

# ECON 409

October 31, 2012

International Monetary Order until the 1980s

International Monetary Order (read Helleiner for this part)

- **Gold Standard System**

- From the late 19<sup>th</sup> century to the early 1930s
- Each currency was tied to gold at a fixed rate (fixed exchange rate system)
- Self-regulating monetary order
  - External imbalances (i.e. trade deficit) would be corrected automatically by wage and price adjustment
- Why is it important?
  - If a country ran a trade deficit, then there would be money (backed by gold) outflow.
  - Countries were expected to tighten their money supply by increasing interest rates

- With higher interest rates, economic activity would slow down
- It would lead to deflation; prices and wages would be lower
- With lower wages and prices, deficit country would improve its competitiveness
- In the short-run, high interest rates would also attract capital flows (mostly external debt) to finance trade deficit
- This system collapsed during the first world war
- In the 1920s, many countries returned to the gold standard system by adopting a fixed exchange rate system

- What happened in the 1920s and 1930s?
  - The US replaced the UK as the main economic power
  - capital exports of the US were pro-cyclical.
    - Its foreign loans expanded when the US economy was growing
    - As long as the US economy grew throughout the 1920s, all countries which had access to US credits experienced economic growth
    - Even if some of them experience trade deficits, they could cover their deficits without deflation (lower prices and wages)
  - When the US economy went into crisis, its credit to the rest of the world shrank accordingly.
  - This created a huge balance of payment problem for other countries that relied on US loans

- World output and volume of trade collapsed in the early 1930s.
- Many countries faced a dilemma: Either they were going to stick with the gold-standard and suffer deflation or they could leave the gold-standard
- Almost every country chose the second option, and that ended the gold-standard
- This was also a political decision
- They devalued their currency in order to restore their competitiveness

- What is the advantage of abandoning the gold-standard system?
  - A floating exchange rate provided greater autonomy for the governments to pursue expansionary monetary policy
    - While on the gold standard, a government trying to stimulate economy by lowering interest rate would experience capital outflow
    - The same government would be forced to reverse its policy in order to restore stability.
    - With the floating exchange rate, the government could simply let the exchange rate depreciate

- The exchange rate would adjust to the changing level of domestic prices and wages instead of the other way around
- Many country have also adopted capital controls in order to curb speculative capital flows
- What are the political implications?
  - Deflationary policies could be very painful for some domestic groups such as workers who had to suffer from wage reductions and unemployment when the countries stuck with the gold-standard

- Beggar thy neighbor (or race to the bottom)
  - If every country tries to devalue its currency, then international prices would go down, and volume of trade would be lower
- New economic order after the WW 2
  - The US has consolidated its hegemony
  - Bretton-Woods Order
    - Keynes and White are the main architects
    - The winners of the war were determined to play a leadership role in building and sustaining a liberal and multilateral economic order



- BUT they did not want to return to the liberal order based on the gold-standard
- On the one hand, they tried to construct a stable economic order (no more beggar-thy-neighbor policies), on the other hand, they were aware of the advantages of expansionary policies as the main strategy to stimulate an economy and attain higher employment
- It was also a struggle between finance and industrial capitalist
- What was the plan?
  - A fixed but adjustable exchange rate system

- Each country would agree to declare the value of their currency to dollar, which was convertible into gold at a fixed rate. (35 \$ per ounce).
- If a country faces a serious balance of payment difficulty (i.e. trade deficit) then it is given an option of adjusting its rate at which its currency is pegged to dollar. In other words, if these countries face growing trade deficits, then they can substitute devaluation for harsh domestic deflation.
- Although they make their currencies convertible to for trade payments, they are given rights to control all capital movements. That would not target all financial flows, and productive flows were permitted. Capital controls can also enable governments to pursue macroeconomic policies through an independent interest rate policy.

- Establishment of two international financial institutions
  - The international monetary fund (IMF)
    - The IMF was interested in helping the countries that face balance of payment difficulties. By having access to the funds of the IMF, those countries were able to pursue policies without being affected by speculative capital movements.
    - Large devaluations have to be permitted by the IMF.
    - the IMF's capacity to loan comes primarily from the contributions of member countries according to their relative size.

- The World Bank (WB)
  - The WB was in charge of providing loans to European countries for reconstruction and development after the second world war, a task that could not be left to private markets.
  - World Bank can borrow from the private markets to fund its lending.
- Keynes had other ideas
  - He wanted to create an international currency, whereas the US supported the dollar as the global currency
  - "we should penalize both deficit and surplus countries in order to keep capital flows balanced. For example, if countries run a surplus above a level, then they must pay a tax."

- Until the early 1970s both the IMF and the WB played very limited roles. However, many countries followed the gold-dollar standard, kept their currencies convertible, and imposed capital controls.
- As long as US provided a stable currency expanding it in line with the liquidity needs of the international economy the system would work.
- What went wrong?

- Mid 1960s/ early 1970s
  - Vietnam War
  - Keynesian Policies in the US
  - Growing trade deficit
- US currency abroad did grow larger than the amount of gold the US government held to support it.
  - By printing dollars, US was able to finance Vietnam War and expansionary domestic programs.
  - If all holders of dollars suddenly decided to convert the US currency into gold, the USA would not be able to meet the demand.

- Flexible exchange rate system
  - In 1973 governments allowed the world's major currencies to float.
    - Some economists argued that floating exchange rate system would lead to smooth adjustment in the presence of external imbalances
    - Exchange rate would be determined by the fundamental economic indicators (e.g. growth, productivity etc.)
    - Other economists claimed that floating exchange rates would promote speculative capital flows

- At the end of the Bretton Woods system, more than 90 percent of foreign exchange transactions were tied to trade and real investment.
- In 1998, foreign exchange trading was about 60 times as great as trade in goods and services.
- The size of daily foreign exchange trading increased from \$15 billion in 1973 to almost \$1900 billion by 2004
- In these circumstances, a floating exchange rate has often been the source of, rather than the means of adjusting to, external imbalances.