeed produce stable exchange rates, but beyond that its virtues have been greatly exaggerated. It lasted in full glory from 1879 to 1914, a period that saw in the United States deflation from 1879 to 1866, followed by inflation from 1896 to 1914, during which period there were repeated financial crises, many business fluctuations, a major depression in the 1890s, and a banking panic in 1907 that led to the establishment of the Federal Reserve System. After World War I, the U.S. formally remained on a gold standard, and it was under that system that the monetary authorities produced the Great Depression. All this took place during a period when government spending ranged around 10 per cent of the national income in all major countries, and when government made no pretense of exercising extensive control over their economies.

Today, when governments in most major countries spend half or even more of the national income and exercise far greater control of the economy, no government would be willing or indeed able to submit itself to the discipline of a strict gold standard. The unwillingness of fairly closely linked countries to submit themselves to the less far-reaching discipline of the European Monetary System is surely persuasive evidence of that proposition. In today's world, political unification must precede monetary unification, not the other way around.

In a recent *Wall Street Journal* op-ed piece (July 15) recommending a return to gold, Judy Shelton started her concluding paragraph: "Until the U.S. begins standing up once more for stable exchange rates as the starting point for free trade . . ." It would be hard to pack more error into so few words. A true gold standard—a unified currency—is indeed consistent with free trade. But a system of pegged exchange rates, such as the original IMF system or the European Monetary System, is an enemy to free trade. It is no accident that the 1992 collapse of the EMS coincided with the agreement to remove controls on the movement of capital, or that the Common Market has not succeeded in more than four decades in achieving free trade, although that was a major objective. I hasten to add that the Common Market has made much progress in reducing trade barriers, but it has been unable to go the whole way precisely because it has consistently sought "stable exchange rates."

This is not surprising. Changes are always occurring that affect the demand and supply for a given country's currency—its balance of payments. There are only four ways to adapt to these changes: 1) a rise or decline in the exchange rate; 2) rises or declines in internal prices and output (the primary method under a unified currency); 3) controls over foreign transactions, in the form of tariffs, subsidies on exports, or exchange controls; 4) increases or decreases in foreign-exchange reserves (a secondary method under a unified exchange rate).

Strict free trade would rule out method 3); strict adherence to a fixed exchange rate would rule out method 1), leaving only 2) or 4). But 4) can at best be a temporary recourse, especially if the changed circumstances lead to an outflow of foreign-exchange reserves, which are necessarily limited (this forced President Nixon's hand in 1971). There remains only 2), rises or declines in internal prices and output. It is inconceivable that a national central bank would stand idly by while changes affecting its balance of payments produced either a significant inflation or a serious recession. By its actions, it would force either controls on trade or a departure from the fixed exchange rate. This is not purely theoretical speculation, as it was when I wrote an article on flexible exchange rates published in 1953; it has occurred time and again since then. The lesson is that for any group of economic entities to have a unified currency, there can be at most one independent central bank. ("At most," because with a pure commodity standard, e.g., a gold standard, no central bank is needed.)

To close on a personal note that also reveals my interest, I spent the final three months of 1950 as a consultant to the U.S. Marshall Plan agency in Paris. My primary assignment was to analyze the Schuman Plan for a European Coal and Steel Community, the precursor to the Common Market. I concluded then, for the reasons summarized in the prior two paragraphs, that the Schuman Plan could succeed in its objectives only if it was accompanied by a system of flexible exchange rates. Since that was clearly ruled out, I recommended that the U.S. oppose the Schuman Plan—my first real evidence on how much easier it is to advise than to get one's advice followed. Nothing that has happened in the more than four decades since has given me reason to believe that my advice was wrong.

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