CHAPTER FOUR

International Money Matters

ALTHOUGH analysts readily acknowledge that international trade and foreign investment have important implications for the distribution of wealth and power among nations, no similar agreement exists regarding the significance of the international monetary system.[1] Many economists believe that money and the international monetary system are, or at least can be, economically and politically neutral. However, in the modern world, the norms and conventions governing the system have important distributive effects on the power of states and on the welfare of groups within these states.

A well-functioning monetary system is the crucial nexus of the international economy. It facilitates the growth of world trade, foreign investment, and global interdependence. Establishment of a sound monetary system is a prerequisite for a prosperous world economy, and breakdown of the monetary system can be a decisive factor in a "Great Depression," as it was in the 1930s. In the present era, monetary stability has become particularly important. Money and financial flows now dwarf trade flows and have become the most crucial link among national economies. The efficiency and stability of the international monetary system, therefore, are major factors in the international political economy.

An efficient and stable international monetary system must solve three technical problems: liquidity, adjustment, and confidence (Cohen, 1977, p. 28). To assure liquidity, the system must provide an adequate (but not inflationary) supply of currency to finance trade, facilitate adjustment, and provide financial reserves. To deal with the adjustment problem, the system must specify methods to resolve national payments disequilibria; the three available methods are changes in exchange rates, contraction/expansion of domestic economic activities, and/or imposition of direct controls over international transactions.[2]

[1] This chapter draws heavily on Cohen (1977) and was inspired in part by Susan Strange's (1971) pioneering book on the subject. The title was adapted from A. James Meigs's book *Money Matters* (1972). With apologies to this monetarist, I use the title in a decidedly different way.

[2] In this book, the terminology applied to international transactions will be simple and nontechnical. It might be helpful, however, to clarify a few of the most frequently used terms. The most important ones are the following: *merchandise trade balance* = export versus imports; *current-account balance* = merchandise balance plus earnings on foreign direct investment, services, and transfers; and *basic balance* = the sum of current

The system must also prevent destabilizing shifts in the composition of national reserves. Such shifts can be caused by loss of confidence in the reserve currency or currencies. Each of these problems must be solved if an international monetary system is to operate efficiently and integrate the world economy.

Despite the belief of most economists that the monetary system is a neutral mechanism, every monetary regime imposes differential costs and benefits upon groups and states as it specifies the nature of international money, the instruments of national policy that are acceptable for balance-of-payments adjustment, and the legitimacy of different objectives of national policy. Every state therefore desires not only an efficient international monetary system but, even more important, one that does not seriously harm its own interests.

Every international monetary regime rests on a particular political order. Because the nature of the international monetary system affects the interests of states, states try to influence the nature of the system and to make it serve their own interests. As hegemonic powers rise and decline, corresponding changes take place in the monetary system. Thus, not surprisingly, the nineteenth-century monetary system primarily reflected British economic and political interests. Following the decline of British power in the early decades of this century, the monetary system collapsed in the 1930s. Similarly, it has again experienced severe strains with the relative decline of American power toward the end of the century.

Money has, of course, always been an important factor in world politics. Rulers have required money to finance their armies, support their allies, and bribe their enemies. The rise and the decline of empires and powerful states have been facilitated by the acquisition or loss of precious metals. But in the modern world the importance of money has multiplied many times and its character has changed profoundly. In fact, the enhanced role of the international monetary system in the affairs of modern states constitutes a virtual revolution in world politics. Its significance can best be appreciated through a chronological examination of the changing role of money, and economic and political implications of these changes, in the international economy.

The Era of Specie Money

In the premodern period, precious metals or specie money (principally gold and silver) served as the basis of the international monetary sys-

account and long-term capital account. Saint Phalle (1981, ch. 1) provides a useful discussion of these relationships.

tem. Local and international currencies tended to be sharply separated from one another. Whereas local trade was dependent upon barter or locally recognized currencies, long-distance or international trade was served by the "great currencies" minted from gold or silver. These—the solidus of Constantine, the dinar of the Arabs, or the ducat of Venice—were universally accepted; they were relatively stable and sometimes held their values for centuries (Cipolla, 1956). Though the empires that issued them enjoyed the right of seigniorage, the fact that a particular currency served as international money conferred few additional special privileges on its issuer; for example, if a state decreased the precious metal content of its coins or otherwise debased its currency, it thereby undermined the attractiveness of and confidence in its currency.[3] Since such practices were self-defeating, the international monetary system based on precious metals even placed restraints on the states supplying the principal medium of exchange. In short, the supplier of the international currency gained few special privileges and the international use of a particular currency was not a source of international power.

Whether minted into the coin of the realm or left in the form of raw bullion, gold and silver constituted a neutral medium of international exchange; one state's gold or silver was as good as another's. Money could not be created by political fiat; it could only be obtained through trade, plunder, or the possession of mines. The value of international money was primarily dependent upon its supply and was largely outside the control of individual states. Local moneys, however, which were usually based on commodities or less precious metals, were very much at the mercy of governments. As their circulation was confined to the realm, they could be, and frequently were, debased to suit the interests of the ruler, at the risk, of course, of domestic inflation or some other economic disruption. The important point is that the circulation and value of these local currencies had little effect on the international position of the state.

In the premodern era, international currencies in effect enjoyed economic and political autonomy. Because their supply and value were determined by fortuitous discoveries or international trade, they were relatively free from the influence of individual governments and governments had limited ability to manipulate the currencies upon which international commerce depended. For millennia, the international monetary system was largely apolitical.

The nature and role of the system began to change in the sixteenth

[3] Seigniorage, as noted earlier, is the profit that comes to the sovereign from the issuance of the economy's money supply (Kindleberger, 1981, p. 248).

and seventeenth centuries with the discovery of gold and silver in the Americas and the expansion of international trade. The separation of local moneys from international moneys began to break down as a consequence of the great influx into Europe of New World precious metals, the growing monetarization of national economies, and increasing economic interdependence. In time, gold and silver drove out traditional local currencies. National and international currencies became increasingly intertwined through the expansion of trade and monetary flows, and governments lost even their former limited ability to manipulate local currencies; domestic economic activity and price levels were becoming subject to international changes. Under these circumstances national economies became increasingly interdependent and subordinate to the operations of the expanding international economic system.

In the early modern period the increasing integration of local and international currencies provided the occasion for the first great contribution to the science of economics and the basis for the development of liberal economics. In his price-specie flow theory, David Hume responded to the mercantilist states' obsession with amassing specie through a trade surplus and their fear that a trade deficit would cause a dangerous loss of specie. He demonstrated that if a country gained specie in payment for an excess of exports over imports, the consequent increase in its money supply would cause its domestic and then its export prices to rise. This in turn would discourage others from buying its goods. At the same time, its own citizens would be able to import more because the relative value of their currency had risen and foreign prices would have fallen due to the decreased money supply abroad. As a result, the nation's exports would decline and its imports would increase. The changed flow of trade and specie induced by price changes at home and abroad would then produce a new equilibrium. Liberal economists have elaborated modern trade and payments theory upon this simple type of equilibrium model.

Although Hume's price-specie flow mechanism continued to characterize international monetary relations into the twentieth century, the nature of the monetary system was revolutionized in the modern world due to a number of economic and political developments (Williamson, 1983, ch. 8). Stated simply, money had been transformed from a gift of nature to a creation of the state. State control over the supply and demand for money became a principal determinant of the level of national and international economic activity. This profound change in the nature of money began nearly two centuries ago, although it did not have its full impact until the Keynesian revolution in economic policy in the post–World War II period. To understand the significance of this monetary transformation, it is first necessary to

comprehend what is known as the Financial Revolution and its consequences.

The Era of Political Money

During the eighteenth and nineteenth centuries, a financial revolution occurred. Governments began to issue paper money, modern banking arose, and public and private credit instruments proliferated (Dickson, 1967). For the first time in history governments acquired extensive control over the money supply; at least in theory, they could influence the level of economic activity through the creation of money (Hicks, 1969, pp. 93-97). The full impact of this rise of political money would not be realized until the Keynesian revolution, but this financial revolution did transform the relationship of state and economy and thus had a profound impact on international economics and world politics.[4]

The Financial Revolution, while solving one major economic problem, created another. On the one hand, it solved or at least relieved the historic problem of the inadequacy of the money supply. Until the innovation of acceptable paper money and easily expandable credit, economies had frequently been hobbled and economic activity was subjected to deflationary pressures due to the inadequacy of the gold or silver supply. However, as governments gained the capacity to create money, the Financial Revolution created an inflationary bias and raised the international problem of monetary instability.

The change in the nature of money permitted development of a serious clash between domestic economic autonomy and international monetary order. Monetary stability and efficient operation of the monetary system require the subordination of domestic policies to international rules and conventions. If individual governments create too much money, the resulting inflation can destabilize international monetary relations. The conflict between domestic economic autonomy and international economic stability has become the fundamental dilemma of monetary relations. The manner in which this dilemma has or has not been resolved in large measure defines the subsequent phases in the history of the international monetary system.

Succeeding epochs (the era of British hegemony, the interwar period from 1919 to 1939, and the Bretton Woods system) will be analyzed on the basis of three characteristics of an international monetary system: the provision of an international money that solves the confidence and

[4] The famous early nineteenth-century controversy between the Currency and Banking Schools centered on the implications of this development (Deane, 1978, ch. 4).

liquidity problems, the establishment of a mechanism to solve the adjustment problem, and the governance of the international monetary system (Scammell, 1983, p. 207).

THE CLASSICAL GOLD STANDARD (1870-1914)

The international gold standard, which reached its zenith in the late nineteenth century, was the classic resolution of the dilemma of domestic economic autonomy versus international economic stability. In theory, this monetary system was the embodiment of the liberal, laissez-faire ideal of "an impersonal, fully automatic, and politically symmetrical international monetary order dependent simply on a combination of domestic price flexibility and natural constraints on the production of gold to ensure optimality of both the adjustment process and reserve supply" (Cohen, 1977, p. 79). Balance-of-payments disequilibria were corrected (at least in theory) and adjustment was achieved by the operation of Hume's price-specie flow mechanism.

As summarized by Benjamin J. Cohen, two key features of the system guaranteed the smooth and automatic operation of the price-specie flow mechanism: (1) the central bank of a nation on the gold standard bought and sold gold at a fixed price, and (2) private citizens could freely export and import gold (Cohen, 1977, p. 77). These two features provided a fixed exchange rate mechanism for adjusting the international balance of payments as trade and payment imbalances among nations were brought back into equilibrium through the flow of gold. In time, the resulting effects on relative prices and trade balances in time corrected any payments disequilibrium.

Comparing the decades of exchange-rate stability that this system achieved with the turmoil of the post-1973 period, many conservatives have become nostalgic about this idealized conception of the operation of the classical gold standard. They believe that return to a gold-based monetary system could eliminate the scourges of rampant inflation and monetary instability caused by the excessive creation of money (or international liquidity). However, this idealistic conceptualization ignores the political basis of the system and the central role of British leadership.

In practice, the classical gold standard operated quite differently from the liberal ideal.[5] It was not an automatic, impersonal, or politically symmetrical monetary order. On the contrary, it was a very hu-

[5] The following discussion of the gold standard is derived largely from Condliffe (1950, ch. 12).

man institution, subject to manipulation and assymetrical in the benefits that it conferred on national economies. This fact, however, does not negate the success of the gold standard; on the whole, it facilitated a then unprecedented growth of world trade, global prosperity, and international economic stability. However, its success and its economic consequences for various national economies and individual groups were due to reasons different from those assumed by many economists.

In the first place, the classical gold standard did not function automatically. The establishment of banking systems and their role in the creation of money had weakened the operation of the price-specie flow mechanism. According to theory, central banks responded to gold flows automatically, buying or selling gold to maintain the fixed exchange rate for the national currency. In practice, the banks could and did respond to gold flows in a highly discretionary manner in order to cushion the effect on domestic prices and the domestic economy. Through rather crude monetary policies, the banking system enabled a country to evade, at least for a time, the discipline of the gold standard. If the international monetary system were to work properly, some nation had to assume leadership in making it work; in the latter decades of the nineteenth century, this responsibility was assumed by Great Britain.

Second, the international monetary system under the classical gold standard did not operate impersonally. It was organized and managed by Great Britain; and the City of London, through its hegemonic position in world commodity, money, and capital markets, enforced the "rules of the system" upon the world's economies. The integration of national monetary systems with the London financial market endowed Great Britain with the ability to control to a considerable degree the world's money supply. By lowering and raising its discount rate, the Bank of England manipulated the flow of gold internationally and in effect managed world monetary policy. Nations that were errant in conducting their internal economic affairs and in adhering to the rules of the gold standard found themselves in difficulty with London money and financial managers. The monetary system under the gold standard was thus a hierarchical one, dominated by Great Britain and, to a lesser extent, by emerging financial centers in western Europe (Ruggie, 1982, p. 390).

Third, the monetary system was not politically symmetrical in its effects on various national economies. The process of balance-of-payments adjustment had very different consequences for advanced economies than for less developed ones. There were several reasons for this, but the role of international capital movements was of critical importance—a development not foreseen by Hume or other classical econo-

mists. Great Britain and other wealthy capital exporters could adjust to payments disequilibria and cushion their ill effects on economic activities through the regulation of capital flows. Capital importers, on the other hand, had no such protection. They were dependent upon decision makers in London, Paris, or Frankfurt and they tended to suffer adversely in terms of trade and with respect to the adjustments forced upon them by the operation of the system.

A principal feature of the operation of the international monetary and hence trading system was the central role of sterling in international transactions. The close integration of the London money market with the capital and commodities markets located there and with monetary centers elsewhere (Paris, Berlin, etc.) gave the system a highly centralized character. As a consequence, the lowering and raising of the bank rate by the Bank of England and its subsequent effects on the supply of credit, the flow of gold, and international prices gave Great Britain a powerful source of leverage over trade, capital movements, and national incomes. In this way the international balancing of accounts was effectively controlled by one dominant center.

In reality, as J. B. Condliffe has characterized it, the classical gold standard was "a series of credit systems based on gold and linked with each other by fixed exchange rates" (Condliffe, 1950, p. 365). Although gold was the ultimate standard of value, in every country there was a "credit superstructure" that governed the price level of the economy (ibid., p. 368). The adjustment process was essentially a matter of manipulating this credit superstructure and through it the relative level of prices (ibid., p. 366). As the creation of credit and hence the supply of money was under national control, the temptation to use credit and the money supply to maintain the price level or to reduce unemployment was great. In the late nineteenth century, the universal commitment to a system of a fixed exchange rate pegged to gold and a currency market dominated by Great Britain limited such actions. As a consequence, the world economy in effect had a uniform world currency with relatively little inflation or currency fluctuation, and the resulting stability of exchange rates was a major factor in the steady growth of trade and foreign investment.[6]

The objectives and policies pursued by the British in their hegemonic position were relatively simple. The ideology of laissez faire, along with British economic interests, dictated an emphasis on monetary stability. The goals of economic policy were modest in this prewelfare state era. Arthur Lewis has observed that Great Britain had only two economic

[6] Until the discovery of new sources of gold and the invention of a new process of refinement around 1900, the shortage of gold was a deflationary factor.

policies in the nineteenth century: upholding the price of gold and maintaining a balance-of-payments equilibrium. This, it should be remembered, was still an age when society's demands on government were few, and the ruling elites preferred the dangers of tight money and deflation to those of cheap money and inflation. Both the poorer nations and poorer classes within societies frequently paid the price of adjustment through higher rates of unemployment and decreased welfare. As Keynes noted, the lower orders of society resignedly accepted their lot as the natural order of things (Keynes, 1919). Judged on its own terms and neglecting its frequent negative impact on particular groups and societies, the classical gold standard was a highly successful international monetary order.

The gold standard reflected a world in which "social purposes," to use Ruggie's term, were minimal (1982, p. 382). In this era of governmental noninterventionism and before the rise of the welfare state, primacy was given to monetary stability. This was the product of British hegemony, the ideology of laissez faire, and the dominance of conservative middle classes. When these conditions changed with the First World War and the rise of the modern welfare state, the gold standard was no longer able to function. These social and political prerequisites of the stable nineteenth-century economy are too easily forgotten in the contemporary search for a reformed international monetary order (Ruggie, 1982, pp. 389-91).

During its reign, the classical gold standard provided an effective foundation for the nineteenth-century international economic and political order (Polanyi, 1957, p. 3). It solved fundamental problems of an international monetary order. The adjustment problem was solved as individual countries adjusted domestic economic activities to a level that maintained the value of their currency relative to gold; the liquidity problem was solved since the production of gold was generally sufficient to meet world demand at the prevailing price in terms of sterling; and the confidence problem was solved because people believed that Great Britain had the power and the will to maintain the prevailing sterling value of gold. These solutions subordinated domestic economic autonomy to the international goal of monetary stability.

The solution to the clash between domestic autonomy and international stability achieved under the gold standard provides an example of a dominant or hegemonic power enforcing the "rules of the game" and managing the world's monetary affairs. A hegemonic power is needed to reconcile the national policies of individual states and to establish the prerequisites of a stable international monetary order. As the world's preeminent industrial, trading, and capital-exporting nation in the late nineteenth century, Great Britain had an interest in a

stable and smoothly functioning international monetary system; it performed the task of leadership because it had the power and the will to do so.

The efficiency and stability of the classical gold standard also benefited the other advanced countries. Because it worked well, the other major trading countries adopted it. Although Germany, France, and the United States resented the special benefits that world monetary leadership conferred on the British, they had neither the will nor the capacity to challenge this leadership effectively. The less developed commodity exporters, however, fared less well; the burdens of adjustment usually fell on them and the terms of trade for their commodity exports frequently suffered. Their compliance with the rules of the game was dictated by the dominant position of Great Britain and the other industrial powers.

Even though most nations probably gained in absolute terms from the well-functioning classical gold standard, relative gain is frequently more important in international relations than absolute gain. France, Germany, and other nations disliked a monetary order that benefited Great Britain most of all; less developed countries grew frustrated with paying the costs of adjustment. But as long as Britain retained economic and military primacy, London was able to resist the rising forces of economic nationalism and to maintain the international monetary order intact. For decades British leadership held off the detrimental effects of competing national policies on a highly interdependent world monetary system.

Near the end of the century, the rise of new industrial powers and the relative decline of British hegemony began to undermine the basis of British global economic leadership. Rising social discontent and a revolt against laissez faire began to shake the system. The force of economic inertia, however, continued British dominance in money and finance long after British supremacy in manufacturing had vanished. The political weakness of disadvantaged groups and classes inhibited any major change in the economic role of the state. The First World War destroyed the political foundations of this economic era and plunged the world into monetary and economic chaos for the next three decades.

The Interregnum between British and American Leadership (1914-1944)

A major consequence of the First World War was a nationalization of the world monetary system. Upon the outbreak of hostilities, the belligerents acted quickly to safeguard their gold supplies and disengaged from

the system of fixed exchange rates to facilitate the freeing and mobilization of their economies for war. The gold standard collapsed and its place was taken by a makeshift arrangement of floating rates. With the end of British economic leadership and the breakdown of economic interdependence, the determination of currency values once again became the responsibility of national authorities; domestic economic autonomy triumphed over international monetary order due to the exigencies of total war.

As Joseph Schumpeter observed during the depths of the war, the First World War transformed economic reality. In order to fight the war, every government had to mobilize the entire liquid wealth of its economy. Through taxation and especially through borrowing, the state acquired control over the resources of the society. Long before Keynes's *General Theory*, Schumpeter foresaw that as a consequence of this "monetarization" of the economy "monetary factors—deficits, money, credit, taxes—were going to be the determinants of economic activity and of the allocation of resources" (Drucker, 1983, p. 127). He also expected that the state, through what would later be called its "macroeconomic" (fiscal and monetary) policies, could harness the economy to its own political and social ends and thus leave behind the autonomous market of nineteenth-century laissez faire. The warfare state had paved the way for the modern welfare state: John Condliffe (1950) characterized this transformation as a "commerce of nations" displacing the nineteenth-century international economy.

The implications of the collapse of the international discipline of the gold standard and state acquisition of control over the domestic economy would one day fragment the liberal economics community. Those who would be called Keynesians focused on the opportunity that this transformation provided for the elimination of the evils of the market such as unemployment, recession, and erratic business cycles. Through manipulation of a few monetary variables—government spending, interest rates, and the money supply—public-spirited economists and their science could achieve social justice and "fine tune" the course of economic progress. Economists of a "liberal" persuasion began to believe that in a Keynesian world the "economist-king" would rule.

Schumpeter and other conservative economists, on the other hand, considered the undisciplined monetary power of the modern state to be an "invitation to political irresponsibility" because it eliminated all economic safeguards against inflation and other evils (Drucker, 1983, p. 128). They feared that the state would use its new taxing and borrowing powers to shift the distribution of national income from the producer and the saver to the nonproducer and the profligate. In a

world without the restraints of the gold standard and other international norms, democratic governments seeking to court popularity and appease special interests through the expansion of costly government programs would be subjected to ever-increasing inflationary pressures; this could undermine both capitalism and democracy. In the new era of the warfare-welfare state, the generals and the politicians, rather than the economists, would govern. Several decades later, this issue appeared in the post–World War Two debates over the welfare state and Keynesian economics.

As Keynes stated in his *The Economic Consequences of the Peace* (1919), the basic task in the immediate aftermath of the First World War was reestablishment of an international economic system and the creation of a stable monetary order. A return to the gold standard was ruled out because severe inflation had eroded the purchasing power of the world's stock of gold. The Genoa Conference of 1922 created a gold-exchange standard as a solution to this problem. Nations would include gold-backed currencies, particularly British sterling, in their reserves in order to economize on the use of gold. Many believed that an international monetary order based on fixed exchange rates would again govern monetary relations among states and that international economic relations would return to the halcyon days of the classical gold standard.

However, the gold-exchange standard survived for just a few years; its collapse was a major factor in precipitating the Great Depression of the 1930s. There were many reasons for the breakdown of monetary order; some are worthy of special attention here. Many governments, using their newly gained control over monetary levers, began to value domestic welfare objectives such as economic stability and full employment more highly than a stable international monetary order. Labor and business had grown in power as a consequence of the war; they could resist the wage/price flexibility (especially in a downward direction) that had facilitated the operation of a fixed exchange rate system.

Another factor was British economic policy. When Great Britain returned to the gold standard in 1925 and reset the sterling value of gold, it did so at too high a par value; as a result, British economic growth was stunted, exports declined, and the working class experienced severe hardships. As Keynes (1925) had foreseen, the British government subordinated domestic welfare to the exigencies of maintaining the international role of sterling. The result was the General Strike of 1926, which failed in its immediate objectives but helped pave the way for the modern welfare state.

Furthermore, Great Britain no longer had the power to manage the

international monetary system. Its industrial decline, the costs of the war, and the rise of new powers had resulted in a major shift in the global distribution of economic power. As Charles Kindleberger has argued in *The World in Depression, 1929-1939* (1973), the severity and duration of the Great Depression was due in part to the collapse of economic leadership. Great Britain no longer had the power to carry out the responsibilities of the hegemon in the areas of trade, money, and finance; the emergent dominant economic power, the United States, was unable or unwilling to assume the mantle of economic leadership. On the contrary, although the United States had emerged from the war as the world's foremost creditor nation, American deflation caused a shortage of global liquidity that accentuated the depression (H. Johnson, 1975, p. 272). With no one to enforce the rules and manage the system, states resorted to nationalistic "beggar-my-neighbor policies" and economic order broke down.

The social purposes and national interests of the Great Powers had changed and their economic policies had become increasingly divergent as a result of both domestic and international developments (Ruggie, 1982, pp. 390-92). Domestic welfare goals and national rivalries became more important than international norms; this made cooperation impossible (Oye, 1983). The ideologies of fascism, Nazism, and the New Deal valued domestic autonomy and national self-sufficiency more than liberal internationalism. As the fabric of international cooperation came apart and hostilities grew, the warfare state began to reassert itself. In one economy after another the state took over the reins of the economy in order to achieve its domestic welfare and foreign policy objectives. In the absence of hegemonic leadership, the triumph of illiberal ideologies and the divergence of national interests led to the collapse of the liberal world economy.

The ensuing economic chaos led to fragmentation of the international monetary system into several competing monetary blocs. At the Ottawa Conference in 1932, the British along with several of their dominions and certain trading partners established the "sterling bloc." Soon thereafter a "dollar bloc" formed around the United States and a "gold bloc" around France. Finally Germany, Italy, and Japan took advantage of the world economic crisis to launch attempts to create autarkic empires. The world economy entered an era of unprecedented economic warfare, with competitive devaluations and fluctuating currencies as each economic bloc attempted to solve its payments and employment problems at the expense of the others.

Responding to this economic anarchy, the United States began to assume the responsibilities of leadership in the mid-1930s. In 1934, the

U.S. Reciprocal Trade Act empowered the President to negotiate the reciprocal lowering of tariffs. Of little immediate consequence, this basic principle of tariff reciprocity would be embodied in the General Agreement on Tariffs and Trade (GATT) after the Second World War. In 1936, the United States, Great Britain, and France signed the Tripartite Agreement to moderate conflict among the three major currency centers (Rowland, 1976, ch. 5). Although these measures signaled a growing United States awareness of its interest in a smoothly functioning liberal world economy, an adequate reform of trade and currency matters would have to await the end of the Second World War and America's emergence as the world's unchallenged hegemonic power.

The events of the interwar period meant an end to the automatic equilibration that, on the whole, had characterized the era of the gold standard (Williamson, 1983, p. 141). The simultaneous achievement of internal and external balance through the operation of Hume's price-specie flow mechanism was decreasingly applicable to a world where central banks tried to counter its effects and prices/wages were not permitted to fall automatically in response to tight monetary policies; the era of government intervention and management of the economy had arrived.

The Bretton Woods System (1944-1976)

The Western democracies, following the trauma of the Great Depression and the sacrifices imposed on their citizenry during the Second World War, established two sets of postwar economic priorities. The first was to achieve economic growth and full employment. The Beveridge Plan in Great Britain, the French establishment of a planning commission, and the United States' passage of the Employment Act of 1946 were symbolic of this commitment to government interventionism in the economy and the establishment of the welfare state. The second priority was the creation of a stable world economic order that would prevent a return to the destructive economic nationalism of the 1930s.

The Bretton Woods Conference in 1944 was charged with the creation of such a stable world economic order. A product of American-British cooperation, the Bretton Woods system had several key features (Cooper, 1984, pp. 22-23). It envisioned a world in which governments would have considerable freedom to pursue national economic objectives, yet the monetary order would be based on fixed exchange rates in order to prevent the destructive competitive depreciations and policies of the 1930s. Another principle adopted was currency convertibility for

current account transactions. Massive and destabilizing capital flows, like those that occurred in the 1930s and have also raised havoc in the 1980s, were assumed to be a thing of the past. The International Monetary Fund (IMF) was created to supervise the operation of the monetary system and provide medium-term lending to countries experiencing temporary balance-of-payments difficulties. And, finally, in the event of a "fundamental disequilibrium," the system permitted a nation to change its exchange rate with international consent; the definition of "fundamental disequilibrium," however, was left vague.

The Bretton Woods system attempted to resolve the clash between domestic autonomy and international stability, but the basic features of the system—autonomy of national policies, fixed exchange rates, and currency convertibility—conflicted with one another (Cooper, 1984, p. 22). For example, a nation cannot at the same time freely pursue macroeconomic policies and absorb foreign currencies without consequences for its exchange rate. It was assumed, however, that capital movements would be small and that conflicts of economic objectives could be reconciled by providing for international deficit financing and, if necessary, for changes in exchange rates. Indeed, this *was* possible until the late 1960s, when American monetary policy began to place severe strains on the system.

As John Ruggie has argued, the Bretton Woods system was a compromise solution to the conflict between domestic autonomy and international norms. It attempted to avoid (1) subordination of domestic economic activities to the stability of the exchange rate embodied in the classical gold standard and also (2) the sacrifice of international stability to the domestic policy autonomy characteristic of the interwar period. This so-called "compromise of embedded liberalism" was an attempt to enable governments to pursue Keynesian growth stimulation policies at home without disrupting international monetary stability. Describing this compromise, Ruggie writes that "unlike the economic nationalism of the thirties, it would be multilateral in character; unlike the liberalism of the gold standard and free trade, its multilateralism would be predicated upon domestic interventionism" (Ruggie, 1982, p. 393). The creation of institutions that limited the impact of domestic and external developments on one another was expected to solve the problem of simultaneously achieving both international liberalization and domestic stabilization.

The Bretton Woods system reflected fundamental changes in social purposes and political objectives. Whereas the nineteenth-century gold standard and the ideology of laissez faire had subordinated domestic stability to international norms and the interwar period had reversed

these objectives, the postwar regime tried to achieve both. The state assumed a greater role in the economy to guarantee full employment and other goals, but its actions became subject to international rules. In this way it would be possible for domestic interventionism and international stability to co-exist. As Ruggie states, "the essence of embedded liberalism [was] to devise a form of multilateralism that is compatible with the requirements of domestic stability" (1982, p. 399).

Nations were encouraged to engage in free trade with minimal risk to domestic stability, although at some cost to allocative efficiency. If they should get involved in serious balance-of-payments difficulties, the IMF could finance deficits and supervise exchange-rate adjustments (Ruggie, 1983b, p. 434); nations would not need to restrict imports to correct a balance-of-payments disequilibrium. International cooperation would make it possible for state interventionism and the pursuit of Keynesian growth policies to occur without risking destabilization of the exchange-rate system and reversion to the competitive nationalist policies of the 1930s. Supporters of Bretton Woods believed that state and market had been successfully amalgamated.

Establishment of the Bretton Woods system did usher in an era of unprecedented growth in international trade and increasing global economic interdependence. Yet within this global Keynesianism lay an inherent flaw that in time would bring down the system. The American economy became the principal engine of world economic growth; American monetary policy became world monetary policy and the outflow of dollars provided the liquidity that greased the wheels of commerce. Following the revolution of the Organization of Petroleum Exporting Countries (OPEC) in 1973-1974, which quadrupled world energy prices, the dramatic shift of the Japanese, West Europeans, and newly industrializing countries (NICs) toward export-led growth strategies made the American role even more central to global economic growth. When America grew, the world grew; when it slowed, the world slowed.

As with the classical gold standard, a gap existed between theory and reality. The war had so weakened the economies of the industrial powers that they could not fully assume the responsibilities and obligations envisioned under the Bretton Woods system until 1958. Faced with potential chaos in the world economy, the problem of the "dollar shortage" and the onset of political conflict with the Soviet Union, the United States assumed primary reponsibility for the management of the world monetary system beginning with the Marshall Plan and partially under the guise of the IMF. The Federal Reserve became the world's banker, and the dollar became the basis of the international monetary

system. The classical Bretton Woods system lasted only from 1958 to 1964, when it was replaced by what the French call the hegemony of the dollar.

Several key elements characterized what in effect became a gold-exchange standard based on the dollar. As other nations pegged their currencies to the dollar, a system of fixed exchange rates was achieved; the adjustment process involved simply taking actions that changed the par value of a currency against the dollar. Because the dollar was the principal reserve currency, international liquidity became a function of America's balance of payments, which were in frequent deficit from 1959 on. The linchpin of the system was the pledge of the United States to keep the dollar convertible into gold at $35 per ounce; as long as the United States backed this pledge and other nations had confidence in the soundness of the American economy, the system worked. The dollar was as good as gold; in fact, it was better. It became the principal medium of exchange, unit of account, and store of value for the world. For the two decades after 1959, outflows of dollars caused by the chronic American budget deficit drove the world economy. Then the crisis came and the Bretton Woods system collapsed.

The Dollar and American Hegemony

American hegemony has been based on the role of the dollar in the international monetary system and on the extension of its nuclear deterrent to include its allies. Whereas the Soviet Union, situated in the heart of the Eurasian land mass, can bring its military might directly to bear on its periphery, the United States must have the foreign exchange to finance its global position, which has involved the stationing of troops overseas, the fighting of two major wars in Asia, and other costs. These economic burdens of global hegemony have been achieved in large part through taking advantage of the international position of the dollar. The price paid for America's exploitation of its role as the world's banker was the destruction of the Bretton Woods system, the transformation of the United States from a creditor into a debtor nation, and a growing dependence on Japanese capital. The latter developments will be discussed in Chapter Eight; I will consider here what economists call the Triffin Dilemma, in order to illuminate why American policy eventually destroyed the monetary system that the United States had worked so hard to create (Block, 1977).

In 1960, Robert Triffin, an economist at Yale University, published a book entitled *Gold and the Dollar Crisis* (1960), which exposed the flaw at the heart of the dollar-exchange standard. He pointed out that

a fundamental contradiction existed between the mechanism of liquidity creation and international confidence in the system. The system was relying upon American balance-of-payments deficits to provide liquidity, but this chronic deficit over the long run would undermine confidence in the dollar. The growth of foreign dollar holdings that were not backed and redeemable by American-held gold at $35 per ounce would eventually destroy faith in the system, and this would lead, in turn, to financial speculation and ever-increasing monetary instability. Either America's balance-of-payments deficits had to stop (thereby decreasing the rate of liquidity creation and slowing world economic growth) or a new liquidity-creating mechanism had to be found.

For a few years, the Triffin dilemma was one of academic interest only, because America's gold reserves were adequate to cover its balance-of-payments deficit and the American inflation rate was low. After 1967, however, things began to change with the devaluation of the pound, which had been providing some protection for the dollar (Scammell, 1983, p. 179). Subsequently, the massive escalation of the Vietnam War and the consequent severe deterioration of America's balance of payments radically transformed the situation. In response to mounting world inflation (caused principally by the stepped-up war effort and President Johnson's Great Society program), increasing monetary instability, and speculative attacks on the dollar, international efforts to resolve the Triffin dilemma were accelerated.

These efforts generally involved two categories of international actions. First, there were cooperative measures taken by the leading economic powers designed to increase confidence in the dollar and to dampen monetary speculation. They included the General Arrangements to Borrow, currency swaps organized by the Bank for International Settlements, and the establishment of a "gold pool" (Kindleberger, 1977, ch. 6). Second, after intense controversy, the IMF created the Special Drawing Rights (SDR) as a reserve asset to complement the dollar as a reserve currency and thereby solve the liquidity-creation problem; this effort was only partially successful because of conflicting political interests and lack of confidence in a money created by an international institution. (For an explanation of SDR see Williamson, 1983, p. 348.) Yet, despite these severe difficulties and unresolved problems, the Bretton Woods system continued to limp along for several more years. To understand why, one must turn to the realm of international politics and the fact that American economic leadership continued, despite its failure to maintain international monetary stability.

The system of fixed rates survived for a time because it continued to

rest on a firm political foundation. In essence, "an implicit bargain was struck," to use Cohen's expression, among the three dominant poles of the international economy—the United States, Western Europe, and, to a lesser extent, Japan (Cohen, 1977, p. 97). Partially for economic reasons but more for political and strategic reasons, Western Europe (primarily West Germany) and Japan agreed to finance the American balance-of-payments deficit. Commenting upon the elements of this important understanding, Cohen writes that "America's allies acquiesced in a hegemonic system that accorded the United States special privileges to act abroad unilaterally to promote U.S. interests. The United States, in turn, condoned its allies' use of the system to promote their own economic prosperity, even if this happened to come largely at the expense of the United States" (ibid.). As long as this bargain was sustained and not overly abused, the Bretton Woods system survived.

During this period the United States ran its foreign policy largely on credit by taking advantage of its role as world banker. It printed money to finance its world position, a tactic similar to the British issuance of "sterling balances" that British colonies and dependencies had once been required to hold. The willingness of Europe and Japan to loan money to the United States by holding inflated dollars in the form of interest-bearing United States government securities helped make it possible for the United States to maintain its troop commitments in Western Europe and elsewhere around the Soviet and Chinese periphery, to finance foreign aid, and, of course, to fight the Vietnam War. Lyndon Johnson did not have to compromise his cherished Great Society program or impose the costs of the program and the war on the American people through increased taxes. In return, the United States continued to tolerate not only discrimination against its exports by the European Economic Community and the Japanese but also their aggressive export expansion strategies. Each nation and the global system appeared to benefit from what can be seen in retrospect as complementary but highly self-centered and nationalistic policies.[7]

Being the supplier of the world's money had become a major source of power and independence for the United States. Initially, America's allies accepted this situation for the reasons discussed above. As time passed, however, many Europeans and Japanese began to believe that the United States was abusing the political and economic privileges conferred on it by the primacy of the dollar. As Charles de Gaulle so

[7] Whether or not the United States abused its power of seigniorage with respect to the international role of the dollar as the international currency is explored by Cooper (1975, pp. 69-73).

frequently complained, the Americans freely printed dollars to fight a colonial war in Vietnam, buy up foreign companies, and generally finance American political hegemony over Europe and the rest of the world. The solution, the French argued, was a return to the discipline of gold. Although few others accepted this Draconian measure, America's economic partners shared a growing concern over inflation, erratic currency speculation, and increasing monetary instability due to the vast overexpansion of the world's money supply. The United States was viewed as shifting the costs of its foreign and domestic policies onto other economies. The American attitude, on the other hand, was in essence that if other countries disliked what was happening, it was their responsibility to do something about it. This position became known as the doctrine of "benign neglect" and characterized U.S. policy until August 1971.

Inherent in this monetary and political arrangement were two basic asymmetries that eventually destroyed the Bretton Woods system in the 1970s. On the one hand, the role of the dollar as reserve, transaction, and intervention currency extended economic and political privileges to the United States that freed it from concern about its balance of payments in the conduct of its foreign policy or the management of its domestic economy. On the other hand, the United States, in contrast to other economies, could not devalue the dollar relative to other currencies in order to improve its trade and payments position. It was assumed that any devaluation of the dollar to improve the American competitive position would immediately have been wiped out by parallel devaluations of the pound, the mark, and other currencies.

Whereas the United States prized the first aspect of this asymmetry, it increasingly smarted under the fact that it could not devalue the dollar in order to improve America's declining trade position. Europeans and Japanese, of course, regarded this asymmetry from the opposite perspective, resenting America's export of inflation but prizing the effects of the overvalued dollar on their own exports. But as long as the American balance-of-payments deficit was moderate and the political unity of the three centers of non-Communist industrial power held firm, the issue remained largely dormant. When changing economic and political conditions accentuated the plight of the dollar and America's deteriorating trade position in the early 1970s, the asymmetries created by the international role of the dollar emerged as a basic issue in the reform of the international monetary system. Responding to these changes, the United States took decisive action to alter those aspects of the system that it disliked.

In order to understand the decisions eventually taken by the United

States, it must be appreciated that there is a latent political conflict in an international monetary system based on fixed rates. The basis for this conflict is the so-called N – 1 or consistency problem (Williamson, 1983, pp. 334-35). In a monetary system composed of N countries, N – 1 countries are free to change their exchange rate but one country cannot change its exchange rate, because its currency is the standard to which all other countries peg their currency values. There is a potential for conflict if everyone tries to change their exchange rate in order to improve their competitive advantage or to achieve some other objective; the conflict can be avoided only if one currency value remains fixed relative to all of the others.

For almost thirty years after the Second World War, the United States played this indifferent and stabilizing role; it was content to be passive regarding the value of the dollar. It did not care about the exchange rate of the dollar because of the overall strength of the American economy and because the foreign sector of the American economy was so small. Moreover, in the interest of cementing alliance relations with Japan and Western Europe, the United States subordinated its domestic economic interests to its larger political interests. The United States, therefore, let others change their rates or, in the case of Britain in 1949, encouraged them to change their rate primarily for the stability of the system. In short, the adjustment mechanism was essentially one of changing a currency value relative to the dollar.

This American attitude of benign neglect toward the increasingly overvalued dollar and declining trade balance began to change in the late 1960s and early 1970s. With the acceleration of the Vietnam War and the simultaneous expansion of the Great Society program by the Johnson Administration, American dollars flooded world financial markets. As other economies were forced to accept these dollars in order to maintain the fixed rates of exchange, U.S. inflation was transmitted to its economic partners via the monetary system. Subsequently, the Nixon Administration, in anticipation of the 1972 presidential election, provided yet another massive stimulus to the American economy, unleashing new inflationary forces and further undermining the value of the dollar. A number of other governments standing for reelection also stimulated their economies at the same time. The cumulative effects of this synchronization of the political-business cycle further accelerated world inflation and put increased strains on the system of fixed rates.[8] To appreciate these developments, it is necessary to return to a discussion of economic theory.

[8] See Tufte (1978) on the theory of the political business cycle.

In the 1960s, "the theory of economic policy" was developed to accommodate this more complex Keynesian world; it recognized that governments required separate policy instruments to achieve the internal objective of noninflationary growth with full employment and at the same time an external balance of international payments. The proper application of the theory would reconcile increased government intervention and international stability. As Harry Johnson wrote, "the post–World War II development of the theory of economic policy for an open economy by Meade, Tinbergen and others restored the concept of an automatic system, on the basis of the assumption that once the theory had been clearly laid out governments could be relied on to apply it intelligently, and deflate and revalue or reflate and revalue in the appropriate combinations as circumstances required" (H. Johnson, 1972, p. 409). These economists expected that nations would replace the automaticity of the gold standard with the choice of correct policy instruments at the *national* level, and for some years they believed that the Bretton Woods system had achieved these goals. But, as Johnson cautioned, "[the] major defect of [this policy prescription] is its assumption that governments have both the understanding and the power to follow its precepts, and that they will do so instead of using the understanding and the power to play international politics against their neighbors" (ibid.). This hope and admonition were not to be realized.

As the rise and ultimate decline of the Bretton Woods system illustrate, advances in economic theory per se did not solve the fundamental problem of the international monetary system, the potential conflict between national objectives and international order. Intelligent international leadership was the necessary condition for its resolution and, in the postwar era, as long as the United States was willing and able to supply such leadership, a liberal order triumphed over the forces of economic nationalism. When U.S. leadership faltered in response to the exigencies of the Vietnam War and the relative decline of U.S. power, technical economics could find no solution. The subsequent crisis of the international monetary system was less a problem of inadequate economic theory and more a political problem of inadequate economic and political leadership.

The persistent growth of global inflation from the late 1950s to the early 1970s, which would lead to American actions disruptive to the Bretton Woods system, presented itself as a new phenomenon (Williamson, 1983, pp. 386-87). In the past, inflation had been thought of as basically a national problem resulting from overambitious full employment policies. With the expansion of economic interdependence by

the late 1960s, it became clear that inflation was an international macroeconomic problem. Due to excessive monetary creation by the United States, inflationary forces were spilling over from one country to another throughout the entire world economy via the channel of price levels in integrated commodity and product markets as well as via capital flows. This novel "age of inflation" distorted currency values and undermined economic stability at both the domestic and global levels.

By mid-1971, the dollar had become seriously out of line with other major currencies and the differential rates of inflation between the United States and other market economies had produced a fundamental disequilibrium in exchange rates. Confidence in the dollar was rapidly eroding and causing havoc in foreign exchange markets. The American government was under pressure to convert tens of billions of dollars into gold, and the international monetary system was threatening to break down. Richard Nixon, faced with this rapidly deteriorating situation, announced on August 15, 1971, what would become, in effect, a new U.S. foreign economic policy. Responding to the first American trade deficit since 1893, rising pressures for protectionism, a massive outflow of gold, accelerating attacks on the dollar, and fears of a financial collapse, he took a series of forceful and unilateral actions designed to stem the outflow of gold and reverse America's rapidly declining economic fortunes (see Gowa, 1983).

First, the President suspended the convertibility of the dollar into gold and thus placed the world monetary system on a pure dollar standard. Second, he imposed a surcharge on U.S. imports in order to force the Europeans and the Japanese to revalue their currencies against the dollar. And third, he instituted wage and price controls as a means of arresting the accelerating rate of American inflation. The most significant outcome of these actions was a substantial devaluation of the dollar in December 1971 (the Smithsonian Agreement). Though successful in achieving its purpose, Nixon's blunt tactics of monetary reform proved disruptive to the relations among the dominant economic powers. He destroyed a central pillar of the Bretton Woods system by unilaterally delinking gold and the dollar.

In brief, as Joanne Gowa (1983) has argued, the American hegemon smashed the Bretton Woods system in order to increase its own freedom of economic and political action. The growing power of Western Europe and Japan was threatening to place restraints on American autonomy, because the vast holdings of dollars by Europeans and Japanese meant that if the dollar were to hold its value and the dollar-exchange system were to be preserved, American policy would have to conform to their wishes. Rather than see its autonomy curbed, the

United States chose to abandon the system. As a former American official put it, "the growing economic and political strength of Europe and Japan made the Bretton Woods system obsolete" (quoted in Keohane, 1985, p. 97).

In 1973, the Bretton Woods system came to an end. In March, the decision was taken to let exchange rates float. Then, the quadrupling of world energy prices in the OPEC revolution dealt another severe blow to the system (Williamson, 1983, p. 392). Its impact on international balances of payment and on financial markets confronted the dominant economic powers once again with the task of realigning their currencies. In contrast to the Smithsonian Agreement, however, in which the currency realignments had been forced upon other countries by the United States and then negotiated multilaterally, the key actor this time was West Germany, which refused to continue to support the dollar. In effect, the United States and its economic partners decided to abandon the postwar system of fixed exchange rates in favor of one based on flexible rates. The refusal of an important ally to follow American economic leadership led to the abandonment of a key component of the Bretton Woods system.

The de facto end of fixed exchange rates and the Bretton Woods system was made de jure in 1976, at a meeting of the leading IMF members held in Kingston, Jamaica. The Jamaica Conference decided as follows: (1) floating exchange rates were legalized, (2) the reserve role of gold was reduced, (3) IMF quotas were increased, especially those of OPEC countries, (4) funding for the less developed countries was increased, and, most important, (5) the determination of the par value of a currency became the responsibility of the country itself. Domestic autonomy had triumphed over international rules; nations disengaged from the requirements of a fixed-exchange system in order to pursue one or another national objectives such as expanding exports, stimulating economic activities, or preventing the importation of inflationary pressures.

The Jamaican meeting confirmed the end of one monetary regime but it did not signal the birth of its successor. It failed to establish the essential characteristics of a stable monetary order: an international money, an adjustment mechanism, and monetary leadership. Although other currencies such as the yen and the mark increased in importance, the dollar could no longer be exchanged for gold; the world was left in essence with a pure (but inherently unstable) dollar standard. Efforts to solve the liquidity problem, such as absorbing excess dollars through the creation of a substitution account or strengthening the role of the SDR, were abandoned. Erratic American monetary policy remained

free to pour too much or too little liquidity into the system and thus to cause unstable exchange rates and cyclical economic fluctuations. Nor was the issue of the international distribution of liquidity and its effects on the less developed countries addressed. The confidence problem and the danger it posed to international monetary stability was not resolved. The adjustment problem was assumed to have been eliminated by the shift to flexible rates that would enable the operation of the price mechanism to realign currencies automatically. Regrettably, it was not to be this simple, as the 1980s would demonstrate.

To summarize, Jamaica was silent on such critical aspects of a stable international monetary order as adjustment and liquidity. In effect, each nation was free to determine monetary matters for itself rather than subordinate to international rules. As Peter Kenen has described it, what took place in Jamaica in 1976 was a move toward renationalization of the world monetary system; individual nations were given greater responsibility for the determination of their own currency values (Kenen, 1976, p. 9). The dilemma of national autonomy vs. international norms appeared to have been resolved in favor of the former.

The abandonment of Bretton Woods and the system of fixed exchange rates meant the loss of international financial discipline. The door had been opened for the vast expansion of private, national, and international debt that occurred in the late 1970s and early 1980s. Without fixed exchange rates, there were no longer external restraints on national behavior. As a result the world monetary and financial system became increasingly unstable, and the threat of a collapse of this system became a major concern for the international political economy. The danger of global inflation became inherent in the system.

By its actions in the 1960s and 1970s, the United States had forfeited its role of monetary leadership. With its adoption of inflationary policies and its stance of "benign neglect," the United States had in fact become part of the problem rather than the leader in the search for a solution. In the mid-1980s, the relative decline of American power and America's unwillingness to manage the international monetary system stimulated proposals for collective leadership, especially in the form of policy coordination and new rules to govern the international monetary system.

The Non-System of Flexible Rates

Advocates of the shift from fixed to flexible exchange rates believed that this change would resolve the fundamental problem of the clash between domestic autonomy and international norms. Under the Bret-

ton Woods system of fixed exchange rates, national economies had become closely linked, thereby constraining domestic policy options. When exchange rates remained fixed, a disequilibrium in the balance of payments necessitated domestic adjustments and required changes in national levels of economic activity or (even less likely to occur) the imposition of direct controls over the economy such as restrictions on capital flows. This system of fixed rates collapsed because the differential rates of inflation between the American and other advanced economies imposed increasingly high costs on domestic economies.

With the official shift to a regime of flexible rates following the Jamaica conference, it was assumed that national economies would be delinked from one another. It would therefore no longer be necessary for a state to regulate the domestic level of economic activity in order to maintain existing currency values; adjustment could take the form of market-induced changes in currency values. This would isolate the national economy and domestic economic management from external developments and international constraints. Of equal importance, domestic policy decisions in one economy would not impinge on other economies, so each economy would be free to carry out its macroeconomic policies and to set its own economic priorities depending upon its preferences, such as that of the presumed trade off between the rate of inflation and unemployment levels.

For this solution to the adjustment problem to work as expected, states had to be willing to leave the determination of their exchange rates up to the market. Yet, in a highly interdependent world economy, states are tempted to manipulate their exchange rates in order to improve their relative position, and the actions of one country can seriously impinge on the welfare of others. For example, a state may engage in "dirty" floating to depress its currency and thereby improve its trade competitiveness or, alternatively, may attempt to raise its currency in order to fight inflation. The system of flexible rates proved once again that international money *does* "matter."

A number of fundamental changes in the nature of the international political economy explain why expectations for the success of the flexible exchange system were not fulfilled. A system of flexible rates was generally expected to: (1) insulate an economy against supply shocks like those engineered by OPEC in 1973-1974 and 1979-1980 (Williamson, 1983, p. 209), (2) limit synchronizations and amplifications of the business cycle like those that occurred in the global inflation of 1973 and the recession of 1975 when industrial economies simultaneously pursued first expansionary and then restrictive policies (Williamson, 1983, p. 385), and (3) stabilize exchange rates (Williamson, 1983,

p. 233). Flexible exchange undoubtedly did facilitate international accommodation to the economic upheavals of the 1970s: the two energy shocks, hyperinflation, and the breakdown of Bretton Woods (Cooper, 1983, p. 36).

In the mid-1980s there had been no test of whether or not the flexible exchange system would permit desynchronization of business cycles so that alternately some economies would expand while others contracted. This was generally due to the European and Japanese fear that expansionary policies would cause renewed inflation (Williamson, 1983, pp. 385-86). The system of flexible rates failed to achieve its objective of monetary stability. Exchange rates became highly volatile following its inception, and this had harmful effects on international trade and financial markets.

The crucial assumption that, under a system of flexible rates, domestic economic management would not be constrained by international factors had become increasingly unrealistic beginning in the late 1950s with the European removal of capital controls and the formation of the so-called Eurodollar or Eurocurrency market. This change in economic reality ("revolution" might not be too strong a characterization) continued with (1) the tremendous growth of world liquidity and financial assets due largely to the chronic American payments deficit and the subsequent generation of the OPEC surplus and (2) the increasing integration of world financial markets. By the mid-1970s, due to new technologies and the deregulation of national financial institutions, the volume of the international flow of capital assets exceeded the volume of world trade many times over.[9] According to one estimate, in 1979 total exports were $1.5 trillion compared to foreign exchange trading of $17.5 trillion; by 1984, whereas exports had increased only to $1.8 trillion, foreign exchange trading had ballooned to $35 trillion (*The New York Times*, May 4, 1986, p. F10). In a world where huge amounts of money and capital overwhelmed trade flows and were free to move across national boundaries in search of security and higher interest rates, international capital movements and the overall balance of payments became an important determinant of international currency values and especially of the exchange rate of the dollar.

Economists remain divided on the issue of what determines exchange rates, especially short-run movements, in a system of floating exchange rates. Several contending theories have been put forward by Keynesians, traditional monetarists, and other schools to explain exchange-

[9] BIS (1986) analyzes the causes and nature of the revolutionary changes in international finance.

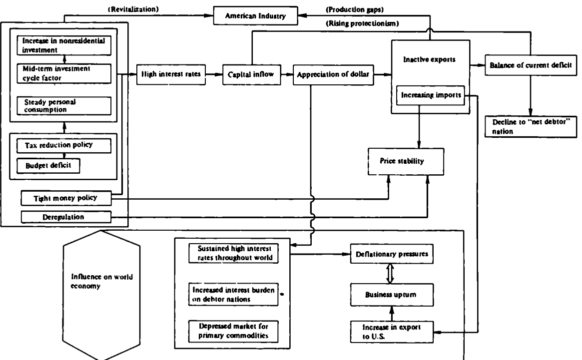
rate behavior (Williamson, 1983, pp. 206-248). In such a situation the noneconomist should be cautious in drawing conclusions on these matters.

What does appear to be substantiated, however, is that macroeconomic policies, and particularly American fiscal/monetary policies, have become an important determinant of exchange rates, most certainly for the dollar, at least in the medium term. These American policies, principally through their influence on interest rates, largely determine the international flow of capital, which in turn affects the exchange rate and currency values. When the Bretton Woods system was established and when the shift to flexible rates was made at Jamaica, little attention was given to the possibility that capital movements would significantly affect exchange rates. However, in the early 1970s and again a decade later, capital movements became a destabilizing feature of the international monetary and financial system.

As such developments indicate, national economies are indeed linked together so that flows of capital and assets in response to differential rates of interest tend to undermine domestic policy autonomy. Macroeconomic policies in one country do affect the economies of other countries. The fiscal and monetary policies of all open economies affect one another through the international capital market. If a country restricts its money supply in order to fight inflation, the consequent rise in the domestic interest rate causes an inflow of capital that then defeats the original policy objective and raises the exchange rate. The adjustment problem and exchange-rate stability are intimately related to domestic policies, and it is impossible to keep the pursuit of domestic objectives separate from the stability of the international economy and monetary values.

Because of these interrelationships, the transition from fixed to flexible rates was followed by erratic exchange-rate fluctuations, especially for the dollar. This volatility in turn caused international transmission of economic disturbances. Rather than smooth adjustment of rates, excessive swings of currencies characterized the system. Since the dollar continued to be the basis of the international monetary system and because the American economy had such a large scale, fluctuations and disturbances tended to originate in the United States. American monetary expansion in 1976-1977 caused a sharp depreciation of the dollar in 1977-1978 and an increase in world inflation. In October 1979, restrictive American monetary policy led to a sharp appreciation of the dollar, accentuated the global recession triggered by the second OPEC price rise of 1979-1980, and stimulated the spread of trade protectionism (Kenen, 1984, p. 18). In 1981, restrictive monetary policy designed

FIGURE 2
The World Economic-Cycle under the Reagan Administration



Source: *White Paper on International Trade—Japan 1985* (Tokyo: Japan External Trade Organization, 1985), p. 8.

to fight inflation dried up world liquidity, drove up the value of the dollar and global interest rates, and aggravated the world debt problem. By the mid-1980s, expansionist American economic policy caused the dollar to become greatly overvalued, with detrimental effects. Whatever the United States did, its policy had a negative impact on the rest of the world. As one European quipped, the American economy was unsafe at any speed (ibid., p. 19).

Erratic American macroeconomic policies and the equally self-centered responses of other governments undermined the stability of the international monetary system. The movement to flexible rates had encouraged a cycle of worldwide inflation and recession. The United States alternately poured too much or too little liquidity into the system, and other nations, because of their own domestic structural problems, responded in ways that aggravated the problem. In the words of Ronald McKinnon, the international monetary system became "out of control." President Ronald Reagan's economic policies and their impact on the rest of the world, as will be argued below, provided the most dramatic example of this judgment. (See Fig. 2.)

The most significant response to these developments in the area of international monetary relations was the 1978 launching of the European Monetary System and the creation of the European Currency Unit (ECU) (Kruse, 1980). Faced with an extremely weak dollar and the transmission of American inflation abroad, the West Germans and other Continental powers agreed to strengthen the alignment of their currencies, to increase coordination of their economic policies, and to lessen the probability of policy competition. As Robert Triffin has suggested, this initiative implied an increasingly decentralized and regionalized international monetary system (Triffin, 1985, p. 22).

With increased interdependence and frequent spillovers from one economy to another, national economies were in a classic Prisoner's Dilemma: although they could all gain through cooperation, a powerful incentive existed to attempt to gain at the expense of other economies. Every government was tempted to export its domestic problems of unemployment and inflation to its economic partners. Such noncooperative action creates the possibility that everyone may lose and be in a weaker position than if they had cooperated with one another. For example, under flexible rates, a government has a powerful incentive to pursue policies that cause its currency to depreciate and thereby improves its international competitive position. If every government did this, however, the results would cancel one another, because all countries would have excessively contractive policies and thus cause a drop in global output and losses for every economy (Sachs, 1983).

This dilemma and the strategic interaction of national policies are inevitable consequences of an interdependent world economy composed of nation-states pursuing independent economic policies. The situation has been accentuated by the shift to flexible rates and the decline of American economic leadership. The nature of the problem has been well expressed by Cooper:

> the structure of the world of nations lies far from what would be required to meet the conditions of perfect competition. There are only about 160 members to the community of nations, many of which are large enough to influence *some* of the markets in which they operate, a few of which are large enough to influence all of the markets in which they operate. In short, the community of nations exists in the presence of extensive monopoly power—although, as with private monopoly power, it is limited by the alternative opportunities that other nations have. The attempt to exercise this limited monopoly in the pursuit of national objectives—to improve the terms of trade or to draw resources from the rest of the world—violates the conditions of "competition" and gives rise to the pervasive possibility of pushing economic policies toward global suboptimality. That in turn gives rise to possible gains from collusion, or, as it is more politely called in the context of economic policy, cooperation and coordination in order to enhance attainment of national economic objectives (Cooper, 1985, p. 1221).

In *The Economics of Interdependence* (1968), Cooper first presented the need for international cooperation to achieve optimal outcomes as follows: (1) "interdependence increases the number and magnitude of the disturbances" to a nation's balance of payments, (2) it "slows down the process by which policy authorities are able to reach domestic objectives," and (3) economic integration can cause "nations to behave with counteracting motions that leave all countries worse off than they need be" (summarized in Hamada, 1979, p. 294). Thus, the preferred solution to the Prisoner's Dilemma caused by increasing interdependence was international economic cooperation, which would keep the benefits of international economic relations without sacrificing the pursuit of legitimate domestic objectives and thereby would reconcile the clash between international norms and domestic autonomy (Cooper, 1968, p. 5).

The achievement of macroeconomic policy coordination necessitates a formal resolution of the $N-1$ problem discussed earlier (Frenkel, 1985, p. 17). Whether one is discussing a system of relatively fixed or floating rates, a particular currency or a prescribed basket of currencies must be established as the yardstick by which the value of all other currencies can be determined. The achievement of such an agreement will

be exceptionally difficult because of its implications for domestic welfare and trade balances.

Under the system of fixed exchange rates, as noted above, the solution of this crucial problem and the achievement of macroeconomic policy coordination had been a rather simple matter. The United States maintained the gold parity of the dollar at $35 per ounce and other countries committed themselves to peg their own currencies to the dollar. As the United States seldom intervened in foreign exchange markets, there was little possibility that American and foreign monetary authorities would operate at cross-purposes. The dollar-exchange system worked and national policies were coordinated because of an implicit political agreement upon a set of economic policy tradeoffs; other governments subordinated their monetary and other policies to the maintenance of fixed rates and the United States reciprocated by stabilizing the domestic and international purchasing power of the dollar.

The breakdown of this cooperation resulted in the collapse of the system of fixed rates. In 1970, the Federal Reserve lowered U.S. interest rates in order to stimulate the economy and thereby help reelect Nixon. West Germany, then the second-greatest monetary power, was attempting to hold interest rates up or actually raise them in its fight against inflation. As the two financial systems were joined through monetary and financial markets, the billions of dollars created in the United States to lower interest rates there flowed into the German economy. The American "liquidity deficit" of $2 to $4 billion a year suddenly ballooned to $20 billion in 1971 and $30 billion in 1972, thereby flooding the world with inflationary dollars. The German government refusal to buy these dollars and thus support the increasingly overvalued dollar and the subsequent stampede out of the dollar led to the August 15, 1971, actions of the Nixon Administration and the subsequent denouement of the Bretton Woods system of fixed rates.

The onus for this collapse of political and economic agreement and the destruction of the Bretton Woods system falls largely upon failures of American political leadership. For both foreign policy and domestic reasons, successive American administrations pursued expansionary and inflationary monetary policies that eventually undermined the value of the dollar and destabilized the monetary system. Subsequently, other governments became less willing to subordinate their own macroeconomic policies to the objective of international economic cooperation. The result has been that national policies frequently have interacted to produce a cycle of inflation and recession. In the 1980s, economists and policy makers became greatly concerned about break-

ing this cycle, and some of the proposed solutions are indicative of the severity of the problem.

For purists, a return to the automatic mechanism of the gold standard provides the best solution to international monetary instability. The essence of the problem, according to this position, is the lack of social discipline in the modern welfare state. The growth of unwieldy government welfare programs, the extreme temptation to finance government through budget deficits, and the powerful inflationary pressures inherent in Keynesian policies are seen as products of the newly found capacity of governments to control the money supply. A return to the discipline of the gold standard and the elimination of "political" money would abolish the inflationary bias of modern governments. International norms would be firmly reimposed on errant politicians. However, whatever the economic merits of this solution might be, no state appears prepared to reverse the Financial Revolution by voluntarily relinquishing control over its money supply and abandoning domestic policy autonomy.

The Reagan Administration, especially during its first term, believed that the solution to the problems of the world economy was policy convergence. It believed that difficulties derived primarily from the misdirected policies and economic structures of other countries. Although the United States joined its economic partners as early as the 1982 Versailles summit in declaring that "we accept a joint responsibility to work for greater stability of the world monetary system," until September 1985 it remained largely committed to its own version of "benign neglect" announced in the spring of 1981. The responsibility for solving the problems of the international monetary order and the American trade deficit lay with other countries.

Rather than the extensive policy coordination and reduction of its budget deficit advocated by its allies and by most American economists, the principal Reagan Administration solution to world economic problems was that of the convergence of domestic policies. This meant the alignment of national economic policies to lower inflation, the use of the IMF to monitor the accomplishment of this task, and the adoption by other countries of expansionary economic policies in order to reduce the American trade deficit. According to this formulation, the American economy had been restructured to enable it again to pursue noninflationary growth policies. Moves toward the elimination of government regulation and the privatization of the public sector, the reduction of economic interventionism, and the dismantling of the welfare state under the banner of supply-side economics, the Reagan Administration argued, had weakened the sources of domestic infla-

tion. If other economies carried out similiar policies, they would also be able to overcome their problems of high unemployment and slow growth. The strong dollar was believed to be proof of American economic strength and the correctness of the American policy. The solution, therefore, was the convergence of the policies of other governments toward those of the United States. In the mid-1980s, however, few other governments were prepared to accept either this diagnosis or the Reagan Administration economic prescriptions.

International coordination of economic policies was the third and most popular solution within the American economics community, one that would win the support of the Reagan Administration in its second term due largely to the influence of Secretary of the Treasury James Baker III. The diagnosis given by economists supporting policy coordination was that the increased interdependence among economies through the integration of financial and product markets, the intensified linkages among prices and interest rates, and the increased information flows had led to a high level of policy interdependence among the advanced economies (Cooper, 1985). These developments had locked the United States, Western Europe, and Japan into a classic game-theoretic or strategic situation in which the policy decisions of each influenced and affected the policy decisions and outcomes of the others. Each government had to take account of the actions and possible responses of others as it formulated its own economic policies, and achievement of its objectives depended upon the behavior and reactions of other economies. In such a situation, optimum outcomes and the avoidance of policy competition could be achieved only through international cooperation.

The solution proposed by a number of distinguished economists was that the United States and its principal economic partners should coordinate their macroeconomic policies and in effect formulate a macroeconomic policy for the entire world. The objective would be to achieve economic growth and full employment for every economy. Through agreement on the growth of aggregate global monetary levels, the dominant economic powers would be able to contain inflation and carry out counter-cycle economic policies. Collective leadership of the world economy would be substituted for the decline of American leadership.

THE ISSUE OF POLICY COORDINATION

Although the meanings of the term "policy coordination" range from ad hoc agreements such as the so-called G-5 agreement of September 1985 to formal and highly technical proposals, it can be understood as

an attempt to recapture the spirit of cooperation that had provided the political foundation for the operation of the Bretton Woods system of fixed exchange rates and international stability from 1945 to 1971. However, a return to a dollar-based system of fixed exchange rates is assumed to be impossible for both economic and political reasons. In an era of integrated capital markets and attractive alternatives to the dollar such as the mark and the yen, the U.S. Federal Reserve by itself can no longer manage the international monetary system. Furthermore, what others had earlier perceived as American abuse of the monetary system along with the relative decline of American power appears to necessitate a cooperative solution to the problem of international monetary instability. Although the best long-range solution, in the judgment of many experts, would be a world bank, a strengthened IMF, or the establishment of a common world currency such as the SDR, the second-best solution was believed to be international policy cooperation (Cooper, 1984, pp. 2-4).

Among the several proposals for macroeconomic policy coordination, none was more ingenious or more illustrative of the problems involved than that put forth by Ronald McKinnon (1984). Whereas traditional monetarists focused on the growth of the money supply in an individual country, McKinnon's "global monetarist" view was that the integration of national economies necessitated the control of the "world money supply." The alternate contraction and expansion of this global supply, according to his analysis, was the cause of deflationary and inflationary fluctuations of the international economy. Because the economies of three countries—the United States, West Germany, and Japan—accounted for nearly two-thirds of the industrial world's output, destabilizing fluctuations in the global supply of money could be controlled if these three countries coordinated their money supply.

In essence, McKinnon proposed that the three major centers of economic power agree upon and set a target for the growth of the world's money supply. Each would direct its domestic monetary policy toward exchange-rate stabilization, expanding and contracting the money supply as necessary to maintain monetary values. Together, these three "hard currency" countries would in effect impose a rule of global monetary growth on the rest of the world, ensuring a stable and noninflationary increase in world liquidity. This cooperation among the three dominant powers would be tantamount to a return to the regime of fixed rates.

The purpose of this tripartite condominium would be to coordinate the global supply of money while preventing synchronized contraction and expansion of national monetary policies. The tendency of these

economies, according to this global monetarist analysis, has been to pursue Keynesian understimulation or overstimulation of their economies and thus produce a global cycle of deflation and inflation. A leveling-out of the global money supply could be achieved if one or another of the major economies contracted its money supply in order to offset the expansionary polices of its partner(s). Through the displacement of synchronous policies by offsetting or countercyclical policies, the three major centers of economic power would be able to stabilize the value of the dollar and bring order to the system.

The actual composition of the global money supply in terms of dollars, marks, and yen would be determined through the combination of a complex econometric formula and central bank decisions rather than on the basis of particularistic national objectives. An international monetary rule would displace national discretion and determine the global supply of liquidity. Thus, technical economic criteria and objective factors rather than parochial political and national interests would determine the rate of monetary creation. In time, the experience of monetary cooperation would and should lead to "complete financial unification among the reserve currency countries" (McKinnon, 1984, p. 75). Over the long term,

> the international cycle of inflation and deflation—through uncontrolled changes in world money and the dollar exchange rate—would be smoothed. The efficiency of international trade should be restored and protectionist sentiment should diminish once arbitrary changes in exchange rates are eliminated. As in an idealized gold-standard regime, domestic and international money would become virtually the same (ibid.).

The world would be returned to the liberal dream of a neutral, automatic, and depoliticized international monetary system.

An unspoken but major purpose of this scheme would be to rein in the United States, the rogue elephant of the global economy. Whether intentionally or not, its erratic macroeconomic policies have seriously disrupted the international monetary system, caused destabilizing fluctuations in the value of the dollar, and stimulated massive speculative flows of capital seeking to take advantage of interest-rate differentials or projected changes in exchange rates. Policy coordination like that proposed by McKinnon would force the United States to become once again a stabilizing influence, as it was under the system of fixed rates.

In effect, McKinnon proposed the creation of a world economic government. The United States had assumed an hegemonic role of economic governance in the 1950s and 1960s; its central bank had managed the international monetary system and its currency had become

the world's principal currency. Now, in the late 1980s and beyond, a "triumvirate" (to use McKinnon's term) of the United States, Japan, and West Germany would govern the international economy. Their central banks would cooperate to manage the money supply and their stable currencies would replace the dollar as the world currency. Thus, the fading hegemony of the United States would be replaced by the leadership of the three dominant economic powers.

For this system to succeed, the three governments would be required to subordinate their domestic policies and, for the United States at least, perhaps even some of its independence in foreign policy, to agreed international economic norms. (Under such a scheme, for example, the United States would not be able to fight a major war as it did in Vietnam, with the attendant monetary consequences, unless it had the explicit support of Japan and West Germany.) Fiscal, commercial, and balance-of-payments policies as well as monetary policies would have to be coordinated. Even labor costs would have to be coordinated and kept under a tight lid to avoid inflationary wage settlements that could cause monetary values to get out of alignment. In short, the political and economic prerequisites of successful policy coordination (at least as conceived by McKinnon and other experts) would be formidable indeed.

Despite its inherent difficulties, this type of coordinated solution gained support in the 1980s, within the Reagan Administration and elsewhere. Some in Washington saw the coordination of national economic policies as a means of overcoming the domestic political stalemate with respect to the budget deficit and economic policy. If the United States could not resolve its own problems, perhaps it could get its economic partners to help. Similarly, other countries saw policy coordination in terms of relieving their own economic difficulties by getting the United States or Japan to take certain actions. It would not be too much of an exaggeration to say that the purpose of policy coordination, in the eyes of each of the leading economic powers, is to get its economic partners to do what it wants done but without doing what they want done.

The Reagan Administration and Policy Coordination

The Economic Recovery Tax Act of 1981 and the ensuing federal budget deficit of approximately 5 percent of the GNP had a profound and unanticipated impact on the world economy. What occurred, however, had been predicted in a classic article written in 1966 by Robert Mundell. As summarized by Peter Kenen, Mundell argued that:

when international capital flows are sensitive to interest rate differences and exchange rates are floating, a country that runs a large budget deficit and does not finance it by printing money will incur a large current-account deficit but will have a strong currency too. The budget deficit will push up interest rates and pull in foreign capital. When exchange rates float, however, a country with a net capital inflow has to have a matching current-account deficit, and its currency must appreciate sufficiently to generate that current-account deficit. In other words, the country must become less competitive in its own and world markets" (Kenen, 1984, pp. 18-19).

Although American consumers and exporters to the United States benefited from this expansive fiscal policy, it had major detrimental effects on the American and world economies. The need to finance the U.S. budget deficit raised global interest rates and reduced investment throughout the world. Other economies responded by restraining domestic demand in order to hold down inflationary pressures and shifted to export-led growth strategies. American absorption of huge amounts of world capital to finance its budget deficit and to compensate for the low rate of U.S. savings moderated the consequences for capital formation in the United States. The resulting overvalued dollar, however, had a devastating impact on American exports and on large sectors of American industry and therefore triggered powerful protectionist forces. In addition, high interest rates exaggerated the world debt problem. The shift to flexible rates and the integration of capital markets had greatly magnified the impact of American macroeconomic policies on the rest of the world.

Despite the impact of its macroeconomic policies on American producers and the balance of trade, throughout its first term the Reagan Administration adhered to the concept of policy convergence. The strong dollar and the flow of funds into the United States were interpreted as a sign of economic strength and the success of Reaganomics, and other sluggish economies were admonished to follow the American example. The attitude of the administration toward the complaints of other countries that the U.S. budget deficit and high dollar were distorting the international monetary and financial system was succinctly expressed in the arrogant words of Treasury Department Under Secretary Beryl Sprinkel: "Let them worry about their exchange rates and we will worry about ours." Benign neglect had become malign neglect.

During the second Reagan term this attitude of indifference began to change. The massive growth of the national debt, the huge trade deficit, and the advent of a new economic team headed by Baker led to the abandonment of the orthodoxy of supply-side economics and also, verbally at least, of the concept of policy convergence. Although the infla-

tion rate had been lowered and economic growth had been restored during the second half of President Reagan's first term, the overvalued American dollar had become a serious problem in its own right and many believed that the correction of the exchange rate should, for the first time, become an explicit and primary objective of economic policy. The American trade imbalance was distorting the American economy, stimulating protectionist sentiments, and destabilizing international economic relations. The administration had realized that the cooperation of its economic partners was required if the situation were to be corrected.

In September 1985, the Reagan Administration launched its first serious effort to achieve macroeconomic policy coordination and secure the monetary cooperation of its economic partners. Alarmed over increasing protectionist sentiment in Congress, the Reagan Administration pressured West Germany, Japan, and other major economies to intervene in monetary markets in order to lower the value of the dollar and to stimulate their own economies, thereby eliminating the growing U.S. trade deficit. The dollar had appreciated approximately 60 percent between June 1980 and March 1985. The task of policy coordination was to bring it back down and make American goods competitive once again in world markets.

In combination with important changes in market forces such as lowered interest rates, the prospect of a declining American budget deficit, and the dramatic drop in the price of oil, this coordinated interventionism by the Group of Five (G-5) caused an estimated one-third devaluation of the dollar against the yen and the mark by March 1986 from the peak value it had reached in early 1985. The ostensible American shift from policy convergence to policy coordination had apparently worked, and the administration grew optimistic that the trade deficit would disappear.

The early success of the G-5 policy coordination led Reagan, in his State of the Union message delivered in February 1986, to make policy coordination a major objective of the United States for the first time. The stated purpose of coordinated action would be to eliminate currency fluctuations and achieve agreed-upon "target zones" for the major currencies; in effect, the administration was proposing a return toward fixed exchange rates. Thus, the G-5 agreement and the President's pronouncement revealed a significant movement away from the earlier stance of the administration on the issue of policy coordination. The United States had been stirred to decisive action by its growing realization that the huge American trade deficit was leading to trade protectionism.

The story of the impact of the Reagan budget and resulting trade deficits on the American economic position in the world and foreign economic policy is told in Figure 2 above and in Table 2. Between 1976 and 1984, the trade deficit jumped from $9.3 billion to $108.3 billion, of which a rising fraction was with Japan. Even in sectors of traditional competitive strength such as agriculture and "high-technology" products the American surplus was declining. To finance its budget deficit, the United States borrowed heavily from other countries, with the result that its net foreign claims shifted in the mid-1980s from positive to negative. Whereas its net earnings on foreign investments were over

TABLE 2. The U.S. Trade Balance *(in billions of current U.S. dollars)*

	Total			Manufactured Goods[a]		
	U.S. Exports	U.S. Imports	Net Exports	U.S. Exports	U.S. Imports	Net Exports
U.S. Multilateral Trade						
1976	114.7	124.1	−9.3	67.3	64.6	2.7
1977	120.8	151.7	−30.9	69.6	76.9	−7.3
1978	142.0	175.8	−33.8	81.9	100.1	−18.2
1979	184.5	211.8	−27.3	99.4	110.9	−11.6
1980	224.2	249.6	−25.3	123.2	122.4	0.8
1981	237.0	256.1	−28.1	133.1	139.1	−6.0
1982	211.2	247.6	−36.4	119.8	140.3	−20.6
1983	200.7	262.8	−62.1	112.7	159.3	−46.6
1984	220.3	328.6	−108.3	121.4	217.9	−96.5
U.S.-Japanese Bilateral Trade						
1976	10.0	16.9	−6.9	2.8	16.0	−13.2
1977	10.4	20.3	−9.9	2.8	19.2	−16.5
1978	12.7	26.5	−13.8	3.7	25.2	−21.6
1979	17.4	28.2	−10.8	5.2	26.8	−21.5
1980	20.8	33.0	−12.2	6.6	31.4	−24.7
1981	21.8	39.9	−18.1	7.2	38.1	−31.0
1982	20.7	37.7	−17.0	6.8	38.2	−31.3
1983	21.7	41.3	−19.6	7.5	41.5	−34.0
1984	23.3	57.3	−34.0	8.1	57.9	−49.8

[a] Manufacturers, machinery and transport equipment, and miscellaneous manufactures.

NOTE: Figures for total trade are f.o.b. Exports of manufactured goods are f.a.s., and imports are c.i.f. (Thus, imports of manufactured goods can be larger than total imports.)

SOURCE: Stephen E. Haynes, Michael M. Hutchison, and Raymond E. Mikesell, *Japanese Financial Policies and the U.S. Trade Deficit*, Essays in International Finance, no. 162, International Finance Section, Dept. of Economics, Princeton University, 1986, p. 3; Haynes et al. cite *Survey of Current Business* and *Highlights of U.S. Exports and Import Trade*, both U.S. Dept. of Commerce, various issues.

$34 billion in 1981, by 1985 the United States also was moving toward a deficit with respect to investment income. This dramatic reversal of the trade and investment positions was causing American protectionism, especially against the Japanese, to increase significantly.

By the late spring of 1986, in order to arrest this deteriorating situation, the Reagan Administration moved more forcefully toward policy coordination and adopted the concept of "automaticity." It wanted an international agreement on a set of predetermined rules and automatic procedures to force other countries into corrective actions to bring down the value of the dollar and eliminate the American trade deficit. The administration had moved decisively away from its earlier monetarist position of letting the market determine exchange rates. Intervention in exchange markets, changes in domestic economic policies, and the realignment of currencies would be based on a set of objective economic criteria such as national inflation rates, growth rates, and unemployment rates. The world would thus be returned to what the Reagan Administration regarded as a mutual compatibility of economic policies.

At the Tokyo summit meeting of Western leaders in early May 1986, the Reagan Administration tried to act on the basis of its conversion to the concept of "managed floats." Although the other summit participants agreed with the idea of increased cooperation, they refused to accept the American concept of "automaticity" and the establishment of a set of objective criteria and formal rules to govern national economic policies. They preferred a more discretionary approach to international cooperation, one that would enable them to exercise domestic economic autonomy.

America's economic partners feared that agreement on a system of managed currencies would mean a return to the problems of the 1970s, and they were strongly opposed to a close relinking of their economies with that of the United States. A commitment on their part to defend established currency values could subject them to inflationary dollar inflows, as had happened before, or the United States might force them to adopt high exchange rates that would harm their export industries. As one European official put it: "We would all be dependent on the U.S. dollar . . . and the U.S. doesn't take sufficient notice of other nations in international monetary affairs" (*The Wall Street Journal*, March 14, 1986, p. 30). They regarded the initiative of the Reagan Administration for automatic and binding rules as an attempt to reimpose American hegemony on the global economic system.

The summit agreement for "enhanced surveillance" over exchange rates and economic policies was a compromise between the American

desire for inflexible rules and the desire of its partners for discretion. In order to end exchange volatility and to realign currencies within agreed-upon target zones, the Western powers committed themselves to "close and continuous" coordination of their economic policies. A system of managed currencies would be achieved through agreement on mutually beneficial economic goals. Through the creation of a new international body, the Group of Seven, composed of finance ministers and central bankers, national economic goals and target exchange rates would be supervised by taking into account such "economic fundamentals" as growth rates, inflation rates, unemployment rates, budget deficits, trade balances, monetary growth, currency values, etc. Thus, currency values would be linked to the overall economic performance of the capitalist economies. Whenever "significant deviations" from an agreed-upon national policy occurred (i.e., whenever one nation's policy caused difficulty for others), the economic officials were to "make their best efforts to reach an understanding" on what corrective action was to be taken, for example, altering interest rates, reducing budget deficits, and, if necessary, intervening in the foreign exchange market. In such cases, however, although "peer pressure" would be exerted, the decision on the specific action to be taken would rest with the delinquent country itself (*The New York Times*, May 8, 1986, p. A6).

Although at this writing it is much too early to determine the probable success of this initiative for multilateral surveillance and a coordinated management of the world economy, the obstacles to be overcome are profound. They reside in the fundamentally different economic and political agendas of the major powers, differences that were masked by the language of the agreement. The international coordination of economic policies had a significantly different meaning for each of the summit participants and it is questionable whether compromises could be found among their conflicting objectives. The lowest common denominator of the agreement was the hope that it would forestall a breakdown of the international economy and could provide a basis to get other countries to take particular desired actions.

Despite its ostensible abandonment of the concept of policy convergence, the United States continued to adhere to this idea as the solution to the difficulties of the world economy and its own economic ills. The Reagan Administration believed that the fundamental problem was the "growth gap" between the American and other economies and not the American budget deficit. From its perspective, the purpose of international coordination of economic policies was to prod the two other strong economies—Japan and West Germany—to reverse course and restimulate their economies. Through expansionary economic policies

these economies would move away from their reliance on export-led growth and would increase their imports. If Japan and West Germany took appropriate actions, the administration believed, the problems of the overvalued dollar and the U.S. trade deficit would be eliminated.

Japan and West Germany, on the other hand, considered the American budget deficit and lack of economic discipline to be the fundamental problem of the world economy. American fiscal policy, in their judgment, was primarily responsible for high global interest rates, the overvalued dollar, and the consequent American trade imbalance. Therefore, they believed that the purpose of policy coordination was to encourage the United States to eliminate its huge budget deficit. This corrective action, by bringing down interest rates and the value of the dollar, would stimulate world economic growth and reduce the U.S. trade deficit. Both were resistant to the idea of stimulating their own economies and were reluctant to see a substantial appreciation of their own currencies lest it decrease their exports and trade competitiveness. They believed that the problems of the world economy would be solved only if the United States took the appropriate action.

The Prospects for Policy Coordination

The concept of international policy coordination as the solution to the problems posed by economic interdependence in a world of autonomous states encounters a number of severe difficulties. If it is to succeed, three major obstacles must be overcome. Although it would be foolish to suggest that international policy coordination cannot be achieved in a pluralistic state system and in the absence of a hegemonic power, it would be equally foolish to ignore its inherent complexity. There are problems, not easily disentangled, regarding its theoretical foundation, economic desirability, and political feasibility.

The first problem to be solved if international policy coordination is to be successful is that of its theoretical foundation. Whether right or wrong, the Bretton Woods system of fixed exchange rates had been based on a general consensus, at least on the part of the United States and Great Britain, on the fundamental determinants of exchange rates; the system and its rationale were largely engineered by an American civil servant, Harry Dexter White, and a British economist, John Maynard Keynes (Gardner, 1980). This basic understanding or, if one prefers, "ideological hegemony" in Gramsci's terms, regarding the working of the economic system has been completely shattered by the dethroning of Keynesian economics, the increasing integration of global financial markets, and the greater interdependence of macroeco-

nomic policies. Even the triumphant monetarists are at a loss because the deregulation of the financial system, the expansion of fiscal instruments, and the proliferation of new types of money (M1, M2, ad infinitum) have shattered the traditional concept of the money supply.[10] The postwar achievement of what was called "the neoclassical synthesis" and enshrined in Samuelson's influential text has been displaced by a cacophony of economic sects.

Without the continued dominance of the Keynesian model or any orthodoxy to take its place, rival theories contend on such subjects as the determinants of exchange rates, the fundamental issue of reconciling full employment and price stability, and other basic questions of economic theory. Should exchange rates, for example, be set by the method of purchasing-power parity, as advocated by McKinnon and others, or by the restoration of equilibrium in the American balance of payments, favored by the Reagan Administration? The divergence of views among economists and policy makers on these crucial issues makes agreement on policy matters very difficult. As Richard Cooper, William Branson, and other authorities have noted, until the analytics or theoretical framework of determining exchange rates is somehow put in place and a new theoretical consensus reestablished, it will be impossible to determine what exchange rates should be or how they can possibly be achieved (Cooper, 1985).

A second issue is that of the economic desirability of policy coordination (Branson, 1986). Due to the relationship of nominal and real exchange rates, if one cannot change nominal rates, then, the adjustment of exchange rates must come through changes in domestic policy.[11] The resulting inflation or deflation, however, might be even more harmful than letting exchange rates change. Under the type of policy coordination envisioned by the Tokyo summit, for example, the Reagan budget deficit would have played havoc with the American economy. Without the rise in the value of the dollar and the resulting inflow of capital, the United States would have suffered from either high interest rates detrimental to business or strong inflationary pressures. It must be asked, therefore, whether it is desirable to interfere in the market if this could

[10] Currency (M1) has been joined by checking accounts, credit cards, and other instruments of creditcreation.

[11] The nominal exchange rate between two currencies is found by dividing one by the other. The real exchange rate is the product of the nominal rate times the relative inflation rate of the two economies. Thus, if nations are prohibited from changing the nominal exchange rate, then the coordination of real rates must come through domestic policy changes that affect relative inflation rates, and one is back to a world in which the international economy may impact negatively on domestic economies (Branson, 1986).

cause even greater economic damage than the damage caused by volatile exchange rates themselves.

A more general difficulty affecting the economic desirability of policy coordination relates to the establishment of predetermined or automatic rules like those favored by McKinnon and the Reagan Administration. Anticipating the nature of the problem is in itself a problem. McKinnon's sophisticated and complex solution, for example, deals only with instabilities and fluctuations caused mainly by financial flows among various currencies. Its technical and automatic formula is designed to prevent synchronous contraction or expansion of national economies. The Reagan Administration, on the other hand, wanted a set of rules precisely to force other economies to join it in a synchronous expansion. One set of rules to solve a particular problem may not be appropriate for other types of problems, and therefore international policy coordination at best should be ad hoc in response to a specific problem. This more flexible approach, however, encounters the question of political will.

The third and most important problem regarding the international coordination of economic policies is the conflict over policy objectives. Is there sufficient agreement among the major and expanding economic powers on economic and political objectives to enable them to subordinate short-term advantage to the benefits of long-term cooperation? With the relative decline of American economic hegemony, one must inquire whether a political base exists that can and will facilitate the pluralistic management of the international political economy.

Past experience does not permit one to be very sanguine about the political prospects for policy cooperation. No political issue has been more divisive than that of the coordinated expansion of the three major economies. Whereas the United States on several occasions has attempted to pressure the Japanese and West Germans to stimulate their economies, they have tended to resist due to such concerns as the fear of renewed inflation or the desire to reduce government spending. For example, at the London economic summit in May 1977, the United States called upon its major economic partners, particularly West Germany and Japan, to carry out a coordinated expansion in conjunction with the United States. The logic behind this so-called locomotive theory was that the American economy was no longer big enough by itself to be the engine of world economic growth. The others, due largely to their own internal domestic constraints, refused to follow the lead of the United States and to expand their economies; this contributed to deterioration in the American trade and payments position and forced an unwanted devaluation of the dollar. In 1979, a similar failure to

reach agreement forced the United States to contract its economy and produced the recession that helped elect Ronald Reagan.

The G-5 Agreement well illustrates the political problems of pluralist management of the world economy. The United States, when forcing the revaluation of the yen and the mark, failed to recognize adequately the considerable diffusion of economic power that had taken place in the 1970s and early 1980s. McKinnon had postulated a monetary triumvirate composed of the United States, West Germany, and Japan that could control exchange rates and hence trade balances; yet the rise of the NICs undermined this determination of monetary and trading relations by the great powers. South Korea, Canada, and other countries were among the principal beneficiaries of the dollar devaluation because they had pegged their own currencies to the dollar. For example, the export of Korean cars soared at the expense of Japanese exporters, and the United States lost a significant portion of the gains it had anticipated from a devalued dollar. The improved competitive position of other countries in turn made them attractive hosts for American and Japanese multinations. In brief, monetary coordination will require the achievement of consensus among a growing number of competitive economies if it is to be "successful."

Throughout the Reagan Administration, the United States and its economic partners have continued to be in conflict over economic policy. In order to decrease the U.S. trade and payments deficit, the administration called upon West Europeans and especially the Japanese to expand their economies and deemphasize their strategies of export-led growth. Both refused and argued that domestic economic conditions, in particular the fear of renewed inflation and the existing public debt, made expansion impossible. They countered that the cause of the international monetary problem was the American budget deficit and that no solution was possible until this was brought under control. Domestic economic conditions and differing national priorities in the three centers of world capitalism make policy coordination or the convergence of national policies a very difficult means for managing a highly interdependent world.

One of the major political obstacles to policy coordination is the desire for a trade surplus. Although the ostensible purpose of policy coordination is to eliminate currency volatility, the real purpose in many cases is to achieve a preferred exchange rate. As Hans Schmitt has convincingly argued, a powerful mercantilistic bias exists in modern economies, due to the employment and technological benefits of an export surplus; the increased output and economies of scale provided by exports facilitate a more rapid rate of technological advance (Schmitt,

1979). In this connection, it should be noted that one of the first actions taken by both Japan and West Germany immediately following the Tokyo summit was to intervene in currency markets to dampen an appreciation of their currencies. Both the Germans and the Japanese have wanted the other to be the one to appreciate its currency and to shift to an expansionary economic policy. The G-5 action can in fact be seen as an attempt by the Americans and the Europeans to pressure the Japanese to revalue the yen, to shift from an export-led to a domestic-growth strategy, and to cut their massive trade surplus. As will be argued in subsequent chapters, pressures have greatly increased in the United States to pursue a similar mercantilistic trade policy.

The acquisition of greater influence over Japanese economic policy was a primary motive of the American initiative at the Tokyo summit and for the mechanism of policy coordination that it put in place. Through pressures on Japan to stimulate its economy and to raise the value of the yen, the United States wished to reduce its massive trade deficit with Japan and to force the Japanese to open their economy. These pressures and the substantial appreciation of the yen since September 1985 to a record high of 153 yen to the dollar have caused great resentment in Japan. Although Japan has gained some benefits, the level of unemployment has risen sharply, profit rates have been reduced, and the small businesses that benefited greatly from the high dollar have been harmed. The idea of a neutral and generally acceptable exchange rate for the dollar and other currencies is a chimera and cannot be achieved.

The United States has also become less willing to subordinate its economic policies to the concerns of its economic partners. It was reluctant to change its economic and political priorities even though, in the judgment of other countries and of most U.S. economists, American fiscal policy and the American budget deficit have been the crux of the global economic problem. Rather than altering its own policies, the United States has preferred that other economies do the adjusting.

The powerful desire of states for policy autonomy is the most fundamental problem encountered by efforts toward policy coordination. When the interests of states coincide, as they did in the coordinated reduction of interest rates achieved in March 1986, then success is assured. The proposals of the Reagan Administration and various economists for increased policy coordination, however, run into strong political resistance. Despite the ostensible reversal of its own position on policy convergence and its expressed willingness to coordinate macroeconomic policies, the United States has shown little disposition to shift permanently away from the unilateralism that caused President

Nixon to overthrow the Bretton Woods system in August 1971. Nothing in the behavior of the Reagan Administration suggests that policy coordination means anything other than getting the Europeans and the Japanese to do its bidding. By the same token, other nations do not wish to subordinate themselves once again to American domination, to tie themselves to erratic American macroeconomic policies, and to forego their mercantilistic desire for trade surpluses.

Unless the dominant powers can resolve the N – 1 problem in some formal and systematic way, the coordination of macroeconomic policy will not be achieved. A more concerted exercise of American leadership than had been demonstrated in the 1980s will be required. The Bretton Woods system of policy coordination, it should be recalled, broke down in part because other economies had lost confidence in American leadership. The fact that the United States has infrequently considered the concerns of others in the formulation of its own policies has made the Europeans and the Japanese wary of American calls for policy coordination. To other countries, President Reagan's proposal for increased coordination has seemed less an abandonment of American unilateralism than an attempt to regain influence over their internal economic affairs and to subordinate them to American objectives.

As Jacob Frenkel has commented, "a reform of the international monetary system might be viewed as a constitutional change that occurs once in a lifetime" (Frenkel, 1985, p. 18). The history of constitution making, however, suggests that this is no easy task. A large array of economic and political factors must be correct, as they were in the founding of the Bretton Woods system. By the late 1980s, these favorable conditions had largely disappeared. There was little to suggest that economic and political conditions were conducive to the making of a new constitution for the international monetary system.

The fact of the matter is that if the economic and political prerequisites for the achievement of policy coordination were in place, coordination would not really be considered necessary. The breakdown of the Bretton Woods system was caused initially by the refusal or the inability of governments, especially the American government, to maintain monetary discipline and to subordinate what they considered to be their national interests to the rules and norms of the existing monetary regime. Would there be any need for policy coordination if the United States brought its budget deficit under control and maintained a stable set of economic policies? Other governments have been equally unwilling to forego national sovereignty in economic matters; they also have structural problems in their economies that constrain domestic economic policies. Would there be a need for policy coordination if the Eu-

ropeans and the Japanese stimulated their own economies and gave up their mercantilist export policies? The problem is not policy coordination as such but autonomous state action in an increasingly interdependent world economy.

The irony of the situation in the mid-1980s has been that the requirements of the type of policy coordination considered necessary by economists have become far more stringent and demanding than those of the defunct system of fixed rates. That system broke down because domestic and (in the case of the United States) foreign policy objectives took precedence over international economic cooperation. The delinking of economies through the system of flexible rates was believed to be the solution to this clash between national priorities and international norms in the mid-1970s. Yet this system proved impossible due to the intensification of financial interdependence that actually relinked national policies. Because of their autonomous pursuit of domestic and other objectives, the advanced capitalist economies have been driven back to the need for some mechanism to govern their economic relations.

One is therefore forced to return to the fundamental issues of international political economy raised in Chapter One: Is any government willing to subordinate its national autonomy and independence in economic matters in the interest of international economic stability? Is international cooperation possible for long in a capitalist world economy? Can cooperation be achieved without an unchallenged hegemonic leader willing to subordinate its narrowly defined interests to the larger objective of maintaining a liberal international economy? The answers to these questions remain unclear.

From the very inception of the liberal international economic order in the late 1940s, divergent national interests and differing perspectives on economic policy have posed a threat to that order. America's economic partners have worried about the international instabilities generated by a United States whose concerns and traditions have been those of a closed economy rather than one concerned about the impact of its actions on the rest of the world (Elliott, 1955). The Europeans have never liked the idea of subordinating themselves to a set of universal norms. As for the Japanese, their primary concern has been the preservation of what they consider to be the unique features of their culture. Whether and how these differences can be reconciled in an increasingly interdependent world economy continues to be problematic.

American behavior in the mid-1980s suggested that the United States would not abandon important domestic economic or foreign policy objectives for what most liberal economists would identify as a larger in-

ternational good. The West Europeans have exhibited a growing reluctance to lower external trade barriers and subordinate themselves to international norms. Similarly, the Japanese have demonstrated a stubborn resistance to changing their traditional ways and to carrying out the "internationalization" of domestic economic practices. Lacking the type of political will, imaginative leadership, and broad consensus on economic and political matters that led to the original creation of the Bretton Woods system, skepticism is warranted regarding the possibilities of economic policy coordination to solve the problems of the international monetary order.

The "embedded liberalism" of the Bretton Woods system worked because of responsible American leadership and the willingness of other nations to subordinate their domestic policies to international norms during the early postwar years. These political conditions made it possible to reconcile domestic policy autonomy, fixed exchange rates, and currency convertibility. In time, however, the regime of fixed rates collapsed because domestic policy freedom led to global inflation. Its successor, the regime of flexible rates, functioned poorly because of the combination of policy autonomy and the massive financial flows that followed currency convertibility. If the instabilities of the nonsystem of flexible rates continue and policy coordination proves to be impossible, the only alternative left for nations or blocs of nations that wish to protect themselves from external disturbances is the exercise of national or regional control over international capital and currency movements.

In place of the American monetary hegemony of the early postwar era and in the absence of a formal mechanism to coordinate national policies, the international monetary system has become an uneasy coexistence of the three dominant currencies—the dollar, the mark, and the yen. As will be argued in Chapter Seven, the reign of the dollar has continued since the end of the Bretton Woods system because it has had the support of first the Germans and subsequently of the Japanese. If this tacit support were to collapse, the political basis of the international monetary system would break down and the postwar trend toward increased economic interdependence would be dramatically reversed.

The fundamental problem is the clash between economic interdependence and political autonomy. The preferred solution in the postwar period has been the development of a set of monetary rules and norms that balance these two objectives. If a satisfactory balance cannot be achieved, the "solution" to the problems created by increasing interdependence will be to reduce interdependence itself and to reverse the postwar process of economic integration. Indeed, by the mid-