Excerpted from *Paper Money* by "Adam Smith" (George J.W. Goodman).

In the mid-1960s, money manager George J.W. Goodman began to write a series of irreverent and witty columns for New York *magazine under the borrowed name of capitalism's founding theorist, Adam Smith. As "Adam Smith," Goodman went on to write several bestsellers about economics, the stock market, and global capitalism, including* The Money Game, Supermoney, *and* Paper Money, *from which this account of the origin of the modern currency market is excerpted.*

In 1944 the finance and treasury ministers of 44 countries met at the mountain summer resort of Bretton Woods, New Hampshire. [There] all the [world's national] currencies were set in a fixed relationship. If you were a central banker and you brought $35 to the United States, you could have an ounce of gold. (Americans could still not own gold.) All the other currencies were pegged to the dollar.

The dollar met all the criteria of a key currency. The United States honored its obligations. It had military and political power. Its institutions were stable. It had every opportunity for economic growth and price stability. And there was an even more overwhelming criterion: there wasn't anything else.

[John Maynard] Keynes brought to Bretton Woods a plan for international prosperity that he hoped would satisfy national ambitions and yet prevent a return to the 1930s. He proposed an international currency, "bancor," and an international bank, an International Clearing Union. "Bancor" was a bit too radical for its time; it called for the United States to put in some money and have the devastated Europeans borrow it. The plans that were adopted did not go that far.

But the nations that met at Bretton Woods wanted to avoid the currency wars of the 1930s and to have cooperation. Out of the agreements at Bretton Woods came the international institutions of the System: the International Monetary Fund, to govern international monetary relations; the International Bank for Reconstruction and Development to rebuild the world [now known as the World Bank], and the General Agreement on Tariffs and Trade [GATT, which has now been transformed into the World Trade Organization].

By 1958 the System was so successful that trade was booming, all the major currencies were convertible into each other, and the dollar was better than gold. Better, because why bother with gold? If you really wanted it, you could turn dollars in for it; but gold is sterile; it earns no interest; you have to pay storage charges on it. It was dollars everyone wanted. The American navy prowled the world, American banks [had] their flags in all the foreign capitals, and American companies owned, worldwide, the nickel mines and auto-parts plants.

Americans were quite happy to spend those dollars abroad. American businesses bought industrial plants and equipment and raw materials overseas. The Pentagon sent dollars out to pay for its bases and its troops. Through the 1960s more dollars went out than came in. Thus began the "overhang" of dollars abroad, the deficit in the balance of payments.

The foreigners, gradually, no longer needed dollars to buy half the world's automobiles from the United States; there were now Volkswagens and Datsuns and Renaults. They no longer needed dollars to buy from Texas half the world's oil; there was oil everywhere. In fact, the Americans themselves were sending out to buy Volkswagens and Datsuns. The foreigners might reassure themselves by the American guarantee that their central banks could have an ounce of gold for $35 if they wanted it, but gradually, the dollars piled up abroad.

The potential claims on the U.S. gold became enormous. The claims, from overseas, were in the form of a curious currency called a Eurodollar, which was simply a dollar abroad. Brought to the United States, it was like any other dollar, except that in the foreign official hands it could be presented for gold.... The Eurodollar, a stateless currency, that respected no borders, was invented by the Russians.

Like everyone else in the mid-1950s, the Russians used the dollar in their international transactions. It was the key currency; no one wanted rubles. If you earned dollars, you could take those dollars to the United States and get oil, aircraft, wheat, soybeans, automobiles; you could also get, if you wanted it, gold. You could leave the dollars in a New York bank and get interest. Like everyone else, the Russians had some dollars in New York.

After the Hungarian revolt in 1956, a Russian bureaucrat moved his country's dollar balances to the Moscow Narodny Bank in London, a bank with a British charter owned by the Soviet Union. He probably thought that if the Cold War got worse, the Americans might freeze those dollars in New York, so he had better keep them in Europe, beyond the reach of politics.

On February 28, 1957, the Moscow Narodny Bank in London put out to loan, through a London merchant bank, the sum of $800,000. This minuscule amount was borrowed and repaid outside the American banking system. The Soviets also owned a bank in Paris, called the Banque Commercial pour l'Europe du Nord, whose Telex address was "Eurobank." The Paris Russian bank took some Narodny dollars and lent them; the dollars were known as Eurobank dollars, and finally Eurodollars.

The capitalist bankers all loved the idea of the Eurodollar. The charm of Eurodollars, to bankers, was that they didn't belong anywhere and owed no allegiance to anyone; therefore, nobody regulated them. They were beyond the reach of the Federal Reserve, the Bank of England, the Bundesbank, and all the other government authorities. The Federal Reserve can require banks to put up a portion of their deposits as reserves; other agencies govern the character and size of loans. But not in Eurodollars; these dollars could be deposited, lent, and repaid, all while the Federal Reserve looked on from afar.

[Now] the would-be borrower could borrow for his needs, not in domestic dollars, but in Eurodollars, from Canadian banks, Dutch banks, the London Moscow Narodny Bank (not very likely), and even from Eurobanks sponsored by American parents—anybody who had Eurodollars and wanted to lend them.

If the Federal Reserve was trying to get a grip on the money supply, it might say that all banks have to ante up another 2 percent in reserves. Or that no bank can pay interest on a time deposit until it's been there 30 days. Or it would set an interest rate ceiling.

Those regulations sent American banks into London, and into the Eurodollar business, where there were no interest rate ceilings and reserve requirements. If the Federal Reserve tried to create penalties against the hometown banks for the London activities, the American banks could say, "Do you want the British and the Germans and the Dutch to get all the business?"

The American banking authorities could regulate the American banks wherever they were, in some respects. In Germany the Bundesbank could not even do that. In the Nazi era the German banks even outside Germany reported back Jewish bank accounts, so in the postwar reforms, in a desire to protect individuals, the new German authorities forbade their banks to collect information over the border.

So the regulation of the banks varied from country to country. But the currency, once escaped, was gone: There was no way to whistle it home. If threatened with regulation, the Eurodollars would flutter up like a frightened flock of warblers and alight in some other country.

Beyond the wonderful country of Euroland was a still more wonderful country called Offshore. In Euroland the dollars were lent and deposited beyond the reach of the monetary authorities. Offshore was beyond the reach of the taxing authorities. For the dollars that belonged nowhere, there were now countries with hundreds of banks whose banking systems did not exist, like the Bahamas, the Netherlands Antilles, and the Cayman Islands. The Netherlands Antilles would get to sell a charter, and some annual stamps, so it was happy; and the bank was happy because it was in the Big Rock Candy Mountain of banking, where bankers are free as the breeze. The banks might be small, or they might have recognizable names Chase, Citicorp, Barclays, Bank of America, Deutsche Bank, Algemeine Nederland, all chartered Offshore and doing business in Euroland.

The currency for Euroland came from the balance-of-payments deficit; that is, from more dollars going out than coming in. If the extra dollars for the Volkswagens had all come back to New York to be lent or invested, there would have been no Eurodollar. But some of those dollars, sent out, never came back; they arrived in Euroland with Caribbean tans.

By 1980 there were over three-quarters of a trillion dollars of this very fecund currency, and there were also Euromarks and Euroyen and Eurofrancs, all looking rested and tanned and showing no desire to go home. The problem with those Eurodollars is that they could come home. What if there were too many of them?

Even in the dollar's sunny heyday, when dollars were convertible into gold at its 1935 price, $35 an ounce, there were some economists who saw some trouble for the American key currency and for the System that depended on it. What if a run started on the U.S. Federal Bank, if countries began to cash in their dollars? Some economists believed that using American payments deficits and dollar outflows to meet the world's need for key currency reserves was a prescription for disaster.

All through the 1960s the French wine dealers, the Italian shoemakers, the German Beetle makers, and the Japanese TV makers found good business selling to Americans. If the Americans didn't earn enough dollars, they printed the difference. [But when] the Toyota exporter in Japan with a batch of dollars wanted to play golf in Japan, the golf course would take only yen, so he took his dollars to the Bank of Japan, got yen for them, and went off to play golf. If the Bank of Japan already had enough dollars, it would complain that it was having to print extra yen for these dollars that were being brought in; the Americans were exporting a bit of inflation. [Then, to put the dollars to work], the Bank of Japan used the dollars to buy U.S. Treasury bonds. The U.S. Treasury would take the dollars back, giving an IOU—a bond—and a promised date for repayment. That financed the American deficit.

And America needed to employ deficit financing in those years—the Vietnam War, for example. The foreign bankers could see that the war was not financed by taxation; therefore, they knew there were going to be still more dollars around.

American administrations might try to stop the dollar outflow; there was a Voluntary Foreign Credit Restraint Program and then a Mandatory Foreign Credit Restraint Program, but the Euros multiplied, and ungentlemanly characters, with Gresham's Law ahead of the Pledge of Allegiance in their minds, kept borrowing dollars to buy the stronger currencies, the Swiss franc and the deutsche mark.

By May 1971 the German central bank, the Bundesbank, could—or would—no longer take in dollars and give out Marks. The international monetary system didn't break down, but it stopped for a while. The German, Dutch, Belgian, Austrian, and Swiss exchange markets all closed on May 6. When they reopened, the Swiss and Austrians had revalued their currencies upward, the French had forbidden their citizens to deal in foreign currency except through the Bank of France, and the Germans cut the relationship between the Mark and everything else.

The neat, classical world devised in 1944 at Bretton Woods had the dollar as its centerpiece, gold at $35 an ounce backing the dollar, and all the other currencies fixed in their relationship to the dollar. Now that system was coming apart. There were too many dollars for the gold; everyone could see that if the Euro holders all cashed in their dollars, Fort Knox would be bare in a day. In August 1971 the Nixon administration cut the tie between gold and the dollar.

One by one, the world's central banks peeled out to the fixed-rate relationships. The exchange rates floated everywhere. A dollar was worth, on any given day, what the buyers and sellers said it was worth.

Floating rates were greeted with great approval by some economists.... One German banker said he preferred the natural cynicism of the marketplace to the political optimism of governments.

The trouble with floating rates is that they bounce all over the place. Let some bad trade figures come out, and the dollar will start to sink.

If you are a manufacturer, you might think a 10 percent profit was okay. But if you're manufacturing in one country and selling in another, with floating rates the currencies could move that much in one day. Here it took you eight months to make this widget and another four to sell it, and a currency bounce wipes out your profit.

The theory is that a forward market develops and protects you. If you sign your widget contract in [2002], you buy a forward currency contract for [2004] when the widgets will be ready. [This futures contract] hedges your widget sale, and what you pay for the hedge is just like an insurance contract, part of the cost of doing business. These forward contracts can be bought through various brokers, banks, and exchanges.

Do they work? Usually, but not always. They work when things are calm. If everybody tries to hedge his way out of [euros] or dollars or whatever at the same time, the futures market stops functioning just because it's a market.

With floating rates, all the opinions on a currency are instantly visible on a computer screen. And markets will always tend to follow old Sir Thomas Gresham's Law: Sell the weak currency and buy the strong one. Better still, borrow the weak currency—pay it back when it's still weaker—and buy the strong one.