Inflation under the Bretton Woods System: The Spillover Effects of U.S. Expansionary Policies

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This paper examines the transmission effects of U.S. expansionary policies on inflation in the G7 countries under the latter years of the Bretton Woods system. Using quarterly data and structural vector autoregressions, this paper investigates the extent of inflation variability due to U.S. aggregate supply and aggregate demand impulses in major industrial countries. Empirical results show that a sizable proportion of inflation variability in these countries can be attributed to U.S. shocks. A brief discussion follows concerning the breakdown of Bretton Woods and implications for the design and functioning of international monetary arrangements. (JEL F33, E33, N10)

Introduction

The Bretton Woods system was inaugurated in 1944 with the signing of the Articles of Agreement of the International Monetary Fund. The system called for fixed exchange rates against the U.S. dollar which was pegged to gold. Member countries held their international reserves in U.S. dollars and in gold, making the U.S. dollar a principal reserve asset. Most countries maintained the official par values of their currencies by intervening in the foreign exchange market. Bretton Woods was characterized by extensive capital controls. Current account transactions were inconvertible until 1958 while controls remained in place for capital account transactions for the entire period. Since the dollar was a reserve asset, other countries accumulated U.S. dollars through U.S. balance of payments deficits.

A commonly held view is that expansionary domestic programs in the U.S. and increases in defense spending due to the Vietnam War brought inflation. In order to maintain fixed exchange rates, other countries had to accommodate U.S. expansionary policies by intervening in the foreign exchange market and increase their money supply by importing U.S. inflation.

Figure 1 presents the U.S. current account balance and the official settlements balance for the 1960-72 period. With the exception of 1968-69, the U.S. had a deficit in its official settlements balance from 1958 until the end of Bretton Woods. Some argued that the U.S. balance of payments deficits did not pose a problem in that the rest of the world voluntarily held dollars because of their valuable service flow — the deficit was demand-determined [Bordo, 1993].

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Figure 1 shows that the U.S. did not have a major current account deficit until 1970. The balance of payments deficit was perceived to be a problem by the U.S. monetary authorities because of the implications for confidence. As official dollar liabilities increased abroad, the fear that these dollars would be converted to gold was a real possibility. At the same time, the official gold price of $35 per ounce had restrained world gold production while industrial demand for gold was growing.

Combined with accelerated U.S. inflation rates (as shown below), the confidence problem resulted in a two-tier gold market in 1968 where only foreign central banks were allowed to buy gold at the official rate of $35 per ounce. Meanwhile, U.S. expansionary policies continued partly because there was little pressure on the U.S. (via reductions in gold holdings) to reduce its monetary growth rates. France did attempt to put pressure on the U.S. by threatening to convert French holdings of U.S. dollars into gold, but such a move would bring a collapse of the system. The U.S. also initiated a number of international arrangements such as swaps and capital controls to prevent the conversion of dollar liabilities into gold [Meltzer, 1991]. The European countries perceived the U.S. balance of payments deficits to be a major problem because the U.S. did not have to adjust its domestic economy to external deficits as the Federal Reserve routinely sterilized dollar outflows. Germany viewed the U.S. as exporting inflation to surplus countries while France resented U.S. financial dominance and the seigniorage they believed the U.S. was earning on its outstanding dollar liabilities [Bordo, 1993].

Table 1 presents inflation rates for the G7 countries for the last decade of Bretton Woods and correlations of inflation rates with inflation in the U.S. It is evident that inflation in the U.S. accelerated in the last half of the 1960s and seems to exhibit some strong correlations with inflation in other major industrial countries, notably Canada,