

What Should We Think About When We Think About Refounding the International Monetary System?

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I. Introduction

Sixty years ago the Bretton Woods Conference saw the architects of the post-World War II international monetary system look back at the past thirty years and try to construct a system that would avoid the mistakes of the generation past. They by and large succeeded--that is, they avoided the mistakes of the generation past, but they did make their own other mistakes. The classic Bretton Woods system they created ran unevenly and imperfectly for nearly thirty years, but "uneven and imperfect" was good enough. The international monetary system that they refounded provided the underpinnings for the "Thirty Glorious Years": the fastest period of worldwide economic growth the world had ever seen.

Now the world stands at another moment at which there is at least the potential for refounding the international monetary system. And once again we look backwards: at the errors of the generation past. But I want to suggest that if there is a pattern in the evolution of the international monetary system, it is that reformers pay too much attention to the errors of the generation past and not enough attention to the errors of the generation future. Thus I want to first review how past episodes of refounding have, to some extent, missed the bus. And then I want to make some arguments about what the errors of the future will be, and how we should try to guard against them.

To telegraph my conclusions—or, rather, speculations—let me try to look ahead. Forty years from now, somewhere on the globe, there will be a conference celebrating the Hundredth Anniversary of the Bretton Woods Conference. What will the people there then wish that we here had talked about today? I think that it is a good bet that there are three sets of issues that they will wish we had talked about:

- Problems of *harmonization*—commercial and financial—created by *service-sector outsourcing*. The fiber-optic cable and the packet switched network will over the next generation or two make trade in services as integral a part of economic life as trade in goods has been over the past century. Yet this process of expanded trade will only function smoothly if there are consistent expectations, operating procedures, rights, and dispute-settlement mechanisms over the entire globe.
- Problems of *political management*, also created by *service-sector outsourcing*. The expansion of trade in services will put enormous stress on distributions of income within countries. More and more people in economic situations like those of the peasants (and landlords!) of Prussia at the end of the nineteenth century as it became clear that the proletarians of Hamburg could buy American wheat cheaper than Prussian rye.

- Problems of *economic autonomy*—as greater and greater interconnections mean that less and less of the monetary affairs that affect a country's economy take place within its borders. Mexico's economy over the past decade has not been greatly retarded by its failure to clean-up and recapitalize its banking system. Northern Mexico has functioned and grown by borrowing the United States's banking system.

But I have no answers to the big question that comes next: what reforms of the international monetary system today will put us in a good position to deal with these potential stresses on the world economy tomorrow?

II. A Quick Review of the History

At the end of the third quarter of the nineteenth century, the newly-formed German Empire spent the war indemnity it exacted from France in going on

the gold standard. The accession of the German Empire to gold, and the accession of the United States to gold a decade and a half after the end of the American Civil War, pushed the world economy past its tipping point: a "gold standard" that had not been worth joining when the gold block was principally the United Kingdom was worth joining when the critical mass of the world's largest economic powers were on gold (Meissner, 2001).

The gold standard period from 1880-1914 saw the fastest worldwide economic growth and the greatest expansion of the international division of labor that the world had hitherto seen. Our estimates of world real GDP are little more than guesses, but our best current guess is that in the years around 1900 that world real GDP was growing, albeit extraordinarily unevenly, at a pace of about 3% per year (Maddison, 2003).

We still know relatively little about the extent to which the gold standard was cause and the extent it was consequence of the tremendous pre-World War I expansion of trade. (However, Lopez-Cordova and Meissner, 2003, do present very interesting evidence that without the gold standard the world's "First Globalization" of 1880-1914 would have been a mere shadow of its

actual self.) That classical gold-standard period of growth, trade expansion, and world economic integration came to an end with the coming of the catastrophe of World War I. (Note that some see signs that it was running up against political limits that would have been likely to constrain the process and prevent further globalization even had the general peace been kept in the 1910s and 1920s. See O'Rourke and Williamson, 1999.)

In the aftermath of World War I, those who found themselves in charge of refounding the international monetary system that had been smashed to pieces by the war decided that the obvious thing to do was to try to rebuild the pre-World War I classical gold-standard system. For the experience of the pre-World War I gold-standard years had taught finance ministers and central bankers three important principal lessons:

- As long as a country's commitment to the gold standard is ironclad, financial crises will be rare and manageable: international financial speculators betting on the continuance of the gold standard will be a powerful stabilizing force.

- The security of asset values and the predictability of commodity prices flowing from the gold standard are powerful spurs to international trade, overseas investment, and economic growth.
- The gold standard with free trade and capital flows was a remarkably successful way of organizing the international monetary system in a period of extraordinary growth and change

Note that I'm not claiming that these three principal lessons were a full or an adequate or the best set of lessons to draw from the pre-World War I period.

I am just claiming that they were the lessons that the near-consensus did draw, and did seek to apply. Thus, after the end of World War I, central bankers and finance ministers tried to apply these lessons to and refound the classical gold standard in the more turbulent world economy that followed.

It was well-known in advance that this would be difficult: John Maynard Keynes dedicated his 1924 *Tract on Monetary Reform* to the Governor and Court of the Bank of England, who faced, he wrote, much more severe

challenges in the 1920s than they had become used to facing back before World War I. But it was very widely believed that the task had to be accomplished. Continued prosperity and growth depended on a well-functioning international division of labor, and nearly all believed that depended on the price stability and confidence in the security of property produced by the gold standard.

The policy of returning to and maintaining the gold standard was, as R.S. Sayers (1976) wrote, seen as “an employment policy.” Keynes (1924) was more eloquent: “We leave Saving to the private investor.... We leave the responsibility for setting Production in motion to the business man.... [T]hese arrangements, being in accord with human nature, have great advantages. But they cannot work properly if money, which they assume as a stable measuring-rod, is undependable...” Monetary theorists might propose new-fangled innovations like targeting the value of a basket of commodities, but for the sensible there was only one way to ensure that money would be stable: make it as good as gold.

Now it is going only a little bit too far to say that the result of the attempts to restore the pre-World War I gold standard was the Great Depression. The “golden fetters” with which interwar policymakers bound themselves kept them from doing much constructive once the Great Depression began to roll forward. The turbulent interwar period saw an unbelievable run of economic and monetary catastrophes, from the German hyperinflation to the British General Strike to the Great Depression itself. Against these problems the “golden fetters” had little power. Eichengreen (1996) believes that the intelligent and creative policymakers of the 1920s and 1930s would have been able to do a much better job in admittedly difficult circumstances had they not been fettered by their long and thorough study of the lessons of the classical gold standard.

Toward the middle of the twentieth century, as World War II came to an end, economists and analysts looked back at the interwar catastrophes, and reported to their finance minister and central banker masters that the interwar period taught three important lessons:

- Without ironclad commitment to the gold standard, free international capital flows were destabilizing--sources of inflation, or financial crisis, and of depression.
- With the coming of universal suffrage, the political costs of the unemployment generated by strict adherence to the gold standard were just too great: a functioning system had to have "give" and allow for periodic exchange rate adjustments.
- A decentralized consortium of central banks each responsible to their political masters was not enough; both more formal institutions and a strong commitment on the part of the largest economy to take on the role of the hegemon were essential preconditions for even a chance at stability and prosperity.

The result was the Bretton Woods conference and the classical Bretton Woods system. With domestic autonomous control over monetary policy seen as a necessity, and with at least quasi-fixed exchange rates seen as

highly desirable, it was international capital mobility that would be sacrificed on the altar of the international finance trilemma of Obstfeld and Taylor (2002). With the coming of mass suffrage, governments could no longer pretend that unemployment was unrelated to the government's economic policy, and so the idea of the fixed-but-adjustable-peg as a safety valve was adopted (see Eichengreen, 1998).

Formal institutions were created in the form of the IMF and the World Bank. And an attempt was made to deal with the fear that the United States would once again withdraw from world affairs by locating the IMF and the World Bank in Washington D.C. Today most complaints about the Fund's and the Bank's location come from those who fear (correctly) that their location three blocks from the White House and four blocks from the U.S. Treasury gives the current administration undue influence on Fund and Bank decisions: it is just too easy for the White House and the Treasury to "lobby" the Fund and the Bank. But half a century ago here was a different calculus at work: the belief was that the current U.S. administration needed to be lobbied by internationalists, and locating institutions of international governance the Fund, the Bank, and the United Nations inside the United

States rather than in Geneva, Basle, or London seemed an easy way of strengthening the internationalist lobby.

The "Thirty Glorious Years" that followed World War II in North America and Western Europe saw the results of central bankers' and finance ministers' attempting to apply these lessons they drew from the interwar period. It is true that at the Bretton Woods conference and thereafter nobody had any clue how large and desperate western Europe's post-WWII reconstruction needs would be. And it is certainly true that the Truman administration was slow to recognize how adverse western Europe's post-WWII terms of trade and how poor and brutish immediate post-WWII standards of living would be if trade had to be carried out at exchange rates where imports balanced exports. But although the Truman administration was late to the party, it brought lots of refreshments: UNRRA, loans, Marshall Plan, MSA, and more (see Milward, 1984).

There were always complaints. Charles de Gaulle and company complained about the "exorbitant privilege" the classical Bretton Woods system granted the United States, which produced international liquidity services at zero

cost and sold them to the rest of the world at a handsome price year after year. American manufacturers pointed to undervalued European (and Japanese) exchange rates that allowed them to pursue policies of export-led growth and boost employment at the expense (so they said) of the American manufacturing sector. Restrictions on international capital flows did slow down processes of diversification, technology transfer, and international investment—but we don't know by how much or how important these would have been. The requirements of maintaining the system did put some constraints on domestic macroeconomic policies—but episodes in which countries ought to have wanted to escape from those constraints were few.

Up until the end of the 1960s things went rather well. The results convinced them that they had discovered the key to the riddle of history--at least, to the riddle of international monetary history.

Then, of course, things fell apart. Western European and Japanese policymakers were unwilling to acquiesce in having what they saw as an uncomfortably high rate of expansion of their money stocks dictated to them by the United States, and the United States was unwilling to take serious

steps to curb domestic inflation if that was the price of maintaining the fixed-but-adjustable-peg system that was at the heart of classical Bretton Woods. “Go home and tighten money,” Treasury Undersecretary Paul Volcker snapped at Federal Reserve Chair Arthur Burns after one too many lectures on the importance of maintaining classical Bretton Woods. And Burns subsided into silence (see Gyohden and Volcker, 1992).

It is still not completely clear to me why the fixed-peg-but-adjustable exchange rates of the Bretton Woods System did not evolve into a crawling-peg based system in the 1970s. One factor was that economists and central bankers thought that they were signing on to more-or-less such a system by committing to floating rates: Rudi Dornbusch's (1976) insight that the real exchange rate was not a slowly-changing ratio of relative national productivities but a rapidly-changing asset price--the present value of expected future interest rate differentials--was still in the future. Another factor was U.S. Treasury Secretary John Connally and his master Richard Nixon. Paul Volcker described Connally as a man with a strong bias toward "bold action" without caring much about in which particular direction that bold action would take him (see Gyohden and Volcker, 1992). Descriptions

of Richard Nixon as economic steward are less complimentary. It certainly seemed unwise to Western European and Japanese policymakers to tie their economies to the mast of such an erratic and unstable hegemonic ship.

For whatever reasons, those looking back in the turbulent years of the 1970s and 1980s on the first-generation post-World War II experience drew three important lessons from that experience:

- It was simply no longer possible to exercise a degree of control over capital movements that would make a fixed-peg-but-adjustable system viable as long as different continents insisted on maintaining their policy autonomy, and there was no chance that the U.S. or western Europe as a whole or Japan would ever surrender their policy autonomy.
- Increasing communications and trade had made the world smaller, and the benefits from international capital mobility higher: there was no

longer such reason to fear destabilizing speculation (except in cases where unsustainable government policies invited it).

- The world economy was subject to shocks of such great magnitude which required sufficiently different macroeconomic responses on each continent that it made no sense to think of it as in any way an "optimum currency area."

And over the past three decades now, finance ministers and central bankers have tried to implement policies based on these principles as the international financial system has evolved. These principles led to a system in which the major currencies floated against one another: different governments on different continents pursuing their own macroeconomic policies for sensible and senseless reasons, and major-currency exchange rates fluctuating widely in response. These principles led to a system of incipient blocs as smaller economies sought to peg to their biggest trading partner (usually America) in order to diminish risk and promote trade. And the IMF took on a new role: it was no longer the referee that decided when a

devaluation was in accord with Bretton-Woods principles; it was the janitor that tried to clean up the mess when failures of governance or large adverse shocks to small economies produced balance-of-payments crises.

By now the pattern should be clear. Each generation the international monetary system is refounded to some degree or other. And each generation economists and policymakers make a very careful study of the past generation, and try to build a system that will handle its crises and its mistakes.

Now I won't claim that these lessons drawn, after each and every historical period, were the right lessons--either in the sense of being based on a true and faithful picture of the history they purported to analyze or in the sense of providing good guides to policy in the subsequent period. That is clearly not the case. And that is very humbling, for I at least am certainly not as smart and not as wise as Keynes, Nurkse, Kindleberger, Friedman, and company. But I will claim that every thirty years or so people take a step back, try to draw new lessons about the international monetary system, and things change in response.

But you can't look back at this history without noticing that each generation's lesson of the past are not the right lessons for the future. Nothing was more disastrous than attempting to establish an ironclad commitment to the gold standard in the interwar period, for you were doomed to fail and in your failure to drag your economy down into the depths. The fear of capital mobility inherited from the interwar period reduced the growth of the international division of labor during the great post-World War II boom, a period of amazing economic stability and opportunity. The experience with the difficulties of managing a peg during the classic Bretton Woods system led central banks and finance ministries in directions that left them poorly prepared for the exchange rate-driven crises of the 1980s and 1990s, whether the Latin debt crisis of the 1980s or Mexico and East Asia.

III. The Current Situation

It has been thirty years since the end of the classic Bretton Woods System.

What has been our experience over the past generation? What consensus lessons have been drawn, and what are the institutions that are emerging?

And are these the right lessons and institutions for the next thirty years?

Once again, we have a generation during which the flaws in current international monetary arrangements have been clear and apparent, and once again there are, I believe, widely-accepted lessons that can be quickly sketched out. Specifically, most important lessons that have been drawn from the experience since the end of classic Bretton Woods are:

- It remains the case that no component of the industrial core is willing to sacrifice its policy autonomy: for good and bad reasons, the yen will float against the dollar, the dollar will float against the euro, et cetera.

- Free capital mobility in emerging-market economies is wonderful when properly regulated, but the chances--especially in emerging markets--that regulators will be properly prepared for the systemic risks created by whatever current financial innovation is going on are low.
- Even a currency board and the certainty of disaster if governments follow unsustainable policies is not enough to allow one to confidently maintain a pegged exchange rate: look at Argentina. For those that want a fixed exchange rate, dollarization (or euroization) are the only possibilities.
- Even a world of largely floating rates is not hostile to rapid expansion in world trade, so very little is sacrificed as a result of the absence of policy coordination between Europe, the United States, and Japan.

The institutions that are being constructed in response appear to be twofold:

First come attempts to construct large fixed-exchange rate areas via currency unification. The euro itself is a fascinating topic that I will not deal with. But it is important to note that it is only part of a broader movement that in Latin America goes under the name of “dollarization.”

Second, we now have an IMF that appears ready to act a bit more like a central bank, serving a bit less as scolder-in-chief of countries that follow unsustainable macroeconomic policies and a bit more as lender-of-last-resort when currency or banking-sector mismatches within a nation generate large liquidity crises.

But much less has been done in the way of institution-building and institution-reforming than I, at least, expected back six or even years ago that we would see. The EMS '92, Mexico '94-'95, East Asia, '97-'98, Brazil, Turkey, and Argentina were a very impressive run of crises--and seemed to me at least to call for a more institutionalized rather than a continued series of one-off bespoke ad-hoc responses. Put me down, for one, as strongly in favor of a much better-funded IMF committed to in times of crisis following Bagehot's rule: lend freely on what would be good collateral if asset prices

and economies were in their normal configurations. And I do think these three most-recent conclusions are reasonably-smart policy-oriented summaries of the lessons taught by the experience of the past generation.

Nevertheless, I cannot help but fear that our current focus on the difficulties of financial regulation and supervision on the one hand, and on currency unions on the other, is in all probability leading us to not talk about what we should be talking about: to neglect the intellectual and institutional investments that would do most to help the world economy in the next generation. That's the big lesson of the past. It seems only reasonable to try to apply this lesson of the past to our future.

IV. What Should We Be Talking About?

What, then, are the big shocks that are likely to affect the international monetary system over the next generation, and what institutions and arrangements should we be building now to guard against them?

The first and most obvious large shock that is coming is something that reared itself up on its hind legs earlier this year, but that has now vanished from view: outsourcing. In the late nineteenth century the iron-hulled ocean going steamship made international trade in staple agricultural and manufacturing products profitable, and the submarine telegraph cable made truly large-scale international investment possible for the first time in human history. The technological underpinnings of the era of the First Globalization of a century ago came into being, and much of the history of the classical gold standard needs to be read as, an attempt to construct institutions to take advantage of the opportunities and ward off the dangers.

Now we have the fiber-optic cable, the packet-switched network, and data bandwidth and data storage capacity large enough to make international trade in *white-collar services* as feasible as trade in commodities became a century ago. There are many pieces of big economic news coming out of the high-tech technological revolution. But this is the piece that has the most impact on the international economy.

Now a century ago the institutions that developed to manage (and mismanage) that era's tremendous expansion in international trade and investment share were four: the gold standard (both to make sure payments could be made and as a commitment to avoid inflation), the gunboat (to "secure" property rights and market access), the creditors' committee (to clean up after things went wrong), and either social democracy or protectionism, depending on the country (to try to protect workers or landlords and bosses from the consequences of expanded trade shares).

Right now "outsourcing" is dropping off the political radar screen. It is ceasing to be an issue that politicians mention and TV journalists comment on. But it will come back.

Consider: cross-country income gaps today are much greater than they have been in the past. Thus the potential downward pressure on the wages of workers in the richer countries are much greater today. Slow wage growth has one set of political and social consequences. Large-scale income losses by whole social classes has another, quite different set of political and social consequences. And there are no "anchors" to tie white-collar paper-shuffling

production to durable long-run unchanging "natural" factors of production (ores, climate, soil quality, et cetera), hence much more rapid change is possible. (Of course, the magnitude of the potential gains is greater as well. Consider India today: Put 10 million people to work at \$25,000 a year providing white-collar services to the industrial core, and you have boosted India's standard of living by at least a quarter.)

This process of expanded international trade in services will come about gradually, but it will come. As it comes we will see a much greater density of economic interconnections across continents, and a much greater need for harmonization of work, commercial, and legal practices to settle the disputes that will inevitably arise as the world division of labor in services is chopped more and more finely. Adding to this pressure will be the fact that world finance is now sending its tendrils into regions in which the structures of title and of obligations are very uncertain. The most important areas for international economic policy in the next couple of decades may well fall under the rubric of *harmonization*.

And as “outsourcing” comes to be a major force in the world economy, it is likely to put nearly unbearable long-run pressure on the internal income distributions of countries. The gains from trade will still be there. But the distribution of these gains and the losses to those in the wrong economic position will be sharper-edged than before. And the resulting political problems will be immense. We know what were the long-run political consequences of the fact a century and more ago that the iron-hulled ocean-going steamship meant that Minnesotans could sell their wheat to the proletarians of Hamburg cheaper than the Prussians could sell their rye (see Gerschenkron, 1944). We are likely to face even larger shocks in the next generation.

Unless somehow people perceive that they are being pulled out of white-collar service-sector work by better opportunities in other sectors (and not being pushed out of white-collar service-sector work by unfair foreign competition), the political problems of maintaining support for expanded world trade over the next generation are likely to prove very difficult indeed.

Second, there have long been speculations that central banks are about to lose control of their standard policy levers and tools—that in the modern world there are simply too many places offshore to put your money and too many financial instruments with too much liquidity for a monetary economics paradigm built early in the last century, when currency and demand deposits were the only liquid assets, to be of much use. I have no fears for the Federal Reserve, or the ECB, or the Bank of Japan, or the Bank of England for generations to come. But fiber-optic cables, packet-switched networks, offshore electronic funds transfer, and alternative payment settlement mechanisms will have consequences for smaller central banks. The recent Argentinean crisis shows how much damage a government determined to wreck the structure of assets and settlements can do. But that crisis may be one of the last such episodes.

Consider the course of the Mexican economy over the past decade: a sharp panic and crisis, followed by sustained growth at about 4.5% per year. But back in the U.S. Treasury in 1995, talking point #6 about the Mexican crisis was always, “Sustained recovery from the crisis requires a clean-up and recapitalization of the Mexican banking system.” That clean-up and

recapitalization didn't happen, and the fact that it didn't happen has hurt the Mexican economy. But it didn't hurt the Mexican economy much. Why not? Because in much of northern Mexico commerce has borrowed the U.S. banking system.

V. Conclusion

Forty years from now, somewhere on the globe, there will be a conference celebrating the Hundredth Anniversary of the Bretton Woods Conference.

What will the people then wish that we here had talked about today? I think that it is a good bet that these three sets of issues are what they will wish we had talked about:

- Problems of *harmonization*—commercial and financial—as the fiber-optic cable and the packet switched network make trade in services as integral a part of economic life as trade in goods has been over the past century.

- Problems of *political management*—as the expansion of trade in services puts more and more people in economic situations like those of the peasants (and landlords!) of Prussia at the end of the nineteenth century.
- Problems of *economic autonomy*—as less and less of the monetary affairs that affect a country's economy take place within its borders.

But I have no answers to the big question that comes next: what reforms of the international monetary system today will put us in a good position to deal with these potential stresses on the world economy tomorrow?

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