# Ebbs and Flows of International Monetary Regimes

POSC 1020 – Introduction to International Relations

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# Puzzle(s) for Today

*How do governments form international monetary regimes and when are they stable?*

# Can There Be Money Without A World Government?

Yes (clearly) but it's tricky.

- National monetary systems are a classic public good but exist only in relation to others.
- International monetary regimes normalize prices across borders.

Everyone is better off for an international monetary regime (IMR) but preferences vary.

- Absent a world government, IMRs are more informal and require voluntary cooperation.

# International Monetary Regimes as Prisoner's Dilemma

IMRs resemble a prisoner's dilemma.

- Mutual cooperation provides a Pareto improvement.
- However, cooperation requires an individual commitment that might be untenable.
- Temptations to "cheat" (i.e. devalue currency) are strong (especially in fixed-rate orders)
- If everyone does this, the IMR collapses.

# How Do IMRs Evolve?

IMRs evolve/grow around two basic principles.

- To fix or float (or some combination of both)
- To benchmark against a commodity, paper, or commodity-backed paper.

This will provide a simple way of categorizing the three main IMRs we've observed.

# The Gold Standard

The most famous regime fixed to gold or gold-backed currencies.

- Required priority of gold and participation in global economy (i.e. why China and Persia did not participate).
- Required close ties among states with major misgivings: Britain, France, Germany.

# The Gold Standard

Gold was stable and predictable, facilitating trade, investment, and finance. But:

- Gold standard hamstrung poorer, developing, and indebted countries (e.g. the U.S.).
- Curtailed ability to respond to economic crises (see: Great Depression)
- Importantly: required participation from the three major financial powers (but: WWI).

The gold standard as IMR was overwhelmed by major crises and wars.

# The Bretton Woods Monetary System

U.S. and British economists convened in New Hampshire to revise the gold standard.

- Organized it instead around the U.S. dollar.
- The dollar was then tied to gold at fixed rate ($35/oz).
- Other currencies were tied to the dollar with an adjustable peg.
- Also: IMF founded to monitor exchange rates.

This facilitated investment and globalization but gave governments some autonomy to adjust.

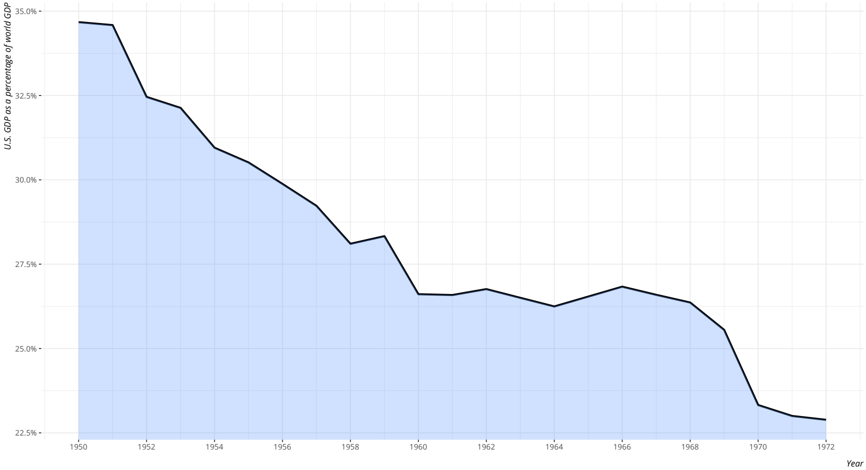
# The Bretton Woods Monetary System

The country most hamstrung by Bretton Woods was the U.S.

- The hard \$35/oz commitment became untenable amid U.S. economic problems.

## The U.S. Share of Global Economic Output Fell Over 34% from 1950 to 1970

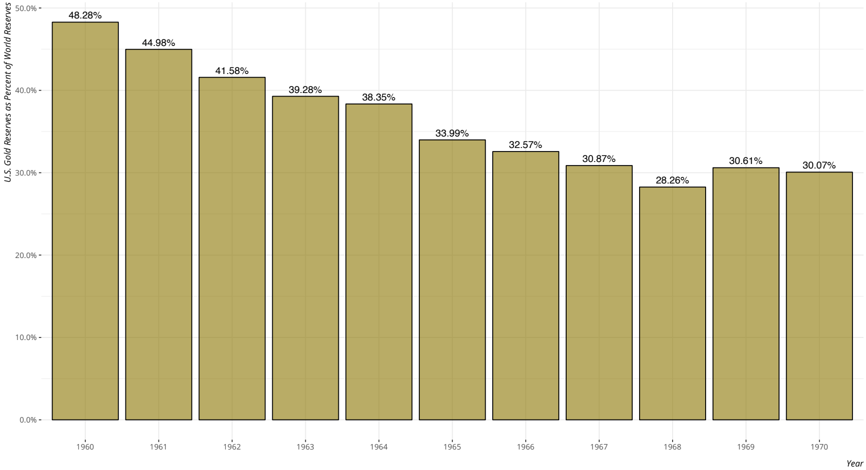
The causes were multiple, but ultimately jeopardized faith in the Bretton Woods monetary system.




*Data: Penn World Table (v. 9.0)*

## U.S. Estimated Gold Reserves Fell Over 37% From 1960 to 1970

This created major problems the extent to which the Bretton Woods monetary system was anchored to the volume of gold reserves the U.S. had in supply.




*Data: World Bank API. Gold reserves estimated subtracting total reserves (minus gold) from total reserves (including gold).*

# “Nixon Shock”

“Nixon shock” followed by executive order, which:

- dropped the link to gold and allowed the value of its currency to float.
- imposed a 90-day freeze on wages and prices.
- placed an import surcharge of 10 percent.

This was politically successful, but may have foretold a “lost decade” of stagflation for the U.S.

## The 'Stagflation' of the 1970s Was a Legacy of 'Nixon Shock'

The decisions Nixon announced on Aug. 13, 1971 were a short-term success but led to the 1973-5 recession and resonated into the Carter presidency.


*Data: Organization for Economic Co-operation and Development, via FRED API. Shaded areas indicate recessions.*

# The Present International Monetary Regime

Today: the biggest financial actors (e.g. US, Japan, Britain, Europe) float their currencies at market values.

- Concerns for volatile shifts still fall under purview of IMF.

However, concerns persist:

- Dollar standard comes with concerns for wide fluctuations in the value of the dollar.
- Smaller countries are reticent to do this and typically fix to some standard.
  - e.g. West Africa is on the franc and many South American countries peg to USD.

# The Euro

The euro is arguably the most conspicuous IMR today. A brief history:

- Discussion about stabilizing exchange rates starts in earnest after Nixon shock.
- Previously: pegged to Deutschmark (as largest economy in Europe).
    - However, this was a commitment some countries like France and Italy were reticent to make.

This led to a rather rigid/conflictual commitment for most of Europe.

- Inflation crisis post-unification magnified this.
- What followed: tit-for-tat interest rate hikes, and breaking the link to the Deutschmark.

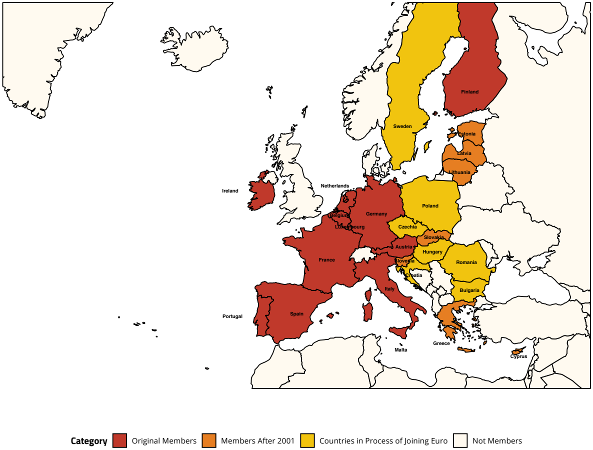
# The Euro

Eventually: the Eurozone wanted to "Europeanize" (sic) the German standard and model.

- For Europe: allow input to monetary relations that revolved around Germany.
- For Germany: use its model as benchmark for other monetary regimes in the region.
- For both: mutual cooperation has its benefits.

## Members of the European Monetary Union, 2018

Bulgaria, Croatia, Czechia, Hungary, Poland, Romania, and Sweden are committed to joining the EMU, contingent on meeting certain criteria.



# How Do Currencies Collapse?

Currencies collapse for familiar reasons: incredible commitments.

# How Currency Collapses Typically Happen

Currency collapses generally follow a template.

- The origins are rarely currency, per se, but some other macroeconomic downturn.
- These usually lead to calls for devaluation.
- Investors start to get shaky as government is cross-pressured.

Eventually, investors panic or the government runs out of time and the currency collapses.

# Currency Crisis as Contagion

What's unique about currency crises: they spread.

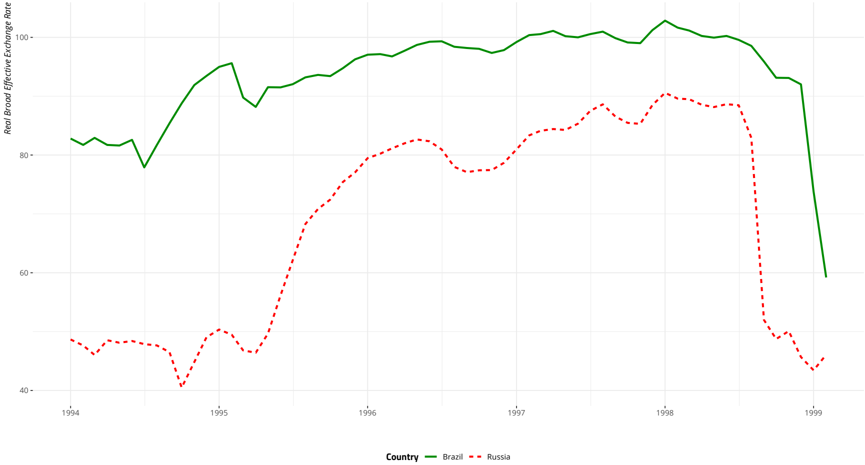
- Most currency crises of the 19th century started in the U.S.
- The tequila crisis resulted in a run on South America.
- Likewise, investors "sold" on Brazil to cover losses in Russia in 1998.

# David Rothkopf, Dep. Commerce Undersecretary (1994-95)

*This crisis [1998] was not a crisis of fundamentals. This was a crisis of confidence. In many of these places, things in a different mindset in the marketplace could have gone on okay. But what happens in a crisis of confidence is that when there is a misstep in one place, the markets start having to look for capital to cover margins and stuff like that from elsewhere.*
*And the places that they look are where they think maybe there's going to be a problem in the future, and a lot of that's based on the confidence that has been engendered by the government's policies there.* ***So the Brazilians had this very unusual experience of watching Boris Yeltsin go to bed drunk and having them wake up in the morning with a hangover.***

## Boris Yeltsin Went to Bed Drunk and Brazil Got the Hangover

Russia defaulted on its debt in 1998, which sent investors into a panic about Brazil's ability to maintain its crawling peg to the dollar.




*Data: Bank for International Settlements via Federal Reserve Bank of St. Louis*

# The 1992 ERM Crisis

# Some Background

Europe was reaping benefits of post-war cooperation but problems persisted.

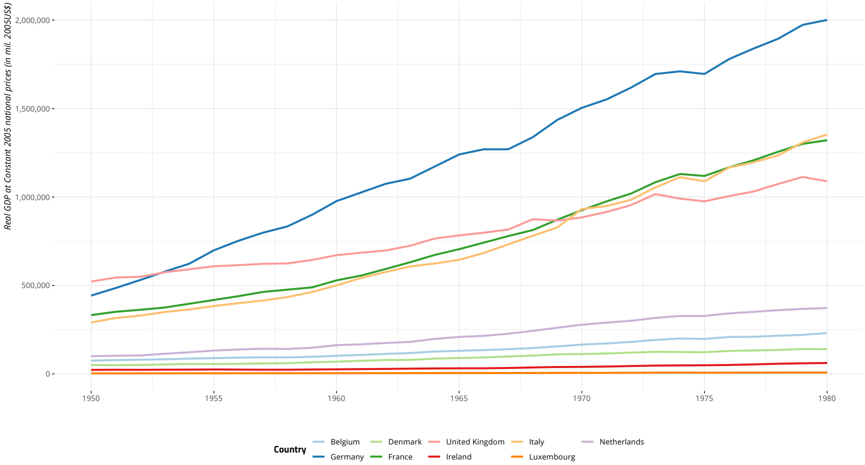
- Europe is comprised of numerous states, some quite small.
- (West) Germany, quite large, emerged as the center of gravity in the region.
- The interest in cooperation was there but variable exchange rates complicated matters.

Europe convened and agreed on the following format:

- A European Currency Unit (ECU) as weighted average of its participating countries.
- Currency could fluctuate within a 2.25% margin (with some country exceptions).
- The Deutsche Mark emerged as the de facto anchor for the ECU.

## (West) Germany Was the Biggest Economy in Western Europe Leading to the 1979 European Exchange Rate Mechanism

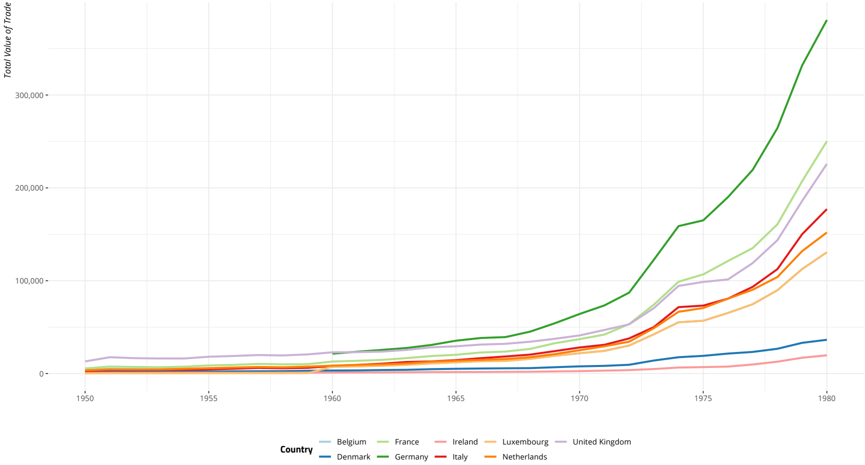
West Germany surpassed the UK as the biggest economy in Europe in 1953 despite its division and occupation by four different countries




*Data: Penn World Table (9.0)*

## (West) Germany Was Also the Biggest Trading Partner in Europe

West Germany's rather quick emergence as the focal point of commerce in post-war Europe underlined calls for exchange rate stability.




*Data: Correlates of War Trade Data (v. 4.0)*

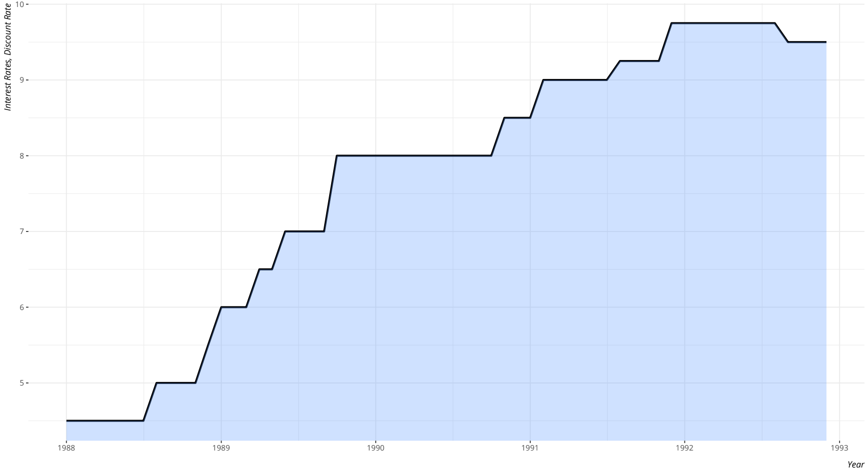
# Problems Emerge

This crisis started in Germany, which was concerned about post-unification inflation.

- Germany responded by raising interest rates steeply.

## (West) German Interest Rates Started to Rise as Talks of Reunification Intensified

Reunification was a political boon but it ignited concerns about inflation following the sudden influx of money and capital into a reunified country.




Data: IMF via Federal Reserve Bank of St. Louis

# The 1992 ERM Crisis

This put Europe in a bind.

- Jack up interest rates: depress domestic consumption and start a recession.
- Keep interest rates level: investors flee to Germany.

# The 1992 ERM Crisis

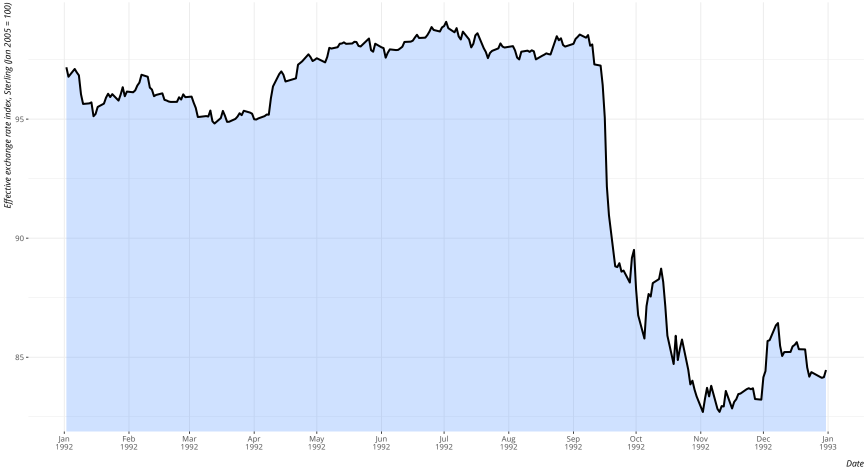
What followed: governments left the European Exchange Rate Mechanism (ERM).

- Italy devalued the lira by 7%.
- UK devalued the pound, losing around 800 million pounds in a two-week span.

Europe recovered and the crisis did not ultimately jeopardize the Euro to come.

## 'Black Wednesday' Triggered a Major Depreciation in the Value of the Pound Sterling

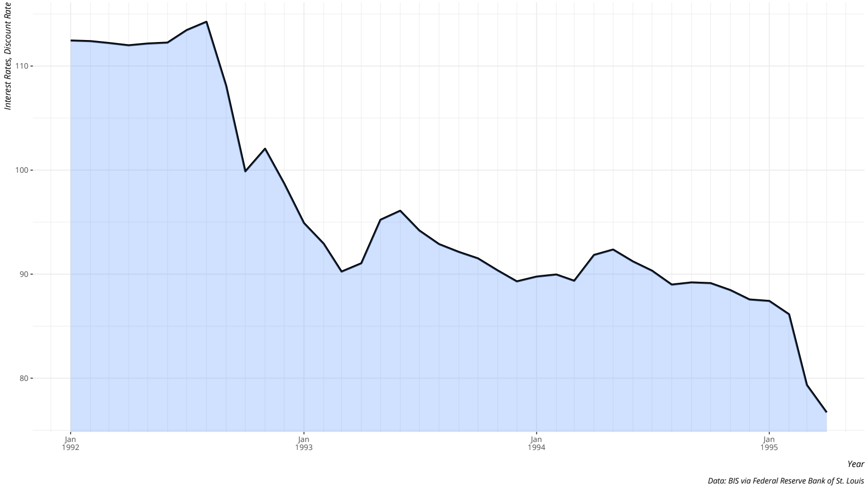
All told, a FOIA request in 2005 revealed the total loss to be around £3.3 billion. The UK lost around £800 million in reserves in two weeks.




Data: Bank of England

## The Italian Lira's Slide Was Even More Pronounced in the 1992 ERM Crisis

The Lira lost about a third of its value in the three year window between 1992 and 1995.



# Containing Currency Crises

The IMF is one of the best means to detail with currency crises, but this is not easy.

- Requires cooperation from effectively the world.
- Amounts to a free-rider problem.

Correction measures routinely assume the form of austerity.

- i.e. crises that routinely start in banking/financial sector are felt by the most vulnerable in society.

# Conclusion

IMRs are public goods, but they're not easy to devise.

- Absent a world government, cooperation is informal, effectively voluntary.
- Greater globalization of IMRs can help avoid future problems/crises.

Indeed, most of what the IMF does is disaster management, not disaster prevention.

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