

BARRY EICHENGREEN



# GLOBALIZING CAPITAL

A HISTORY OF THE INTERNATIONAL MONETARY SYSTEM

Second Edition

# GLOBALIZING CAPITAL

—

*This page intentionally left blank*

**BARRY EICHENGREEN**



# **GLOBALIZING CAPITAL**

**A HISTORY OF THE INTERNATIONAL MONETARY SYSTEM**

**Second Edition**



**PRINCETON UNIVERSITY PRESS**

**PRINCETON AND OXFORD**

Copyright © 2008 by Princeton University Press  
Published by Princeton University Press, 41 William Street,  
Princeton, New Jersey 08540

In the United Kingdom: Princeton University Press,  
6 Oxford Street, Woodstock, Oxfordshire OX20 1TW

All Rights Reserved

Library of Congress Cataloging-in-Publication Data  
Eichengreen, Barry J.  
Globalizing capital : a history of the international monetary system /  
Barry Eichengreen.  
— 2nd ed.  
p. cm.

Includes bibliographical references and index.

ISBN 978-0-691-13937-1 (pbk. : alk. paper)

1. International finance—History. 2. Gold standard—History. I. Title.

HG3881 .E347 2008

332/.042 22 2008018813

British Library Cataloging-in-Publication Data is available

This book has been composed in Times

Printed on acid-free paper. ∞

press.princeton.edu

Printed in the United States of America

1 3 5 7 9 10 8 6 4 2

# — CONTENTS —

<i>Preface</i>	vii
<b>Chapter One</b>	
Introduction	1
<b>Chapter Two</b>	
The Gold Standard	6
<i>Prehistory</i>	7
<i>The Dilemmas of Bimetallism</i>	8
<i>The Lure of Bimetallism</i>	12
<i>The Advent of the Gold Standard</i>	15
<i>Shades of Gold</i>	19
<i>How the Gold Standard Worked</i>	24
<i>The Gold Standard as a Historically Specific Institution</i>	29
<i>International Solidarity</i>	32
<i>The Gold Standard and the Lender of Last Resort</i>	34
<i>Instability at the Periphery</i>	37
<i>The Stability of the System</i>	41
<b>Chapter Three</b>	
Interwar Instability	43
<i>Chronology</i>	44
<i>Experience with Floating: The Controversial Case of the Franc</i>	49
<i>Reconstructing the Gold Standard</i>	55
<i>The New Gold Standard</i>	59
<i>Problems of the New Gold Standard</i>	61
<i>The Pattern of International Payments</i>	66
<i>Responses to the Great Depression</i>	70
<i>Banking Crises and Their Management</i>	73
<i>Disintegration of the Gold Standard</i>	75
<i>Sterling's Crisis</i>	78
<i>The Dollar Follows</i>	83
<i>Managed Floating</i>	86
<i>Conclusions</i>	89

## **Chapter Four**

The Bretton Woods System	91
<i>Wartime Planning and Its Consequences</i>	94
<i>The Sterling Crisis and the Realignment of European Currencies</i>	100
<i>The European Payments Union</i>	104
<i>Payments Problems and Selective Controls</i>	107
<i>Convertibility: Problems and Progress</i>	111
<i>Special Drawing Rights</i>	115
<i>Declining Controls and Rising Rigidity</i>	118
<i>The Battle for Sterling</i>	123
<i>The Crisis of the Dollar</i>	126
<i>The Lessons of Bretton Woods</i>	132

## **Chapter Five**

After Bretton Woods	134
<i>Floating Exchange Rates in the 1970s</i>	136
<i>Floating Exchange Rates in the 1980s</i>	142
<i>The Snake</i>	149
<i>The European Monetary System</i>	157
<i>Renewed Impetus for Integration</i>	164
<i>Europe's Crisis</i>	168
<i>Understanding the Crisis</i>	172
<i>The Experience of Developing Countries</i>	178
<i>Conclusions</i>	183

## **Chapter Six**

A Brave New Monetary World	185
<i>The Asian Crisis</i>	192
<i>Emerging Instability</i>	198
<i>Global Imbalances</i>	210
<i>The Euro</i>	219
<i>International Currency Competition</i>	225

## **Chapter Seven**

Conclusion	228
------------	-----

Glossary	233
----------	-----

References	241
------------	-----

Index	259
-------	-----

## — PREFACE —

This history of the international monetary system is short in two senses of the word. First, I concentrate on a short period: the century and a half from 1850 to today. Many of the developments I describe have roots in earlier eras, but to draw out their implications I need only consider this relatively short time span. Second, I have sought to write a short book emphasizing thematic material rather than describing international monetary arrangements in exhaustive detail.

I attempt to speak to several audiences. One is students in economics seeking historical and institutional flesh to place on their textbooks' theoretical bones. They will find references here to concepts and models familiar from the literature of macroeconomics and international economics. A second audience, students in history, will encounter familiar historical concepts and methodologies. General readers interested in monetary reform and conscious that the history of the international monetary system continues to shape its operation and future prospects will, I hope, find this material accessible as well. To facilitate their understanding, a glossary of technical terms follows the text: entries in the glossary are printed in italics in the text the first time they appear.

This manuscript originated as the Gaston Eyskens Lectures at the Catholic University of Leuven. For their kind invitation I thank my friends in the Economics Department at Leuven, especially Erik Buyst, Paul De Grauwe, and Herman van der Wee. The Research Department of the International Monetary Fund, the International Finance Division of the Board of Governors of the Federal Reserve System, and the Indian Council for Research on International Economic Relations provided hospitable settings for revisions. It will be clear that the opinions expressed here are not necessarily those of my institutional hosts.

Progress in economics is said to take place through a cumulative process in which scholars build on the work of their predecessors. In an age when graduate syllabi contain few references to books and articles written as many as ten years ago, this is too infrequently the case. In the present instance I hope that the footnotes will make clear the extent of my debt to previous



scholars. This is not to slight my debt to my contemporaries, to whom I owe thanks for comments on previous drafts. For their patience and constructive criticism I am grateful to Michael Bordo, Charles Calomiris, Richard Cooper, Max Corden, Paul De Grauwe, Trevor Dick, Marc Flandreau, Jeffry Frieden, Giulio Gallarotti, Richard Grossman, Randall Henning, Douglas Irwin, Harold James, Lars Jonung, Peter Kenen, Ian McLean, Jacques Melitz, Allan Meltzer, Martha Olney, Leslie Pressnell, Angela Redish, Peter Solar, Nathan Sussman, Pierre Sicsic, Guiseppe Tattara, Peter Temin, David Vines, and Mira Wilkins. They should be absolved of responsibility for remaining errors, which reflect the obstinacy of the author.

This expanded edition updates the story from 1996, when the original version appeared. The subsequent period opened with the Asian financial crisis, a traumatic episode in which the exchange rate played a central role. It continued with European monetary unification, an event unprecedented in modern international monetary history. The period also saw the emergence of developing countries as key players in the international monetary system. It is impossible to understand how the United States was able to run such large current account deficits for much of this period, for example, without appreciating the incentives and actions of the developing countries that provided the bulk of the financing. Together, these developments—chronic U.S. deficits, the advent of the euro, and new consciousness on the part of emerging markets of their capacity to shape the international monetary system—raise questions about the role of the United States and the dollar in international financial relations going forward. This story is complex. I will suggest, perhaps predictably, that the best way of comprehending it by using the analytical framework set out in this book.

I have resisted the temptation to comprehensively revise earlier chapters, but I have made few small changes for internal consistency. I am grateful to Cheryl Applewood, Peter Dougherty, and Michelle Bricker, each of whom, in their different ways, provided the support needed to complete this second edition.

Berkeley  
January 2008

# GLOBALIZING CAPITAL

—

*This page intentionally left blank*

## — CHAPTER ONE —

# Introduction

The international monetary system is the glue that binds national economies together. Its role is to lend order and stability to foreign exchange markets, to encourage the elimination of balance-of-payments problems, and to provide access to international credits in the event of disruptive shocks. Nations find it difficult to efficiently exploit the gains from trade and foreign lending in the absence of an adequately functioning international monetary mechanism. Whether that mechanism is functioning poorly or well, it is impossible to understand the operation of the international economy without also understanding its monetary system.

Any account of the development of the international monetary system is also necessarily an account of the development of international capital markets. Hence the motivation for organizing this book into five parts, each corresponding to an era in the development of global capital markets. Before World War I, controls on international financial transactions were absent and international capital flows reached high levels. The interwar period saw the collapse of this system, the widespread imposition of *capital controls*, and the decline of international capital movements. The three decades following World War II were then marked by the progressive relaxation of controls and the gradual recovery of international capital flows. The fourth quarter of the twentieth century was again one of significant capital mobility. And the period since the turn of the century has been one of very high capital mobility—in some sense even greater than that which prevailed before 1913.

This U-shaped pattern traced over time by the level of international capital mobility is an obvious challenge to the dominant explanation for the post-1971 shift from fixed to flexible *exchange rates*. Pegged rates were viable for the first quarter-century after World War II, the argument goes, because of the limited mobility of financial capital, and the subsequent shift to floating rates was an inevitable consequence of increasing capital flows. Under the Bretton Woods System that prevailed from 1945 through 1971, controls loosened the

constraints on policy. They allowed policymakers to pursue domestic goals without destabilizing the exchange rate. They provided the breathing space needed to organize orderly exchange rate changes. But the effectiveness of controls was eroded by the postwar reconstruction of the international economy and the development of new markets and trading technologies. The growth of highly liquid international financial markets in which the scale of transactions dwarfed official international reserves made it all but impossible to carry out orderly adjustments of currency pegs. Not only could discussion before the fact excite the markets and provoke unmanageable capital flows, but the act of devaluation, following obligatory denials, could damage the authorities' reputation for defending the peg. Thus, at the same time that pegged exchange rates became more costly to maintain, they became more difficult to adjust. The shift to floating was the inevitable consequence.

The problem with this story, it will be evident, is that international capital mobility was also high before World War I, yet this did not prevent the successful operation of pegged exchange rates under the classical gold standard. Even a glance back at history reveals that changes in the extent of capital mobility do not by themselves constitute an adequate explanation for the shift from pegged to floating rates.

What was critical for the maintenance of pegged exchange rates, I argue in this book, was protection for governments from pressure to trade exchange rate stability for other goals. Under the nineteenth-century gold standard the source of such protection was insulation from domestic politics. The pressure brought to bear on twentieth-century governments to subordinate currency stability to other objectives was not a feature of the nineteenth-century world. Because the right to vote was limited, the common laborers who suffered most from hard times were poorly positioned to object to increases in central bank interest rates adopted to defend the currency peg. Neither trade unions nor parliamentary labor parties had developed to the point where workers could insist that defense of the exchange rate be tempered by the pursuit of other objectives. The priority attached by *central banks* to defending the pegged exchange rates of the gold standard remained basically unchallenged. Governments were therefore free to take whatever steps were needed to defend their currency pegs.

Come the twentieth century, these circumstances were transformed. It was no longer certain that, when currency stability and full employment clashed, the authorities would opt for the former. Universal male suffrage and the rise of trade unionism and parliamentary labor parties politicized monetary and fiscal policymaking. The rise of the welfare state and the post-World War II commitment to full employment sharpened the trade-off between internal and

external balance. This shift from classic liberalism in the nineteenth century to embedded liberalism in the twentieth diminished the credibility of the authorities' resolve to defend the currency peg.<sup>1</sup>

This is where capital controls came in. They loosened the link between domestic and foreign economic policies, providing governments room to pursue other objectives such as the maintenance of full employment. Governments may no longer have been able to take whatever steps were needed to defend a currency peg, but capital controls limited the extremity of the steps that were required. By limiting the resources that the markets could bring to bear against an exchange rate peg, controls limited the steps that governments had to take in its defense. For several decades after World War II, limits on capital mobility substituted for limits on democracy as a source of insulation from market pressures.

Over time, however, capital controls became more difficult to enforce. With neither limits on capital mobility nor limits on democracy to insulate governments from market pressures, maintaining pegged exchange rates became problematic. In response, some countries moved toward more freely *floating exchange rates*, while others, in Western Europe, sought to stabilize their exchange rates once and for all by establishing a monetary union.

In some respects, this argument is an elaboration of one advanced by Karl Polanyi more than half a century ago.<sup>2</sup> Writing in 1944, the year of the Bretton Woods Conference, Polanyi suggested that the extension of the institutions of the market over the course of the nineteenth century aroused a political reaction in the form of associations and lobbies that ultimately undermined the stability of the market system. He gave the gold standard a place of prominence among the institutions of *laissez faire* in response to which this reaction had taken place. And he suggested that the opening of national economic decision making to parties representing working-class interests had contributed to the downfall of that international monetary system. In a sense, this book asks whether Polanyi's thesis stands the test of time. Can the international monetary history of the second half of the twentieth century be understood as the further unfolding of Polanyian dynamics, in which democratization again came into conflict with economic liberalization in the form of free capital mobility and fixed exchange rates? Or do recent trends toward floating rates and monetary unification point to ways of reconciling freedom and stability in the two domains?

<sup>1</sup>The term *embedded liberalism*, connoting a commitment to free markets tempered by a broader commitment to social welfare and full employment, was coined by John Ruggie (1983).

<sup>2</sup>Polanyi 1944.

To portray the evolution of international monetary arrangements as many individual countries responding to a common set of circumstances would be misleading, however. Each national decision was not, in fact, independent of the others. The source of their independence was the *network externalities* that characterize international monetary arrangements. When most of your friends and colleagues use computers with Windows as their operating system, you may choose to do likewise to obtain technical advice and ease the exchange of data files, even if a technologically incompatible alternative exists (think Linux or Leopard) that is more reliable and easier to learn when used in isolation. These synergistic effects influence the costs and benefits of the individual's choice of technology. (For example, I wrote this book on a Windows-based system because that is the technology used by most of my colleagues.) Similarly, the international monetary arrangement that a country prefers will be influenced by arrangements in other countries. Insofar as the decision of a country at a point in time depends on decisions made by other countries in preceding periods, the former will be influenced by history. The international monetary system will display *path dependence*. Thus, a chance event like Britain's "accidental" adoption of the gold standard in the eighteenth century could place the system on a trajectory where virtually the entire world had adopted that same standard within a century and a half.

Given the network-externality characteristic of international monetary arrangements, reforming them is necessarily a collective endeavor. But the multiplicity of countries creates negotiating costs. Each government will be tempted to free-ride by withholding agreement unless it secures concessions. Those who seek reform must possess political leverage sufficient to discourage such behavior. They are most likely to do so when a nexus of international joint ventures, all of which stand to be jeopardized by noncooperative behavior, exists. Not surprisingly, such encompassing political and economic linkages are rare. This explains the failure of international monetary conferences in the 1870s, 1920s, and 1970s. In each case, inability to reach an agreement to shift the monetary system from one trajectory to another allowed it to continue evolving of its own momentum. The only significant counterexamples are the Western alliance during and after World War II, which developed exceptional political solidarity in the face of Nazi and Soviet threats and was able to establish the Bretton Woods System, and the European Community (now European Union), which made exceptional progress toward economic and political integration and established the European Monetary System and now the euro.

The implication is that the development of the international monetary system is fundamentally a historical process. The options available to aspiring

## INTRODUCTION

reformers at any time are not independent of international monetary arrangements in the past. And the arrangements of the recent past themselves reflect the influence of earlier events. Neither the current state nor the future prospects of this evolving order can be understood without an appreciation of its history.