

Although monetary policy may not—as the two authors here point out—capture the popular imagination, it does hold profound repercussions for the quality of life of populations around the globe. The following two articles examine from diverging perspectives the history and effects of international postwar monetary policy. In the process, they demonstrate the variety of interpretations to which history is often subject.

In the first, Geoff Day summarizes the background and philosophy behind both the gold standard and floating rate policies. For Day, market forces—in the long-term beyond the control of individual government intervention—play the primary role in shaping and directing the course of the international monetary structure. While each of the postwar systems has significant weaknesses, he argues, a global monetary solution—though deemed idealistic by some—is necessary and might not be completely intractable.

Brahm Eiley, in his lively analysis of U.S. monetary policy over the last fifty years, takes a different tack, de-emphasizing the predominance of the market. Rather, he assigns pride of place to government monetary tactics and points specifically to the “hegemony” of the U.S. in postwar monetary relations. Short-sighted U.S. fiscal policy, trade goals, and an inability to adapt to changing international monetary relations, he argues, have created unsettling results in the American and world economies—a U.S. influence that will only wreak more damage if policy is not improved.

International Monetary Policy: From a Fixed to Uncertain Future

by Geoff Day

Each day, some \$750 billion to \$1 trillion is traded on the world's foreign exchange markets. In the past few decades, currency speculation by traders, in conjunction with massive trading volume, has created an environment distinctly unsuited to exchange rate stability. These instabilities in turn have affected nearly every individual, corporation, and government institution through changes in employment, inflation, and interest rates.

To understand today's chaotic environment, one must turn to the events that have shaped the international monetary system from the end of the Second World War through today. Since that time, two major alternative systems have ruled the global currency market: the gold exchange standard initiated by the Bretton Woods agreement, and the present, alternative system of floating exchange rates. Understanding these two systems provides not only a valuable perspective on the evolution of the money market, but also hints at future directions and needs.

Bretton Woods and the Gold Exchange Standard

As the end of the Second World War approached, grave concern over the future of the international monetary system led to the International Monetary Fund's Articles of Agreement, signed by representatives of forty-four nations in Bretton Woods, New Hampshire, in July 1944. The system established at the Bretton Woods called for a “gold exchange standard,” in which currencies had fixed exchange rates against the U.S. dollar and dollars were in turn redeemable for gold at the fixed price of \$35 per ounce. The selection of the U.S. dollar as the principal reserve currency in the post war monetary framework was to have profound effects on the international economy until the eventual collapse of the system in 1973.

The Bretton Woods agreement was intended to provide a stable international economic environment to maximize growth and avoid the protectionist, insular conditions that led to the worldwide pre war depression. To accomplish these goals, Bretton Woods relied on a series of checks and balances in an effort to maintain the stability of the system.

The primary balance mechanism limited the power of the United States as owner of the reserve currency. By obligating the U.S. central bank—the Federal Reserve—to redeem dollars for gold, the agreement prevented the U.S. from increasing the dollar supply too rapidly in order to fuel domestic growth. Since the Federal Reserve held a finite supply of gold, theory dictated that a more prudent monetary policy would result.

The second balance was intended to prevent excessive monetary growth by foreign central banks. A foreign government allowing immoderate mon-

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etary expansion would eventually suffer a loss of international reserves. Its central bank would be forced to buy quantities of the domestic currency to reduce the oversupply in the world's money markets and maintain the fixed exchange rate. The loss of reserves would lead directly to currency instability and the inability to maintain the fixed dollar exchange rate, triggering a currency depreciation.

Cracks in the Facade: The End of Bretton Woods

While the Bretton Woods system had worthwhile advantages

for the post war international economy, key weaknesses in the system soon became apparent. The first was the "dollar shortage" problem in the immediate post war period. Although the IMF Articles encouraged member nations to restore their currencies to convertibility (meaning their currencies could be freely used in international transactions by citizens of any country), the war-ravaged economies of Europe and Japan lacked a proper domestic economic infrastructure and thus were incapable of supporting convertibility.

This meant that until most major European currencies became convertible in 1958 (and Japan in 1964), the U.S. dollar reigned supreme. With the vast majority of international trade conducted in U.S. dollars, shortages were inevitable—a situation exacerbated by the need of most recovering nations to purchase American goods, again in U.S. dollars.

A longer-term concern was the "confidence problem." While the United States initially had adequate gold supplies to guarantee dollar redeemability, many economists and speculators soon realized that this situation could not continue in perpetuity. As the U.S. Federal Reserve expanded the money supply in response to strong worldwide growth throughout the 1950s and early 1960s, eventually a time would come when the global supply of dollars would be greater than the Fed's supply of gold. In such a situation, a revaluation of the dollar price for gold would be required. Otherwise, the outright collapse of the system was inevitable. Given these expectations, foreign governments began to redeem their U.S. dollar holdings for gold in anticipation of similar actions by other governments.

However, the key structural problem of Bretton Woods lay not with American hegemony or long-term worries, but rather with the IMF article that allowed for adjustable parities. While Bretton Woods fixed foreign exchange rates to the U.S. dollar, it allowed for future adjustment to these rates. If a currency ran a persistent, or "structural," trade deficit, it could be termed in fundamental disequilibrium with the IMF agreement. In such a situation, IMF members could agree to adjust, or devalue, the parity of the offending currency, with the goal of an eventual restoration of the trade balance. Unfortunately, the condition (a trade deficit) leading to such a devaluation was easily observed

Word Watch

Depreciation: Adjustments to an exchange rate that cause foreign currencies to become more expensive in relation to the local currency.

Internal Balance: Full national employment combined with price stability (i.e. low inflation).

External Balance: A balanced current account (i.e. neither a trade deficit nor a surplus).

Beggar-thy-neighbor Policies: Policies adopted to increase national welfare at the expense of foreign nations' welfare.

Hedging: An importer's agreement to sell a set amount of the foreign currency expected as part of a transaction for a predetermined ("forward") exchange rate, thus providing a protection against currency movements (i.e. a depreciation in the foreign currency).

Central Bank: The domestic institution responsible for managing the supply of money.

by market speculators, who in turn sold their holdings of the suspect currency.

The problem of adjustable parities was graphically illustrated by the experience of Britain from 1964 to 1967. A record trade deficit in 1964 led to widespread speculation that the pound would be devalued. Foreign holders of pound deposits sold massive amounts of currency (at the official Bretton Woods exchange rate), thus forcing the Bank of England to purchase pounds by selling official reserves. Such a situation was unsustainable and eventually devaluation suspicions by currency speculators became a self-fulfilling prophecy. As the

loss of foreign reserves by the Bank of England continued, Britain had no choice but to devalue the pound in November 1967. Similar speculative attacks against the French Franc and the German Deutsche Mark (DM) in 1969 forced similar devaluations to those currencies.

Further undermining the Bretton Woods system of fixed exchange rates were the economic policies of the United States from 1965 to 1968. Increased military spending to fund the growing Vietnam conflict, in conjunction with spending for President Lyndon Johnson's "Great Society" social programs, raised U.S. government expenditures considerably after 1965. Unfortunately, these spending increases were not matched by tax increases and the fiscal stimulus soon pushed American inflation rates upward as the Federal Reserve pursued an aggressive monetary expansion.

As the U.S. economy slipped into recession in 1970, the nation developed a trade deficit, quickly putting the United States in an untenable position. While any other country would simply be allowed to devalue its currency, the U.S. dollar, as the reserve currency in the Bretton Woods system, did not have this luxury. To achieve a similar devaluation of the dollar, currency speculators expected that simultaneous appreciations of all the major currencies would have to be undertaken.

By 1971, the pressures on the system became so severe that the U.S. was forced to halt gold convertibility (in theory temporarily) so as to stem the gold losses by the Federal Reserve. An attempt by IMF members in 1973 to fix the system by devaluing the dollar against most major European currencies failed to stop the currency speculators and on March 1, 1973, the world's foreign exchange markets closed. When the markets reopened on March 19, the Bretton Woods system had been replaced. In the new system, the world's major currencies were no longer fixed to the dollar; rather, their values "floated" in response to market forces.

The New Monetary Order: The Era of the "Dirty Float"

With the demise of the Bretton Woods agreement and the structure of fixed exchange values, a new system was born

predicated on the concept of freely floating exchange rates. Rather than fixing rates against gold or a standard reserve currency, the floating system determined exchange rates on the open market in response to standard supply and demand.

In purely economic terms, floating exchange rates are better described as a non-system, where such rates are determined by the "invisible hand" of the marketplace without predetermined targets or supports by governments or central banks. In reality, however, today's system of floating exchange rates represents an unusual synthesis of economic theory and the realities of international affairs.

Floating exchange rates provide a number of key benefits over the gold exchange standard. Foremost is monetary policy autonomy. Under the Bretton Woods agreement, governments within the system were obligated to pursue similar macroeconomic policies in order to ensure that their currencies remained at their target value. With floating rates, however, governments and central banks no longer face this constraint and are able to adopt policies more suited to their particular domestic needs. For example, recessionary economies can be stimulated by monetary growth without short-term concern over exchange-rate maintenance.

Another key advantage of floating exchange rates results from the obsolescence of the reserve currency. Without the need to fix exchange rates to a particular currency (the U.S. dollar under the gold exchange standard), no single currency must deal with a set of unique constraints. Rather, all globally traded currencies face, in theory, a level playing field. In practice, however, key currencies such as the dollar, the yen, and the DM continue to face somewhat more singular market conditions because of the size of their economies.

Finally, floating exchange rates provide a system of automatic stabilization through market adjustments to the exchange rates. For example, a country with a persistent trade deficit should be expected to experience a currency depreciation when foreign institutions sell their excess holdings of the currency. A depreciation in turn increases domestic prices of imports

while decreasing prices of export goods. In time, these adjustments would tend to balance the trade deficit. For an economy running a persistent trade surplus, the reverse situation applies.

The quick adjustments of the system in response to the first price increase by OPEC in 1973 indicated that floating exchange rates dealt well with severe economic price shocks that caused trade imbalances. Such initial successes strengthened the case for floating rates and convinced IMF members against the return to a fixed exchange structure.

True to historical experience with other monetary systems, however, floating exchange rates suffer from considerable problems. For example, the advantage of monetary policy

autonomy can quickly become a disadvantage. Without the discipline of a fixed exchange rate structure, central banks are free pursue a wide variety of monetary policies—including damaging ones. Policies that grow the money supply at excessive speed can fuel dangerous levels of inflation, unopposed by the checks and balances inherent in the need to maintain a fixed exchange rate. The lessons of many South American economies that have suffered from continual excessive inflation rates are proof of the dangers of a lack of monetary discipline.

Another key problem of floating exchange rates lies in the damaging effects on international trade. Without fixed values, corporations are continuously exposed to potential losses from

exchange rate fluctuations. For example, the past year has seen a significant depreciation of the U.S. dollar against the Japanese yen. For Japanese exporters, this results in significantly lower revenues, as dollars have become worth less in terms of the yen. While some of the dangers of unanticipated exchange rate fluctuations can be offset by short-term rate agreements between buyer and seller (hedging), the inability of exporters to anticipate exchange-rate movements makes long-term planning a difficult, inaccurate, and potentially expensive process.

Speculative currency transactions continue to trouble floating exchange rates. Current estimates indicate that some ninety-five percent of the nearly \$1 trillion traded daily in for-





"The electronic superhighway": billions of dollars in currency traded each day.
[Christopher Travell]

eign exchange markets is for speculative purposes. The root of the problem continues to be central bank intervention in currency markets. Since traders are aware that political pressures to maintain exchange rates may force intervention, executing trades in expectation of such an event can produce a self-fulfilling prophecy. Furthermore, the increased sophistication of the foreign exchange market allows these trades to be conducted more quickly and efficiently than in the past.

Another Option: The European Exchange Rate Mechanism

The long-term goal of greater integration among the members of the European Economic Community (EEC) led to the formation of the European Monetary System (EMS) in 1979, eventually supplanted by today's Exchange Rate Mechanism (ERM). Through a mix of policy coordination and frequent but minor exchange rate adjustments, the ERM provides for a system of fixed exchange rates among Community members as part of the first step towards a common EEC macroeconomic policy and a common currency, the "ecu" (European Currency Unit).

Unlike Bretton Woods, however, exchange rates for most currencies in the EMS are allowed to fluctuate 2.25 percent above or below the fixed target rate. Other currencies with histories of significant exchange-rate movements are allowed a larger "band" of 6 percent. Currencies' ability to fluctuate within these bands eliminates the need for constant central bank intervention to support a suspect currency.

Unfortunately, the ERM suffers from the same systemic weaknesses as the Bretton Woods gold-exchange system. Countries within the ERM that demonstrate structural trade deficits or consistent inflation are still the target for currency speculators who anticipate an impending devaluation. For example, the last eighteen months have seen extreme cases of

speculation of some key ERM currencies because the German central bank, the Bundesbank, resisted requests from ERM members to lower interest rates. These speculative attacks culminated with the withdrawal of the British pound and the Italian lira from the ERM after a futile attempt by the Bank of England and the other ERM members to prop up the pound with massive open-market purchases.

Future Policy Implications

The lessons learned from the failure of the Bretton Woods agreement and from subsequent experience with the floating exchange rate system suggest that both systems suffer from numerous flaws. Both share the common government tendency of pursuing its own economic agenda without coordinating with other members of the international community. For example, long-term weaknesses in the Bretton Woods system were exacerbated by the United States' unilateral fiscal expansion. Similarly, the most serious problems with the floating exchange system and the European ERM have occurred when central banks pursue different strategies to common macroeconomic problems.

The need of modern businesses for a stable exchange rate environment in conjunction with the growth of free trade and economic cooperation zones would indicate that the future of the global currency market may lie with a single currency managed by the equivalent of a world central bank. That such a system could provide international trade free of exchange rate costs and a monetary policy immune to political pressures or intervention are clear advantages over today's monetary structure.

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Unfortunately, the experience of the EEC and the slow, painful steps toward adoption of the ecu indicate that a global currency may not appear for some time. Such a step, however, may be a necessary component of a truly global economy. ●

Suggestions for Further Reading

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