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From the Postwar World Economy to the Modern World Economy, 1973–2023

MAURICE OBSTFELD

The year 1973—the year the Bretton Woods system of pegged exchange rates conclusively expired—was a watershed for the international monetary system, although many did not realize it at the time. The year capped a brief period of tumult, which corresponded roughly to the first term of the US Nixon administration, in which the postwar world economy neared a close and the outlines of the modern world economy emerged. Indeed, the immediate origins of several key aspects of today's world economy are found in the years just before 1973. The changes set in train then went far beyond the international monetary system and have had momentous geopolitical and political as well as economic and financial implications.

It is within the context of a discontinuously evolving post-1973 world that the exchange rate regime has accommodated and influenced developments in trade, finance, and economic policy. Several novel threats to global prosperity—climate change, pandemics, cyber vulnerabilities—have gained salience over the past 50 years. But many of today's international tensions echo or even reincarnate those of a half century ago.

Maurice Obstfeld is the C. Fred Bergsten Senior Fellow at the Peterson Institute for International Economics. He thanks Serra Pelin and Asher Rose for excellent research assistance and Douglas Irwin for helpful suggestions.

Economic and Political Challenges Facing President Nixon in 1969

To illustrate how so many features of the modern world economy have proximate roots in 1973 and the handful of years leading up to it, consider the economic and political challenges Richard M. Nixon perceived as he was inaugurated as the 37th president of the United States on January 20, 1969.[1]

The World and the International Monetary System

At the end of the 1960s, an oversimplified but comprehensive description of the world placed countries into the three buckets of First, Second, and Third World—the rich democracies; the Communist world (principally the Soviet bloc and China); and the rest of the world (the developing economies of Latin America, Africa, and Asia, many of them former colonies of First World empires that had gained independence by the early 1960s). In the Third World, the First and Second Worlds vied for influence. Nowhere was this competition more evident and violent than in Vietnam. Over the late 1960s, an escalating US military effort had led to street protests in the United States, strains on US public finances and the balance of payments, and friction between the United States and its allies in Western Europe.

The key multilateral reference point for commercial and financial relationships in the non-Communist world was the Bretton Woods system, centered on the International Monetary Fund (IMF).[2] At Bretton Woods,

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1. By framing initial conditions in 1969 with reference to Nixon's presumed perceptions, I do not mean to imply that the actions of individual policymakers, no matter how immediately consequential, are fully or even mostly determinative of the way history unfolds. Such actions can influence the timing and character of major transitional events and induce some degree of path dependence. But larger economic, social, and political forces, operating through institutions that themselves reflect historical factors, drive much of the action. They help explain which madmen gain authority and when. The Bretton Woods system would eventually have changed dramatically, as a result of underlying societal, geopolitical, and economic fundamentals, even if Hubert Humphrey had won the 1968 presidential election. It might have done so in a different way and on a different time scale, but I suspect that five decades later, the exchange rate system under the alternative history would have looked much as it does today.

2. Postwar planners in the United States and the United Kingdom initially hoped to include an International Trade Organization (ITO) as one of the bedrock multilateral economic institutions. However, the initial Bretton Woods conference took up in detail only monetary/exchange rate and growth/development issues (the latter the domain of the World Bank). Proposed rules for international trade were not included in the Bretton Woods architecture but were left instead to the Havana Charter, completed in March 1948. It never came into force, because the United States refused to ratify it. As a result, for nearly five decades, postwar trade negotiations were conducted under the aegis of the General Agreement on Tariffs and Trade (GATT), signed on October 30, 1947. It lacked a permanent institutional structure or membership and was originally intended as a

New Hampshire in 1944, the United States and 43 allies declared fixed (but infrequently adjustable) currency parities against gold or the US dollar and agreed to enforce those parities by buying or selling dollars in the foreign exchange market. On Inauguration Day 1969, for example, parities included 5 French francs per dollar, 4 Deutsche marks per dollar, 360 Japanese yen per dollar, and 2.40 dollars per pound sterling. But world foreign exchange markets were showing increasing signs of stress. Under the pressure of speculation, sterling had been devalued from 2.80 dollars per pound in November 1967; by the end of 1969, the French franc parity was 5.55 per dollar (an 11 percent devaluation) and that of the Deutsche mark was 3.7 per dollar (a 7.5 percent revaluation).

What was the United States' responsibility to the system? The US Gold Reserve Act of 1934 ratified President Franklin D. Roosevelt's Executive Order 6102 of 1933, which made it a criminal offence for US residents to hold or trade gold anywhere. The act gave the Executive Branch the authority to set the dollar price of gold at the level "most advantageous to the public interest." FDR set the price at $35 an ounce in 1934, raising it from the $20.67 level that had prevailed since the US Coinage Act of 1834. There the price remained when the IMF commenced operations, in 1947. The United States promised foreign economic authorities that it would redeem their dollar holdings at the US statutory price of $35 per ounce; until 1968, it made efforts (usually in concert with other central banks) to stabilize the gold price in the London market once it reopened in 1954. These commitments were extended in the global "public interest" of maintaining confidence in the dollar. The US government took the fixed dollar–gold parity very seriously, though; safeguarding it was viewed as a pillar of the US-led international monetary system centered on the IMF, which presupposed a fixed-dollar gold price by allowing countries to specify their currency's parities in terms of either gold or US dollars.[3]

This system gave the United States great power and responsibility—but at a cost. If there are *N* currencies in the world, there are only *N*–1 exchange rates. The United States was the *N*th country, which effectively supplied the world's numeraire currency. It could not unilaterally "devalue" the dollar, however; its exchange rates were up to the *N*–1 other countries.

Until 1971, the United States felt responsible for maintaining foreign governments' confidence that it could and would redeem their dollar holdings at the promised $35 an ounce price, even as official foreign claims on the United States grew to exceed its gold holdings. This "confidence

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provisional forum for tariff-reduction talks pending the establishment of an ITO. This state of affairs continued until the birth of the World Trade Organization in 1995.

3. See Hirsch (1969) and Yeager (1976).

problem" (or "Triffin dilemma") was to a large degree a US fiscal problem (Obstfeld 2014), but it was a real problem nonetheless.[4] As C. Fred Bergsten points out in chapter 3, during the 1960s much official energy was spent manipulating the London gold market, initiating reciprocal currency swap lines (in 1962), and using administrative measures to limit capital outflows from the United States, which exceeded the dwindling US current account surplus and therefore swelled the potential foreign official claims on US gold.

Because the United States alone had no obligation to intervene in foreign exchange markets, it alone had the "exorbitant privilege" of a fully independent monetary policy—provided foreign official holders of dollars exercised forbearance by not cashing their dollars in for gold. US monetary policy effectively provided the nominal anchor for the world economy, largely determining medium-term inflation rates everywhere. US inflation that was persistently higher than what trading partners were willing to accept would, however, set off an unstable doom loop in which speculators bought non-dollar currencies in anticipation of revaluation, foreign official reserves swelled even further beyond what the United States could feasibly redeem in gold at the $35 price, and foreign inflation rose to politically unacceptable levels, increasing the temptation to convert official dollars into gold and revalue (Emminger 1977; De Groot 2019).[5]

Against this backdrop, the Soviet bloc and China were largely autonomous economically. Third World countries tended to maintain heavily controlled economies, often with multiple exchange rate practices and extensive external payment controls. A majority had joined the IMF by the end of the 1960s, although most had not yet accepted the IMF's Article

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4. For a discussion of the Triffin dilemma, see chapter 24 by Hélène Rey.

5. There is debate over the role of the Triffin dilemma in the collapse of the Bretton Woods system. Kindleberger (1965) famously argued that the United States functioned as a global financial intermediary, issuing a global currency that foreign countries willingly held in short-term maturities to enhance their liquidity. Like a bank, the United States might be "runnable" in principle under the gold commitment, but there was no inevitability that a run would occur, given the valuable financial services the United States provided through its balance sheet. Several subsequent authors—including Portes (2012), Matsui (2016), and Bordo and McCauley (2019)—have questioned Triffin's analysis. A more balanced view is that crises generally result from a confluence of multiple vulnerabilities. The Triffin dilemma alone need not have brought down the dollar's link to gold, but it became an additional destabilizing factor and an accelerant in the context of several more fundamental economic and political forces pushing the dollar decisively toward devaluation during the early 1970s. Kindleberger's views have regained prominence in light of recent research on the international roles of the dollar and the global liquidity of US Treasury liabilities.

VIII convertibility obligations.[6] Communist China and the USSR were not Fund members at the time, even though the USSR had been one of the initial parties to the Bretton Woods agreement.

Nixon's Challenges—and an Opportunity

In 1969, the incoming US president faced a number of domestic and international challenges and at least one big foreign policy opportunity. From the outset, a major priority was reelection in 1972.

In the US economy, the fiscal demands of the Vietnam War and the Great Society helped push the US (seasonally adjusted) unemployment rate down to 3.4 percent at the start of 1969. But inflation had been on the rise for several years, and in Nixon's first year in office it would reach 5.5 percent (figure 1.1, panel a).

The United States' international trade position was weakening, and there was growing concern that competition from European and Japanese imports could undermine the US manufacturing base and the wages of American workers, leading to political backlash (Alden 2016). US postwar reconstruction efforts (including the Bretton Woods project) had succeeded in their principal goal of reviving world trade—perhaps all too well. An influential study by Houthakker and Magee (1969, 122) suggested that the deterioration in the US trade balance was structural, that "the United States is gradually becoming a net importer of finished manufactures" and that only a substantial fall in the US terms of trade could offset those developments.[7] Foreign direct investment (FDI) outflows by US multinationals added to short-term balance of payments pressures; fueled growth in the offshore eurodollar market, where international banks freely borrowed and lent dollars; and supported initial forays into outsourcing American jobs.

In December 1969, a US recession began. Although mild, its conclusion in November 1970 left the unemployment rate at around 6 percent (it would not decline to below 5.5 percent before the 1972 presidential election). Any president would have found these economic circumstances daunting.

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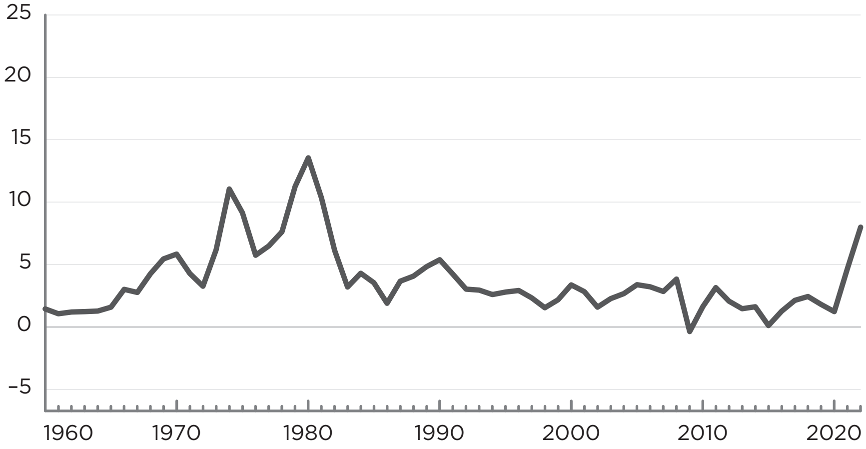
6. International Monetary Fund, *Article VIII Acceptance by IMF Members: Recent Trends and Implications for the Fund*, May 26, 2006, https://www.imf.org/external/np/pp/eng/2006/052606.pdf.

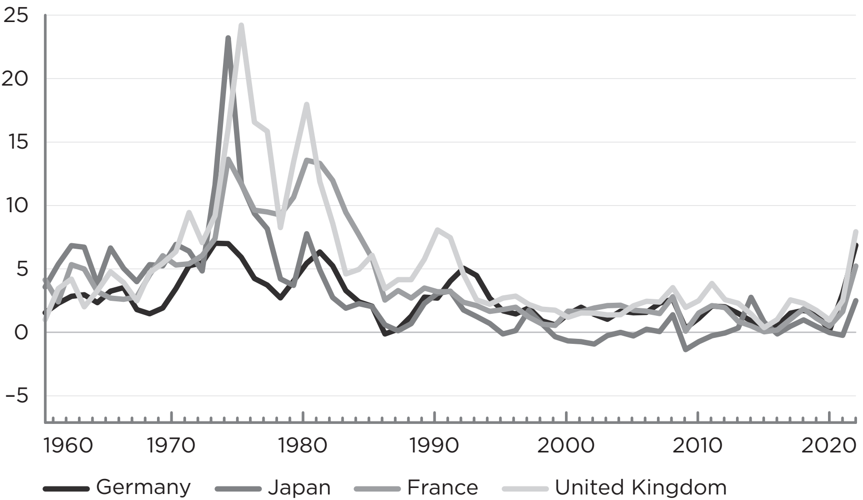
7. Subsequent research has tempered the conclusions about the US trade position that readers originally drew from the Houthakker-Magee study (Krugman 1989; Gagnon 2007). The shift should not obscure the fact that the study had a significant impact on the policy debate at the time. Houthakker, a professor at Harvard, won the American Economic Association's John Bates Clark Medal in 1963 and served as a member of President Nixon's Council of Economic Advisers from February 4, 1969, to July 15, 1971, leaving only a month before the announcement of Nixon's August 1971 economic package.

Figure 1.1
Inflation in major industrial economies, 1960–2022

a. United States



b. Germany, Japan, France, and the United Kingdom



Source: Annual data from the World Bank's *World Development Indicators*, via Federal Reserve Bank of St. Louis, Federal Reserve Economic Data (FRED).

Accompanying the economic challenges was widespread domestic social unrest, amplified by the Vietnam War, and uneasy relations with US allies in Europe, exacerbated by unwelcome spillovers from the US economy. France had withdrawn from the NATO military command structure in 1966, part of its broader pushback against US "privilege." In West Germany, Willy Brandt (who became chancellor in October 1969) was seeking closer relations with Eastern Europe, and there was general unhappiness about US involvement in Vietnam. Western European countries were experiencing their own social unrest, accompanied by wage developments that were fueling inflation (Nordhaus 1972). Further price pressures emanating from US policies and propagated through the fixed exchange rate regime threatened to add to Europe's woes (see figure 1.1, panel b).

Not all prospects were ominous. Starting in the mid-1950s, doctrinal differences had opened a widening dispute between the USSR and Mao Zedong's China, exacerbated by commercial discontents and geopolitical disagreements over issues such as the USSR's support of India. Border tensions between the two countries eventually emerged, resulting in military clashes in the Manchurian and Xinjiang regions in 1969. As Nixon appreciated early on, the Chinese-Soviet rift offered a potential opening to drive a wedge between the two great Communist powers.

The Nixon Shock

Halfway into Nixon's first term, the United States faced dual problems of internal and external equilibrium. Nixon's surprise solution, announced August 15, 1971, accordingly contained domestic and international components.[8]

On the domestic front, the most striking aspect of the "Nixon shock" was a wage and price freeze, in total opposition to Republicans' traditional free market bent. The controls allowed Nixon to pressure the Federal Reserve, then headed by Arthur F. Burns, into a looser monetary policy, pumping the economy up before the 1972 election while measured inflation fell. Following the removal of controls, in 1973, inflation jumped to 11 percent in 1974 under the pressure of higher global oil prices. Also inconsistent with the sustainable moderation of wage and price increases, but consistent with the logic of political business cycles, was a package of tax cuts, announced even though the federal budget deficit had set a near postwar record in the fiscal year that had just ended.

The external measures Nixon unveiled were a lead-in to the events that motivated this conference. Economist Arthur Okun, chair of the Council

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8. Garten (2021) provides detailed context around Nixon's policies.

of Economic Advisers in the Johnson administration, summarized Nixon's August television address by saying, "We just ended the Bretton Woods system forever."[9] The US Treasury announced that it would no longer convert foreign official dollars into gold, slamming shut the US "gold window." Nixon also imposed a 10 percent surcharge on all dutiable imports—the first general US tariff increase since the 1930 Smoot-Hawley tariff, as Irwin (2014) observes. The intent was to pressure US trade partners into revaluing their currencies.

In December 1971 at the Smithsonian Institution, Group of Ten (G10) economic officials agreed to a multilateral dollar devaluation.[10] According to Nixon's famous description, it was "the most significant monetary agreement in the history of the world." The import surcharge was rescinded. As part of the agreement, Nixon devalued the dollar against gold, raising the price to $38 an ounce. Markets reacted negatively, and the dollar was soon in crisis again, as Edwin M. Truman recounts in chapter 2. The last coordinated attempt to save fixed exchange rates came in February 1973, with a further negotiated 10 percent dollar devaluation, entailing a rise in the gold price to $42.22 an ounce. By the following month, under pressure of unrelenting speculation, exchange rates had been cut loose. That move, initially viewed as a temporary tactical retreat, has endured for a half century.

Gold had suddenly become irrelevant to the world monetary system. In 1974, President Gerald Ford signed legislation legalizing the holding of gold by US citizens. More than 50 years after the February 1973 change in the gold price, the US statutory price remains at $42.22 an ounce. The market price on November 30, 2023, was $2,046.28 an ounce.

The Economic Consequences of 1969–73

The events of 50 years ago seeded the ground for the modern world economy. Many recent events grew out of and in some respects echo events that took place then.

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9. Edwin L. Dale, Jr., "Nixon Orders 90-Day Wage and Price Freeze, Asks Tax Cuts, New Jobs in Broad Plan; Severs Link between Dollar and Gold," *New York Times*, August 16, 1971, https://www.nytimes.com/1971/08/16/archives/severs-link-between-dollar-and-gold-a-world-effect-unilateral-us.html.

10. The G10 industrial countries include the current G7 (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States) along with Belgium, the Netherlands, and Sweden.

International Dollar Politics

The Nixon shock was hardly the first time in the postwar era that the United States had pursued its national interest with scant regard for allies' opinions. But it represented a new frontier in America's willingness to cut back on providing key international public goods when they became too costly in domestic economic or political terms. Allies had no warning of the new policy, despite their supposed partnership in operating the international monetary system and other joint endeavors. The new attitude was summarized in US Treasury Secretary John Connally's infamous quip to G10 finance ministers that "the dollar is our currency, but it's your problem." The episode did not end US participation in multilateral economic cooperation, which has continued through the IMF, the G7, and the G20, among other venues, but it set a precedent that the Trump administration embraced and future US administrations could revisit.

In particular, the external effects of US dollar fluctuations have been a recurring locus of disagreement. In the early 1980s, a combination of tight US monetary policy and loose fiscal policy drove the dollar to stratospheric heights (figure 1.2). This development complicated allies' own fights against inflation (because of upward pressure on dollar-invoiced import prices); it also set off a protectionist storm in the United States. The result was the Plaza Accord of September 1985, in which industrial countries, including the United States, intervened jointly to push the dollar down.

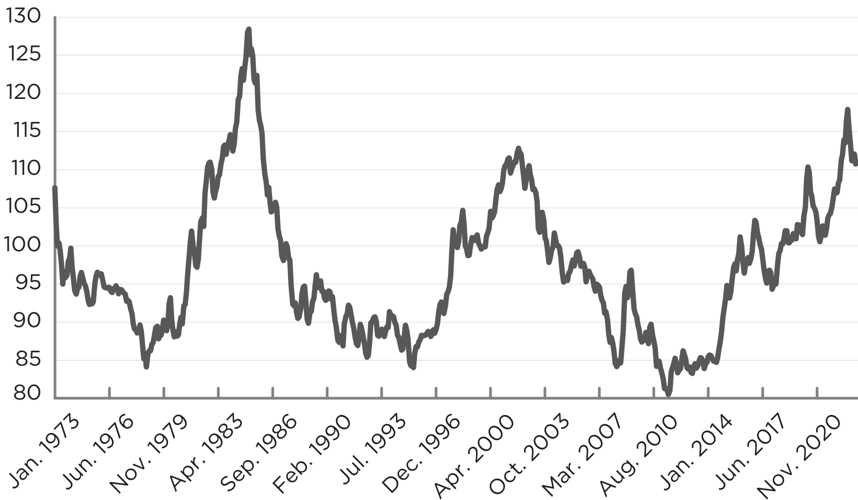
Exceptional dollar weakness has also been a source of contention at times. When the Federal Reserve's quantitative easing drove the dollar to unprecedented lows after the global financial crisis, some emerging-market policymakers accused the United States of engaging in currency wars. The Fed protested that it was merely following its mandate to stabilize the US economy and declined to recognize any serious conflict between its domestic mandate and the effects on trading partners. Dollar appreciation since 2021 has also raised concerns abroad, but the Fed has gotten better at at least acknowledging the global impact of the dollar.

OPEC's Influential Role

During the Arab-Israeli Yom Kippur War, in 1973, Arab members of the Organization of Petroleum Exporting Countries (OPEC) imposed an oil embargo on the United States and other countries supporting Israel. The price of oil nearly quadrupled, the largest part of the hike happening when OPEC boosted the oil price to $11.65 a barrel in January 1974 (it had been $2.90 before the war). The price hike called for supply reductions; supplies remained restricted even after the embargo ended, in March 1974,

Figure 1.2
US dollar real effective exchange rate, 1973–2023

index (March 1973 = 100)



Note: The discontinued real broad dollar index (for goods only) was updated using the renormalized real broad dollar index starting in January 2006.
Source: Board of Governors of the Federal Reserve System via Federal Reserve Bank of St. Louis, Federal Reserve Economic Data (FRED).

so higher prices were maintained. The result in oil importers was lower growth coupled with higher inflation—stagflation (see figure 1.1).

OPEC had learned how to flex its muscles in 1973; it has remained a key actor in the global economy ever since, adding (and sometimes losing) members and at times seeking to coordinate its actions with non-OPEC members, such as Russia. The dollar's travails in the early 1970s were, however, one concern that encouraged OPEC to raise dollar oil prices. Just after the Smithsonian Agreement, in January 1972, OPEC raised the dollar price of its oil by roughly 8.5 percent to (nearly) match the dollar's devaluation in terms of gold. The action taken two years later was bolder but also motivated in part by the dollar's shrinking value in terms of gold, which in turn owed something to the oil shock (James 1996; Hammes and Wills 2005). Triffin (1978, 10) also tied the OPEC shock to the dollar's travails.

An interesting irony concerns one of the main arguments advanced by those who opposed raising the dollar gold price to defuse the Triffin problem (chapter 4 by Robert Aliber raises this alternative, which was widely discussed before the Nixon shock). The argument was that a rise in the gold price would benefit the USSR, which then supplied much of the world's

newly mined gold. Both the rise in the gold price in the early 1970s and the related rise in the price of oil encouraged further development of Soviet deposits and a huge increase in oil exports by 1980. Russia's energy production and policies remain central to global economics and geopolitics.

Monetary Theory and Policy Frameworks

The burst of inflation that emerged under the Nixon administration was unprecedented since the early postwar period. It was much more prolonged than the earlier episodes (in 1946–47 and 1951). By the end of the 1970s, a second oil shock hit, and inflation moved into double digits again in the United States and several other industrial countries.

Macroeconomic theories based on the rational expectations paradigm showed how monetary authorities unable to commit themselves to low-inflation policies could enter high-inflation traps through their attempts to reduce inefficient unemployment or achieve other socially desirable goals (Kydland and Prescott 1977; Calvo 1978). In his Per Jacobsson lecture of September 1979, former Fed chair Arthur Burns, perhaps unknowingly channeling recent economic research, lamented that central banks in democratic societies necessarily find their price stability goals held hostage by political forces. "By and large," he said, speaking of the past decade, "[US] monetary policy came to be governed by the principle of undernourishing the inflationary process while still accommodating a good part of the pressures in the marketplace. The central banks of other industrial countries, functioning as they did in a basically similar political environment, appear to have behaved in much the same fashion" (Burns 1979, 16).

Returning from Burns's speech in Belgrade, Yugoslavia, then-Fed chair Paul Volcker decided to prove him wrong (Silber 2012). After a deep recession driven by exceptionally tight monetary policy, the United States entered a long period of moderate-to-low inflation that lasted until 2021. Inflation rates over this period moderated around the world; by the 2010s, they had fallen in many emerging-market and developing economies (EMDEs).

This striking development grew directly out of the inflationary turbulence of the 1970s. Volcker had demonstrated what a determined central banker, willing and able to stand up to political pressure, could do. But Burns had been fundamentally correct in his analysis of the obstacles that even well-intentioned monetary policymakers normally face. The problem was to create institutions and policy frameworks that could bolster the commitment capability of central banks. One was statutory central bank independence, which spread to many countries (albeit in several variants). A second was the policy framework of inflation targeting, with its

emphasis on transparency in terms of goals and instruments, accountability, and public communications (Bernanke et al. 2001). Many countries, including many EMDEs, adopted this approach to monetary policy in at least some form; it was most effective where central banks were independent. Of course, inflation targeting also presupposed a reasonable degree of exchange rate flexibility, which by the 2000s many more EMDEs had embraced.

By the 2020s, the central banking landscape was radically different from what it had been in the early 1970s. The influential economist Harry G. Johnson had predicted in 1969 that in a world of floating exchange rates, central bankers would lose prominence, because their jet-setting role in propping up the fixed exchange rate system would disappear. He could not have been more wrong (Obstfeld 2020). One reason was the greater visibility of central banks attempting to communicate more transparently with the public. Another was the financial instability evidenced by the global financial crisis and the euro crisis, which necessitated unprecedented market interventions by central bankers and brought home the fact that inflation targeting alone is not enough to guarantee overall macroeconomic stability.

The global reemergence of inflation in 2021 as economies relaxed COVID-19 lockdowns blindsided central bankers in the advanced economies and illustrated that the issues raised by the 1970s were not ancient history. How do supply shocks influence inflation, especially when they come in an environment of demand pressures? Can central banks afford to "look through" supply shocks in these circumstances, assuming they are temporary and will not undermine inflation credibility much, even if there is no strong monetary response? Once inflationary momentum builds more broadly, how deep of a recession is needed to restore anchored price expectations? We are learning some of the answers in real time.

Global Financialization

The classic "trilemma" of international finance states that countries must choose two out of the following three: a pegged exchange rate, a monetary policy oriented toward domestic objectives, and open international financial markets. The Bretton Woods system, at least as conceived in the original IMF Articles of Agreement, advanced a trilemma solution in which the freedom of private cross-border financial conditions would be limited. The move to more flexible exchange rates in 1973 freed the economies taking that path—at that time the advanced industrial economies—to liberalize international financial transactions consistent with more monetary policy autonomy. However, the trilemma alone does not explain why they chose to do so (Obstfeld and Taylor 2017).

As the dollar was under speculative attack in 1972, European countries floated proposals for developing more instruments to curtail private financial capital markets, including approaches coordinated among countries. The United States—channeling a free market ideology championed by officials such as Treasury Secretary George Shultz and Council of Economic Advisers Chair Herbert Stein, as well as outside advisers like Milton Friedman and Alan Greenspan—pushed back. As Helleiner (1994, 105) points out:

> Opposition by the US representatives to any type of cooperative controls, however, prevented the issuance of firmer recommendation. Indeed, the US representatives hoped to discourage other countries from controlling capital movements altogether. According to US representatives, a more fully liberal international financial order would permit international capital movements to encourage "the growth of international trade" and increase "the economic well-being of developed and developing countries." They also challenged the view that disequilibrating capital movements were necessarily undesirable, asserting that such movements prompted countries to take appropriate adjustment measures.

As part of its work in 1972–73, a working group of the Committee of 20 (which Truman discusses in chapter 2) considered European and Japanese proposals for cooperative regulatory measures among both capital-flow sender and recipient countries, as well as enhanced regulation of the offshore euro markets.[11] US negotiators rejected these ideas. Indeed, the United States had announced as early as February 1973, at the height of currency stresses, that its own capital controls would be lifted in December of the following year—and overdelivered by lifting them in January (Helleiner 1994).

Apart from ideology, officials in the Nixon administration had several practical, national interest motivations for rejecting international capital flow restrictions. Liberalized financial flows might weaken the dollar further, promoting desired employment and trade balance adjustment. A liberalized global financial system could also enhance the United States' position as a global financial hub.[12] That goal became even more important with the oil shock, after which huge oil surpluses suddenly needed to be banked and recycled. Throughout the 1970s, US money center banks pros-

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11. The IMF board set up the Committee of 20 in 1972 to consider reforms of the international monetary system. The group contained one member from each of the 20 IMF constituencies.

12. The United Kingdom promoted the offshore London euro market with a similar motivation of regaining the City's past preeminence. Even though the market was providing finance for speculators, the UK government resisted proposals to rein it in (by, for example, imposing reserve requirements).

pered by recycling petrodollars to developing economies, notably in Latin America. But perils loomed. By 1981, just before the devastating developing-economy debt crisis emerged under the pressure of Volcker's tight monetary policies, the developing-economy loans of the eight largest US banks amounted to 264 percent of their capital (FDIC 1997). Official action saved the banks, but the developing-economy debtors suffered almost a decade of lost growth. The episode was a harbinger of crises to come. The frequency of financial crises, including severe ones, rose precipitously after 1973, and not just in the less prosperous countries (Reinhart and Rogoff 2009).

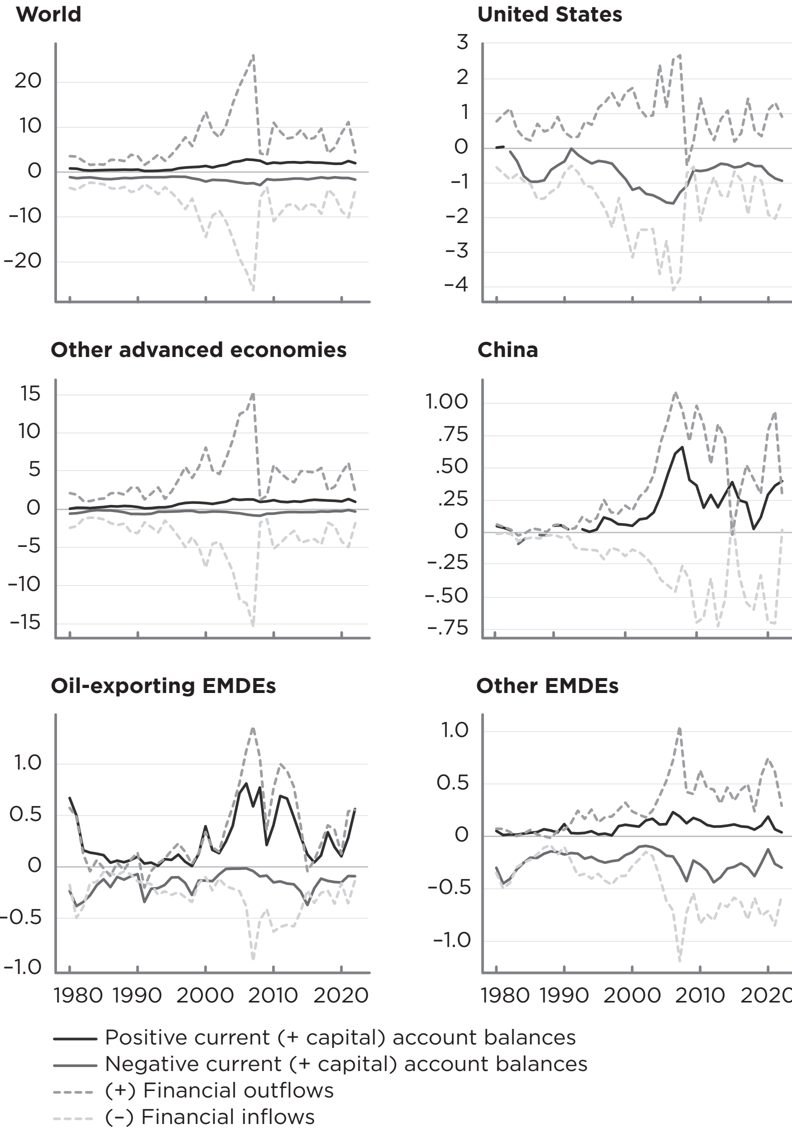
US domestic financial deregulation, pursued further under the Carter and Reagan administrations, cemented the United States' preeminent status in global finance, with an assist from the end of the Cold War. For various reasons, including competitive pressures and ideology, other countries followed the deregulatory trend. The result was an explosion of international financial transactions over the past five decades.

Figure 1.3 shows two possible measures of that growth: the sizes (relative to world GDP) of (a) current account deficits and surpluses and (b) total (gross) financial inflows and outflows. Five implications of the figures are noteworthy:

1. The absolute sizes of current account deficits and surpluses (global imbalances) have grown substantially over time. During the mid-2000s, about 3 percent of world GDP was intermediated to fund imbalances.
2. The financial inflows and outflows that finance global imbalances are far larger than the minimum that would be needed if each deficit country merely borrowed the excess of its imports over its exports and each surplus country lent out only its excess current foreign earnings. There is a good deal of two-way asset-for-asset trading in the global economy, some of it well-motivated (e.g., to seek portfolio diversification) but some of it of questionable or even negative social value (e.g., to avoid taxes, to finance asset bubbles).
3. Financial flows peaked massively just before the global financial crisis of 2007–09, a glaring sign of financial excess, as we now know. Their growth largely stabilized after around 2010.
4. Because the well-lubricated global financial system allows bigger and more persistent global imbalances, the medium-term link between exchange rate movements and trade imbalances has been weakened.
5. That link is weakened even further by the prevalence of financial transactions over "real" transactions involving goods and services in foreign exchange markets. There is now much more scope for purely financial disturbances to move exchange rates, in the light of which

Figure 1.3

Dispersion of global current account balances and financial flows as percent of world GDP, 1980–2022



EMDE = emerging-market and developing economies

Source: Balance of payments data are from the IMF's *International Financial Statistics*; world GDP data are from the World Bank's *World Development Indicators*; country classifications are from the IMF's *World Economic Outlook*, April 2023.

their comparative stability among advanced economies in recent decades has been remarkable. However, all economies, but especially EMDEs, are buffeted by a global financial cycle in asset prices, leverage, and capital flows that drives an array of macro-relevant quantities and relative prices (Rey 2013).

Policymakers have not been blind to the financial risks of globalized capital markets. Regulatory initiatives have been pursued mostly at technical, nonpolitical levels, however (which is not to say that political and commercial considerations have been absent). Early instances of banking problems stemming from the new and relatively unfamiliar world of fluctuating exchange rates (Franklin National Bank, I.D. Herstatt Bank), as well as heightened perceived risks from petrodollar recycling through the eurodollar market moved international regulators to coordinate. A result was the Basel Committee on Banking Supervision, which met for the first time in February 1975 (see Goodhart 2011 for detailed background). Later came the Financial Stability Forum (which became the Financial Stability Board), established in 1999. The "soft law" promulgated in these forums, which participant countries largely adhere to without formal inter-governmental agreements, has no doubt helped avoid some financial risks, but it has also supported what some claim is excessive financialization of the world economy. Despite three waves of Basel reforms, with a fourth on the way, regulators continue to play catch up with evolving market innovations (such as digital finance), and wide supervisory gaps remain.

Global financial markets remain dominated by the US dollar, which 50 years after the death of Bretton Woods has emerged as a "currency among currencies"—essentially a global numeraire and medium of exchange (see chapters 24 to 27 in this volume). The persistence of the dollar's role as a global currency even after the end of the Bretton Woods regime that enshrined it—and despite the decline in the US share of world GDP—seems surprising from the standpoint of 1973, though it may well play a role in the relative resilience of international trade that Douglas Irwin describes in chapter 14.

Several factors explain the continued dominance of the dollar. They include Volcker's success in curbing US inflation; the depth and breadth of US financial markets; the comparative US laissez-faire attitude toward international transactions; and not least, US willingness to supply the world with ample safe assets in the form of US Treasuries, a process that began in earnest with the Reagan-era budget deficits. The dollar's de jure special status in the Bretton Woods system ended a half century ago, but US monetary and financial conditions still exert an outsized influence on the global macroeconomy.

Neoliberalism and Supply-Side Economics

The Nixon administration was heavily influenced by free market advocates, although Nixon departed from Chicago-style orthodoxy when he found it politically useful to do so. By the time Ronald Reagan took office, the neoliberal school of thought had become dominant in the US government. It had also migrated to the United Kingdom under Margaret Thatcher's premiership.[13]

A key talking point of conservative critics was that it was Keynesian economics that had given rise to the stagflation of the 1970s (see Clavin et al. 2023).[14] The solution, according to these voices, was to radically scale down the government's footprint in the economy by dismantling social safety nets and reducing or eliminating government regulations. To some degree, the case for a less interventionist state took hold in European countries beyond Britain as well as in many EMDEs, where more liberalization was sorely needed.

The impact of this philosophical shift on growth, inequality, market power, development, and democracy is too big a topic to pursue here. I note the shift as one outgrowth of the turbulent era after Bretton Woods came to an end and observe that in some respects the political pendulum is swinging back toward more *dirigisme* in several major countries and regions. The shift is most striking on the Right, where new skepticism ranges from pragmatic concerns about winning elections to cultural fears about "globalism" (which are eagerly amplified through social media to mobilize voters).

A key component of the conservative approach, in both the United States and the United Kingdom, has been the idea that tax cuts have powerful growth-enhancing effects beyond the effects identified by John Maynard Keynes under conditions of unemployment. The intellectual basis for this supply-side view comes in part from a May 1971 essay by Robert Mundell suggesting that the United States address its simultaneous internal and external imbalances through the joint use of fiscal and monetary policy. Contractionary monetary policy would exert downward pressure on inflation while drawing in foreign capital, thereby improving the US payments position. Targeted tax cuts would expand incomes, if not through Keynesian effects then through the supply-side effects of expanding labor supply and investment.

13. Reagan also heeded the voice of expedience when doing so was politically convenient, as in the case of some of his administration's trade policies.

14. Keynes was clear in his writings about the perils of inflation, in particular its regressive effects.

In the event, Nixon adopted tax cuts in August 1971 but opted to keep monetary policy loose while controlling prices administratively. This policy was not sustainable, and the world economy paid a price, which it seems hard to blame entirely on Keynes or even on Keynesians. Mundell's supply-side ideas found a home in the Reagan administration and continue to attract prominent US adherents five decades on.

Rise of China

In July 1971, US National Security Adviser Henry Kissinger traveled secretly to China to meet with Premier Zhou Enlai. As Nixon pondered his August 1971 announcement, he knew that he would soon be introducing a new China policy. Much of the urgency in unveiling the economic shock—apart from deteriorating economic fundamentals in the United States—was to avoid overshadowing press coverage of the upcoming foreign policy shock. On February 21, 1972, Nixon landed in China for the talks with Mao and Zhou that would eventually lead to China's entry into the world economy.

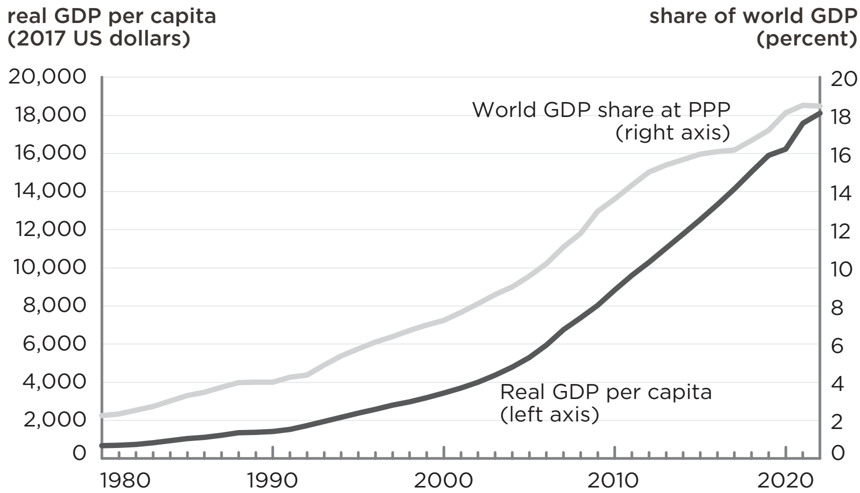
Deng Xiaoping gained power in December 1978. He quickly initiated a program of partial economic opening and market-based economic development that was enormously successful in propelling China into the ranks of upper-middle-income countries and creating an economy that is now the world's largest in purchasing power parity terms. Diplomatic relations with the United States were normalized in 1979, and Deng visited the White House that year. In April 1980, the People's Republic took over China's representation at the IMF from Taiwan.

Figure 1.4 illustrates China's steep economic ascent.[15] The impacts on the world's economies, financial system, domestic politics, and geopolitics have been dominating factors since China's entry into the World Trade Organization at the end of 2001. Events around China will reshape the global economy further in the years ahead.

Geopolitically, the US-China *rapprochement* ended an era of US foreign policy dominated by the imperative of containing Communism globally. The very open splintering of international Communist solidarity presaged the demise of the Soviet bloc and the Soviet Union in 1989–91, an event that has had immense repercussions, economic and otherwise.

15. For comparison, the IMF's *World Economic Outlook* database (October 2023) projected a US share of world output at PPP of around 15.4 percent for 2023.

Figure 1.4
China's economic growth, 1980–2022



PPP = purchasing power parity
Source: International Monetary Fund, *World Economic Outlook*, April 2023.

The European Union and the Euro

With growing exchange rate instability in the late 1960s and early 1970s, member countries of the European Economic Community (EEC) sought ways to link their currencies more closely. (Chapter 8, by Harold James, discusses the European response to the dollar in detail; see also chapter 28, by Philip Lane.) The Werner Report of October 1970 set out a phased path to a single EEC currency within a decade, an idea the United States opposed at the time that became a reality in 1999.

The EEC's internal problems with variable exchange rates (see Giavazzi and Giovannini 1989) became more acute after the Nixon shock and the Smithsonian Agreement. In April 1972, EEC countries set up a "snake mechanism" to limit intra-European currency fluctuation margins to ±2.25 percent. The United Kingdom and Denmark, which did not become EEC members until 1973, joined the snake in May 1972, only to withdraw the next month (Denmark rejoined soon after; the United Kingdom did not). The snake eventually failed, succeeded in 1979 by the European Monetary System's Exchange Rate Mechanism (ERM), which eventually helped pave a path to the single currency (European Parliament 2015). Denmark was an early participant in the ERM. The United Kingdom did not join until October 1990, only to leave in September 1992 amid the

ERM crisis, when speculators attacked multiple ERM members' pegs to the Deutsche mark. To many in the United Kingdom, the ERM interlude indicated the folly of pegging sterling at the possible expense of internal balance and increased resentment of the European Union.

Both the United Kingdom and Denmark were able to negotiate opt-outs from the Maastricht Treaty requirements concerning accession to the single currency. Denmark has shadowed the euro closely within ERM II, the post-euro successor to the ERM, linking its monetary policy closely to that of the European Central Bank. In contrast, the United Kingdom followed its own monetary path and felt increasingly marginalized within the European Union, as economic decision centers linked to the euro (the Eurogroup of finance ministers, the Eurosystem of central banks) expanded. Britain's long-standing aversion to giving up its monetary autonomy, dating back to the debates over EEC accession in the early 1970s (see Obstfeld 2020), was one of several factors that led to Brexit in 2020.[16]

A Postmodern World Economy?

After the "America First" hostility of the Trump administration toward international cooperation and leadership, the COVID-19 pandemic, and the Russian invasion of Ukraine and its spillovers, the postwar world economy may be reverting in some ways to earlier forms. Trade tensions are rife, and the World Trade Organization is largely toothless. Governments are turning to industrial policies. Right-wing populism, often hostile to global economic integration, has gained ground in many democracies. The world seems to be sliding back into three blocs—the high-income economies, the China-Russia axis with a few associated countries, and the Global South—as nation groups take different stances with regard to economic sanctions and trade with Russia. Tensions have risen further with the war between Israel and Gaza. Disintegrative tendencies were certainly present to some degree before 2017, but they have intensified and accelerated.

A divided world is especially ill-suited to contend with the threats it now faces, which include but go beyond those apparent in the early 1970s. As the Bretton Woods system was buckling, April 1970 saw the first Earth Day, a milestone for the environmental movement. Its goals have not been realized. Instead, climate change has become an existential problem, as ocean levels rise, biodiversity plummets, humans interface increasingly with disease vectors, various forms of pollution proliferate, and events linked to extreme weather (including floods, droughts, and wildfires) occur with increasing

16. Chapter 8 by Harold James says more about British attitudes toward European currency projects.

frequency and severity. There are also other collective threats, old and new. Although the world has inevitably moved toward more national autonomy in economic policies, the interdependence that Richard Cooper famously highlighted in the late 1960s has deepened and broadened (Cooper 1968). Even more today than before, the world needs the cooperative spirit that inspired the founding of the Bretton Woods institutions.

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