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Bretton Woods and the Forgotten Concept of International Seigniorage

Bretton Woods

In the summer of 1944, delegates from 44 allied nations met for the now famous economic conference at Bretton Woods, New Hampshire. Their mandate was to finalize plans for the post-war economic order and currency cooperation that had been circulating among the Allied nations.

Some of the institutions this meeting established are still familiar elements of the current structures for international economic co-operation, for instance the International Monetary Fund and the World Bank.

Largely forgotten today is that the establishment of an international reserve currency had also been on the agenda. Keynes, chairing the British delegation, proposed the establishment of a special reserve currency, provisionally named the "bancor." At first, President Roosevelt's had instructed the American delegation to support the initiative.

Keynes envisaged the bancor as an international trade currency and unit of account. Its management and issue was to be in the hands of another proposed international organization, the International Clearing Union (ICU). The value of the bancor was to be determined by the value of the major national currencies in a trade-weighted basket. Values of currencies would be fixed, but could be changed by mutual agreement.

A fundamental aim of Keynes' plan was to install a truly multilateral system. No nation would be allowed to dominate because of (economic) size, and nations in surplus or deficit alike should be disciplined. Shortly before the conference, however, the Americans rescinded their support for the bancor. Presumably, they felt that the bancor scheme, with its control in the hands of the ICU, was a shrewd strategy by the wily Brit to rob the United States of its greatest spoil of victory: unfettered post-war economic dominance.

Instead, the Americans insisted on a system where the US dollar would be fixed to a gold value of $35 per ounce, though convertible only for central banks. All other currencies were to be aligned to this dollar-gold anchor. If adopted, this would confer on the US an unprecedented economic supremacy through currency control, which even Britain at the pinnacle of her power had not enjoyed. But at

Bretton Woods, Britain as well as the other exhausted European allied nations were eager to assure a continued flow of dollars to finance the endgame of the war and the impending reconstruction. Consequently, no government, including the instructions Keynes received from London, showed anyone in the mood to seriously challenge the American volte-face.

Generally, the dollar-gold link is viewed as the key feature of the Bretton Woods system. Its regime of fixed exchange rates served a clear purpose in the immediate post-war period when stability was at a premium and the essential ingredient needed to foster the post-war economic boom, that surprisingly quickly restored most of the market-based economies to life. However, after economic activity and trade had rebounded, the tendency of fixed exchange rates to magnify misalignments took over by he mid-1960s. Adding to that, the American economy came under inflationary pressures during the Vietnam War years, causing the system to falter.

Consequently, in 1971, President Nixon "closed the gold window", that is, he unilaterally cancelled the right for all other central banks to convert dollar holdings into gold at the artificial Bretton Woods exchange rate, which in the meantime had become much lower than the market price for gold. Many have considered this for the demise of the Bretton Woods system. However, the dollar-gold link had always been an optical illusion serving the main purpose of elevating the dollar to the premium global reserve currency. The main significance of Nixon's decree in 1971 was simply to destroy that illusion. It would quickly be seen that there was other factors developing in the international economy that would keep the dollar's position as the international reserve currency fully intact.

International seigniorage

Seigniorage is a concept originating in medieval times. Monarchs used their monopoly to coin precious metals as a major source of revenue. Periodically, an issue of gold or silver coins would be recalled and recoined with the same face value, but in fact with a lesser precious-metal content. The difference in value between the face value and the value of the actual gold or silver content was the 'seigniorage' gain, an amount of precious metal that the ruler could claim as his own. Of course, this trick can cause inflation, but as long as the expansion of the money supply the seignoirage creates is close to the rate of the country's economic growth it is not likely to be a problem; and, in fact, a debasement of the currency would be desirable in case a prospering country had difficulties in acquiring enough precious metals for coinage. In such a case, the ruler gets the free lunch that everybody says cannot be had.

When modern states expand their monetary base, they do so by sending more money into circulation, which either pays for some of their expenditures or allow banks to expand credit. Since money today is largely credit created by electronic postings, the seigniorage gain by having the power to issue money is as a practical matter equal to the face value of the issue expansion, as only small administrative and handling cost are to be subtracted.

Normally, trade deficits caused by real economy imbalances will initially cause an accumulation of a country's currency to occur among its trading partners. If a country's currency has no function as international reserves, excess accumulations of a currency will have no intrinsic use, and foreigners will consequently want to convert their excess accumulations into interest bearing instruments, in other words, there can accrue considerable costs from having a negative trade balance.

In contrast to this, countries, whose money functions as international reserve currencies can benefit from seigniorage on an international scale. They can, as a nation, pay for some of their imports or foreign assets purchases with the seigniorage gain accruing from the expansion of international reserves held in their currency; the part that other countries keep as expansion of their reserve holdings and therefore not will want to repatriate in the form as claims on the issuing country's economic assets.

In a parallel to ordinary seigniorage, if the international seigniorage gain is close to the growth in international trade, it can be considered as a standard assumption that the currency will not to be weakened by inflation (which in this case means its currency are not weakening against the basket of other main currencies, or, in other words, it is preserving its full international purchasing power).

Ultimately, a main consequence of Bretton Woods was that it set up an international currency system that allowed the US to reap international seigniorage in exchange for providing the world with

much needed trading reserves. As a result, the US has been able to shove many of its internal economic problems onto other nations. This key outcome of Bretton Woods continues to be an integral part of the global economic order.

Oil priced in dollars a new anchor

By the late seventies, the oil crises had dramatically changed the terms of trade between the oil exporting nations and the rest of the world. Through forging a close political partnership with Saudi-Arabia, the leading oil exporter, the US ensured that oil would continue to be priced in dollars.

The oil exporting countries' collective surplus of petro-dollars was recycled back into the international financial system as liquidity, which was increasingly held in offshore accounts as eurodollars. Although many of the developed nations experienced rising trade deficits, they had few problems in financing them by drawing on these new pools of liquidity. The real losers were the non-energy exporting developing nations that ran into exploding debt burdens.

Currently, international organizations with a role in providing development assistance to the Third World are almost entirely dependent upon contributions or paid-in quotas from richer nations. The bancor plan would have left the gain from international seigniorage in the hands of the planned trio of international organizations, the ICU, the IMF, and the World Bank. In this scheme, the seigniorage gain would have been partially or fully accessible for development assistance. By axing the bancor and the ICU, Bretton Woods became an entirely different plan. Only Keynes, the old master, but at the time weak and with a failing health (he would die within two years, and some would blame his return to top economic leadership as a contributing factor) understood that the long-time outcome instead would be—as we indeed see it now—the seigniorage gain accruing from international reserves expansion used in support of the world richest nation and its over-consumption. But in 1944, with Europe still burning, no one else cared.

The American Slide

By the late nineties, US dollars holdings were estimated to account for approximately 65% of all international held reserves. The US was still the world's leading single economy. Furthermore, everybody—from tax evading wealthy people, oil sheiks, drug cartels, and the world's black marketeers—continued to prefer to operate in greenbacks, and store their wealth in dollar bank accounts or dollar denominated financial instruments. Consequently, the US seigniorage gain has been much larger than the standard assumption. The resultant dollar strength has allowed the US to sustain imbalances in the form of budget and trade deficits that no other nations would be capable of. While the Clinton administration successfully turned the budget deficit around, the cost was a trade deficit that escalated uncontrollably.

The US economy has reaped the benefits from the international economic system's inability to discipline its consumption excesses effectively. Because of this, the economic policymakers in American administrations have become accustomed to pandering to the short term economic interests of their key constituencies. Not surprisingly, these policies have resulted in such abysmal deficit levels, that had a developing nation applied for IMF support with such numbers, they would have been promptly rejected or at least placed under a harsh array of conditions.

However, there is evidence that the days of smooth sailing are drawing to an end. First of all, the US, that for a long time was able to keep her currency relatively strong, has in recent years seen this picture reverse and its value slide precipitously.

The second problem arises from the fact that dollars need to be invested in dollar denominated assets in order to earn a return. Consequently, when the world experiences a rising dollar overhang, it creates inflationary tendencies in the pricing of dollar assets. This was no doubt a major factor behind the stock market bubble of the '90s. The resultant correction should have made international dollar holders wary of repeating the cycle. Nevertheless, the emerging evidence points to the fact that the recent

American financial bubble, generated by over-inflating housing backed assets, also sucked considerable amounts of international investor money into its vortex.

Adding to the American woes is the emergence of the euro as a full-fledged currency, presently used by the majority of the EU nations. This means that for the first time since Bretton Woods there exists an alternative for a general reserve currency that meets all the required standards with respect to market depth and available banking sophistication.

But any circulating currency, in order to function smoothly, needs some form of backing; either intrinsically, as is the case with gold and silver coins; or some form of tangible asset or consumable general-use commodity that an excess holding of the currency always can be converted into at will.

Keynes' bancor scheme was in some way the most radical: The totality of commodities transacted in the international trading system would constitute their backing. Having excess bancors, one would be able to buy any commodity or services traded in the international trading system without any need for a previous currency exchange.

The End of An Illusion

The gold-dollar link was, as indicated, merely an illusion. In reality, everybody who held excess dollars in the countries that participated in the system had to be content with their governments telling them: Well, you, as a citizen in our country, can't get gold, but we can (i.e. the relevant country's central bank). In fact the situation was—neither could the central banks in any sense of reality after the market price for gold shot up to levels high above the mechanism's $35 rate; by the end of the period it was at ten times the link-price. The reality was that excess dollars only bought dollars priced commodities or assets, instead of commodities or assets from any country, as the bancor scheme would have had it.

As previously mentioned, a major development that maintained the dollar's dominant position in the wake of the oil crises was the Saudi's commitment to preserve the dollar as the currency in which oil was priced. With the dramatically enhanced role of oil in the international trading system this worked for a long time well from a technical point of view. The volume of gold available for reserve use is relatively fixed in the short term and therefore prone to speculative volatility in the time of crises. Contrariwise, output from oil fields (pumping) is variable in the short term, and will tend to follow economic cyclic activities.

This leads to the third, but potentially the most worrisome, cloud in the sky for the Americans in their quest for maintaining the dollars dominance as the world's preferred reserve currency and which their economy increasingly is addicted to. Up until the turn of the millennium, the majority of nations seemed to acquiescence to the oil-dollar relation, the linchpin of American economic dominance. Nevertheless, in the new millennium signs have started to emerge signs that this no longer is so. A clear example can be observed in the actions of Chavez in Venezuela who started to counter-trade oil with some of his Latin American neighbors (for example, oil for doctors with Cuba), thus cutting the dollar out of the loop.

But the real shocker for the Americans must have been when Saddam in November of 2000 declared that Iraq would commence pricing their export under the oil-for-food program in euros. American worries were compounded by subsequent rumours that both Libya and Iran were considering a similar currency shift.

This leads to the question concerning the real reasons behind the American attack on Iraq. Did the American neocons in the Bush administration really have such faulty intelligence that they deemed Iraq to be an imminent threat to their security?

Of course not. However, by pricing Iraq's oil in euros—WMDs or not—Saddam engaged in an ultimate act of American defiance. What definitive role it played in galvanizing the American call to war, is hard to say. What is clear, however, is that toppling Saddam's regime showed everybody the big stick, and, more importantly, took the impending euro pricing of oil off the table.