International Approach to Int’l Monetary Issues

- Explain international monetary outcomes (origins and stability of int’l monetary systems) by way of international conditions (distribution of “power” among nation-states)
  - Over past 125 years, the world has gone through several distinct monetary systems (Gold Standard, Bretton Woods, current managed-float system). What explains the genesis of these systems?

  - Monetary instability has been high at several times (interwar period, exchange-rate volatility in the 1980s, currency crises in the 1990s). What explains the stability of the int’l monetary system?

Collective Action Problems

- A stable int’l monetary system is a <u>global public good.</u> The <u>nonexcludable</u> feature of public goods creates two collective action problems:

1. <u>Problem of provision</u>: since the benefits of a stable int’l monetary system are available to all nations, the rational thing for nations to do is free ride.

2. <u>Problem of maintenance</u>: for the same reasons, nations have incentives to cheat on the rules and principles of an established int’l monetary system.

Akin to a Prisoners' Dilemma Game

Two burglars, Bob and Al, are captured near the scene of a burglary and are given the "third degree" separately by the police. Each has to choose whether or not to confess and implicate the other.

- If neither man confesses, both get 1 year for carrying a concealed weapon.
- If each confesses and implicates the other, both get 10 years.
- If one confesses and implicates the other, and the other does not confess, the squealer goes free and the other gets 20 years.

These payoffs (penalties, actually) are the sentences served.

		AL	
		confess	don't confess
Bob	confess	Bob=10 AL=10	Bob=0 AL=20
	don't confess	Bob=20 AL=0	Bob=1 AL=1

If both men want to minimize the time they spend in jail it is best to confess no matter what the other guy does.

Hegemonic Stability Theory (HST)

- HST says genesis and maintenance of a stable int’l monetary regime requires a single, economically-dominant country to resolve collective action problems.
  - Dominant country provides the requisite int’l public goods and leads the coordination effort that produces adherence to the rules of the regime.
  - Akin to Mancur Olson’s <u>privileged group</u> solution to collective action problems

Evaluation of HST

- Review history of international monetary relations with two questions in mind:

1. Did the dominant country in each era actually supply the world with a monetary regime (e.g., is the genesis of each int’l monetary system linked to the actions of the hegemon)?

2. Did the dominant country provide the necessary stabilizing functions to insure the maintenance of the regime?

History of the Classical Gold Standard

- **Genesis**
  - No formal leadership evident here. Great Britain led by example…and by force of its importance in int'l trade.
- **Operation**
  - Adjustment: dominance of London in world finance led to *de facto* harmonization of national monetary policies. Bank of England the "conductor of the international orchestra" (Keynes).
  - Liquidity: No evidence supporting a role for GB here since new gold discoveries were the basis of liquidity.
  - Lender of Last Resort: GB not the lender but the "borrower" of last resort during the major crises of the era (1873, 1890, 1907). France the most important lender in emergencies.

History of the Bretton Woods System

- **Genesis**
  - Somewhat supportive of HST in that the U.S. led the negotiations. However, GB also played a role.
  - To understand the debate between US and GB, recall "Unholy Trinity." Can't have (a) fixed exchange-rates, (b) free int'l capital mobility, and (c) modern democratic policies aimed at full employment all at the same time.
  - GB (Keynes) thought that (c) was most important. Was willing to sacrifice (b) and (a) to get it.
  - US (White) thought (a) and (b) most important.
- **Design reflected influence of GB**
  - Exchange rates fixed but adjustable - softened (a). Controls on international capital flows explicitly allowed - sacrificed (b).
  - A more gentle system in the context of (c) showed GB influence

History of the Bretton Woods System, cont.

Operation

- **Adjustment:** In theory, the system allowed for devaluation; in practice devaluations were rare. Moreover, the U.S. could not devalue the dollar (in terms of gold) without threatening confidence in the entire regime. Adjustment thus came to depend on the willingness of the US. to run macroeconomic policies consistent with the needs of the system.
- **Liquidity, 1945-58**
- US trade surpluses after the war created <u>dollar shortage</u> in world economy (a shortage of liquidity)
- US acted "hegemonic ally" by allowing other countries to discriminate against US goods via trade barriers and by sending massive amounts of dollars overseas in the form of foreign aid (i.e., the <u>Marshall Plan</u>), and overseas military expenditures (e.g., the <u>Korean War</u>).

History of the Bretton Woods System, cont.

Operation (cont)

- **Liquidity 1958-71**
  - expansionary U.S. policies (Great Society) and foreign policies financed by inflation (Vietnam war) turned dollar shortage into a dollar glut in world system (an excess of liquidity)
  - U.S. policies inconsistent with the needs of the int'l regime.
  - Ability of the U.S. to avoid adjustment showed the unfairness of the system. "Exorbitant Privilege" (de Gaulle)
  - Confidence in gold convertibility of the dollar erodes
  - "Nixon Shocks" of 1971
  - Summary: Macroeconomic laxity at home *harmed* world economy in this period.