The Economist

The global monetary system

Not floating, but flailing

After 150 years of monetary experimentation, the world remains unsure how to organise global finance

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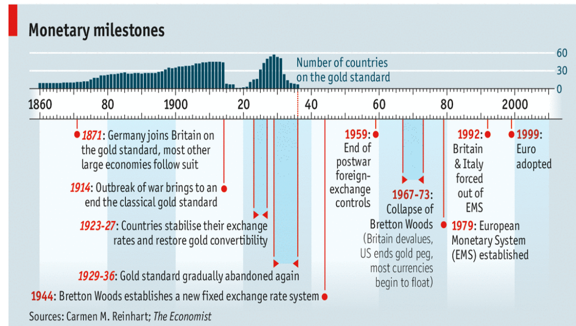
SEVENTY years ago this month, 730 delegates gathered in Bretton Woods, New Hampshire to reopen an old debate. Global commerce has long faced a fundamental tension: the more certainty countries create around exchange rates, the less room they have to manage domestic economic affairs. Thirty years before Bretton Woods a war wrecked the world's first stab at the problem—the gold standard—and the attempt to rebuild it in the 1920s led to depression and another war. The exchange-rate system agreed at Bretton Woods lasted only a generation. After 150 years of experimentation the world has yet to solve its monetary problem.

Most monetary systems have been the product of accident rather than design. The classical gold standard developed in industrialising Britain. Its economic success encouraged others to transact on its terms. Germany's adoption of gold in 1871 put Europe's two leading economies on one standard; others quickly followed suit.

The gold standard's priority was the lubrication of global trade. Exchange rates were fixed across economies and capital flowed without any regulatory hindrance. Though the free flow of capital left currencies vulnerable, the system survived for decades thanks to governments' iron commitment to gold. That, in turn, was built on the relatively feeble political influence of working people and the relative strength of creditors. Central banks refrained from destabilising actions and lent to each other in times of crisis.

The first world war changed all this. Belligerent countries instituted capital controls and printed money to pay for the war. Europe tried to patch up the system after the war but it no longer worked well. Gold reserves grew increasingly unbalanced; France and America built growing hoards, while Britain and Germany ran short. Central bank solidarity was also in short supply. America, which at times controlled 46% of the world's gold, could have rebalanced the system by expanding its money supply and allowing prices to rise. Yet it refused to do so thanks to domestic worries, chiefly a desire to limit a Wall Street boom.



The revived system broke under the strain of depression. Struggling economies were forced to choose between saving domestic banks and defending their currencies' pegs to gold. Central bankers met repeatedly to discuss ways to contain the crisis, but failed to recapture the cooperative spirit that prevailed before 1914. Austria and Germany dropped out of the system in 1931. By 1936 the gold standard was dead.

At Bretton Woods, the world took another crack at a universal system. Yet the compromises of the 1944 conference yielded a patchwork of policies. Countries fixed their currencies' values relative to the dollar, which was in turn pegged to gold. But pegs could be adjusted in extraordinary circumstances. The IMF was created to help manage crises; the World Bank was designed to lend money to poor countries. The conference also paved the way for the General Agreement on Tariffs and Trade: a forum for trade talks and forerunner of the World Trade Organisation.

In their first years the Bretton Woods institutions flirted with irrelevancy. The World Bank's lending to Europe between 1947 and 1953 amounted to just 5% of American aid under the Marshall Plan. As controls on capital and trade were lifted, tensions became apparent. When governments splashed out on welfare states and military adventures, trade imbalances and inflation ballooned, reducing confidence in currency pegs. By the late 1960s these strains became unmanageable. In 1967 Britain was forced to devalue, shaking confidence in the system. And in 1971 President Richard Nixon opted to drop the gold peg and devalue rather than make swingeing cuts to balance budgets and control inflation. Most big countries dropped out of the system and floated their currencies.

The repeated collapse of fixed exchange-rate regimes did little to shake faith in the idea. In Europe, leaders introduced the European Monetary System in 1979—the ancestor of today's euro zone. Yet markets repeatedly found reason to question peripheral economies' willingness to subordinate domestic policy to the demands of the system. A bout of scepticism fuelled attacks on British and Italian pegs, driving them out of the system in 1992. Italy nonetheless signed up for deeper monetary integration in the euro zone. The euro's recent crisis is a variation on an old theme.

Developing countries also found pegs hard to resist. Fixed exchange rates can encourage monetary discipline and tame inflation—a common emerging-world problem—while reducing borrowing costs. Yet too often pegs ended painfully, as overindebted economies found it impossible to maintain the discipline needed to protect them. Markets pounced, initiating crises and forcing devaluations—most dramatically in the Asian financial crisis of 1997-8.

Despite this history, floating exchange rates remain unpopular. Emerging economies have instead shifted toward managed rates maintained through market intervention. China, the world's second-largest economy, is a particularly energetic manipulator of its currency, and has at times used an outright dollar peg. As a result over half of global economic activity is concentrated within two massive single-currency blocs. Less than a tenth of emerging markets allow the market to set their exchange rate.

The aversion to floating is a puzzle. Fixed rates can reduce borrowing costs, but the result is often a debt-binge and crisis. Modern technology reduces currency transaction costs. IMF research finds that flexible exchange rates reduce vulnerability to both macroeconomic and financial crises. And Joseph Gagnon of the Peterson Institute for International Economics, a think tank, finds that economies with floating currencies did better in the global financial crisis and its aftermath.

History suggests that monetary arrangements last only as long as the political economy that supports them. Given the dramatic changes in the global economy marked by the rise of the emerging world, it is hard to imagine that prevailing currency alignments can survive. Indeed, China claims to be gradually freeing its capital account and encouraging trade denominated in yuan. That may finally bring down the curtain on the dollar era initiated by Bretton Woods. Yet in practice China is reluctant to give up the perceived safety of a managed exchange rate. Gold habits are hard to break.

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