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— CHAPTER ONE —

Introduction

The international monetary system is the glue that binds national economies together. Its role is to lend order and stability to foreign exchange markets, to encourage the elimination of balance-of-payments problems, and to provide access to international credits in the event of disruptive shocks. Nations find it difficult to efficiently exploit the gains from trade and foreign lending in the absence of an adequately functioning international monetary mechanism. Whether that mechanism is functioning poorly or well, it is impossible to understand the operation of the international economy without also understanding its monetary system.

Any account of the development of the international monetary system is also necessarily an account of the development of international capital markets. Hence the motivation for organizing this book into five parts, each corresponding to an era in the development of global capital markets. Before World War I, controls on international financial transactions were absent and international capital flows reached high levels. The interwar period saw the collapse of this system, the widespread imposition of *capital controls*, and the decline of international capital movements. The three decades following World War II were then marked by the progressive relaxation of controls and the gradual recovery of international capital flows. The fourth quarter of the twentieth century was again one of significant capital mobility. And the period since the turn of the century has been one of very high capital mobility—in some sense even greater than that which prevailed before 1913.

This U-shaped pattern traced over time by the level of international capital mobility is an obvious challenge to the dominant explanation for the post-1971 shift from fixed to flexible *exchange rates*. Pegged rates were viable for the first quarter-century after World War II, the argument goes, because of the limited mobility of financial capital, and the subsequent shift to floating rates was an inevitable consequence of increasing capital flows. Under the Bretton Woods System that prevailed from 1945 through 1971, controls loosened the

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constraints on policy. They allowed policymakers to pursue domestic goals without destabilizing the exchange rate. They provided the breathing space needed to organize orderly exchange rate changes. But the effectiveness of controls was eroded by the postwar reconstruction of the international economy and the development of new markets and trading technologies. The growth of highly liquid international financial markets in which the scale of transactions dwarfed official international reserves made it all but impossible to carry out orderly adjustments of currency pegs. Not only could discussion before the fact excite the markets and provoke unmanageable capital flows, but the act of devaluation, following obligatory denials, could damage the authorities' reputation for defending the peg. Thus, at the same time that pegged exchange rates became more costly to maintain, they became more difficult to adjust. The shift to floating was the inevitable consequence.

The problem with this story, it will be evident, is that international capital mobility was also high before World War I, yet this did not prevent the successful operation of pegged exchange rates under the classical gold standard. Even a glance back at history reveals that changes in the extent of capital mobility do not by themselves constitute an adequate explanation for the shift from pegged to floating rates.

What was critical for the maintenance of pegged exchange rates, I argue in this book, was protection for governments from pressure to trade exchange rate stability for other goals. Under the nineteenth-century gold standard the source of such protection was insulation from domestic politics. The pressure brought to bear on twentieth-century governments to subordinate currency stability to other objectives was not a feature of the nineteenth-century world. Because the right to vote was limited, the common laborers who suffered most from hard times were poorly positioned to object to increases in central bank interest rates adopted to defend the currency peg. Neither trade unions nor parliamentary labor parties had developed to the point where workers could insist that defense of the exchange rate be tempered by the pursuit of other objectives. The priority attached by *central banks* to defending the pegged exchange rates of the gold standard remained basically unchallenged. Governments were therefore free to take whatever steps were needed to defend their currency pegs.

Come the twentieth century, these circumstances were transformed. It was no longer certain that, when currency stability and full employment clashed, the authorities would opt for the former. Universal male suffrage and the rise of trade unionism and parliamentary labor parties politicized monetary and fiscal policymaking. The rise of the welfare state and the post–World War II commitment to full employment sharpened the trade-off between internal and

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external balance. This shift from classic liberalism in the nineteenth century to embedded liberalism in the twentieth diminished the credibility of the authorities' resolve to defend the currency peg.[1]

This is where capital controls came in. They loosened the link between domestic and foreign economic policies, providing governments room to pursue other objectives such as the maintenance of full employment. Governments may no longer have been able to take whatever steps were needed to defend a currency peg, but capital controls limited the extremity of the steps that were required. By limiting the resources that the markets could bring to bear against an exchange rate peg, controls limited the steps that governments had to take in its defense. For several decades after World War II, limits on capital mobility substituted for limits on democracy as a source of insulation from market pressures.

Over time, however, capital controls became more difficult to enforce. With neither limits on capital mobility nor limits on democracy to insulate governments from market pressures, maintaining pegged exchange rates became problematic. In response, some countries moved toward more freely *floating exchange rates*, while others, in Western Europe, sought to stabilize their exchange rates once and for all by establishing a monetary union.

In some respects, this argument is an elaboration of one advanced by Karl Polanyi more than half a century ago.[2] Writing in 1944, the year of the Bretton Woods Conference, Polanyi suggested that the extension of the institutions of the market over the course of the nineteenth century aroused a political reaction in the form of associations and lobbies that ultimately undermined the stability of the market system. He gave the gold standard a place of prominence among the institutions of laissez faire in response to which this reaction had taken place. And he suggested that the opening of national economic decision making to parties representing working-class interests had contributed to the downfall of that international monetary system. In a sense, this book asks whether Polanyi's thesis stands the test of time. Can the international monetary history of the second half of the twentieth century be understood as the further unfolding of Polanyian dynamics, in which democratization again came into conflict with economic liberalization in the form of free capital mobility and fixed exchange rates? Or do recent trends toward floating rates and monetary unification point to ways of reconciling freedom and stability in the two domains?

[1] The term *embedded liberalism*, connoting a commitment to free markets tempered by a broader commitment to social welfare and full employment, was coined by John Ruggie (1983).

[2] Polanyi 1944.

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To portray the evolution of international monetary arrangements as many individual countries responding to a common set of circumstances would be misleading, however. Each national decision was not, in fact, independent of the others. The source of their independence was the *network externalities* that characterize international monetary arrangements. When most of your friends and colleagues use computers with Windows as their operating system, you may choose to do likewise to obtain technical advice and ease the exchange of data files, even if a technologically incompatible alternative exists (think Linux or Leopard) that is more reliable and easier to learn when used in isolation. These synergistic effects influence the costs and benefits of the individual's choice of technology. (For example, I wrote this book on a Windows-based system because that is the technology used by most of my colleagues.) Similarly, the international monetary arrangement that a country prefers will be influenced by arrangements in other countries. Insofar as the decision of a country at a point in time depends on decisions made by other countries in preceding periods, the former will be influenced by history. The international monetary system will display *path dependence*. Thus, a chance event like Britain's "accidental" adoption of the gold standard in the eighteenth century could place the system on a trajectory where virtually the entire world had adopted that same standard within a century and a half.

Given the network-externality characteristic of international monetary arrangements, reforming them is necessarily a collective endeavor. But the multiplicity of countries creates negotiating costs. Each government will be tempted to free-ride by withholding agreement unless it secures concessions. Those who seek reform must possess political leverage sufficient to discourage such behavior. They are most likely to do so when a nexus of international joint ventures, all of which stand to be jeopardized by noncooperative behavior, exists. Not surprisingly, such encompassing political and economic linkages are rare. This explains the failure of international monetary conferences in the 1870s, 1920s, and 1970s. In each case, inability to reach an agreement to shift the monetary system from one trajectory to another allowed it to continue evolving of its own momentum. The only significant counterexamples are the Western alliance during and after World War II, which developed exceptional political solidarity in the face of Nazi and Soviet threats and was able to establish the Bretton Woods System, and the European Community (now European Union), which made exceptional progress toward economic and political integration and established the European Monetary System and now the euro.

The implication is that the development of the international monetary system is fundamentally a historical process. The options available to aspiring

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reformers at any time are not independent of international monetary arrangements in the past. And the arrangements of the recent past themselves reflect the influence of earlier events. Neither the current state nor the future prospects of this evolving order can be understood without an appreciation of its history.

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