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International Monetary Relations

THE PUZZLE *In the absence of global government, how are international currencies supplied and international monetary relations regulated?*

Above: International monetary relations are often controversial. Today, the European Central Bank in Frankfurt, Germany, implements monetary policies for the entire eurozone, which comprises 19 member countries that gave up their national currencies for the euro.



On December 18, 2001, rioters swept through the cities of Argentina. They were furious about three straight years of economic stagnation and government economic policies that seemed to make matters worse. Most recently, the government had frozen bank deposits so that Argentines could take only small amounts of cash out of their bank accounts—and nothing out of the very popular accounts that many people had in U.S. dollars.

In response to the rioting, President Fernando de la Rúa declared a state of siege, but the following day the disorder spread as hundreds of thousands of middle-class Argentines joined the protests in the streets. That evening, the economy minister stepped down. A day later, violent clashes with police led to more than two dozen deaths around the country, and huge crowds surrounded the presidential palace in Buenos Aires. At the end of the day, de la Rúa resigned and was evacuated by helicopter from the presidential palace to avoid the hostile crowds.

The president of the Senate, a member of the opposition Peronist Party that controlled both houses of Congress, assumed the interim presidency. Two days later, the Peronists installed provincial governor Adolfo Rodríguez Saá as president until national elections could be held.

Rodríguez Saá declared the largest default the world had seen—on \$93 billion in sovereign debt. But he too faced protests, and resigned a week after taking office.

This time the president of the Chamber of Deputies, also a Peronist, stepped in as interim president. After further turmoil, the legislature appointed to the presidency Eduardo Duhalde, the Peronist candidate who had lost the 1999 presidential election to the now disgraced de la Rúa. Meanwhile, the country had entered full-fledged economic collapse. Argentine gross domestic product (GDP), which had declined by 8 percent over the three previous years of recession, dropped by 11 percent in 2002, and unemployment soared above 20 percent.

The ultimate reason for these extraordinary events—nationwide riots, five presidents in less than two weeks, the biggest default in history, economic disintegration—was the Argentine government's policies toward its currency. Ten years earlier, the government had made the Argentine peso equal to one U.S. dollar and fixed it at this exchange rate. The currency policy had led to rapid growth and many other economic achievements in Argentina. But by 2001, the commitment was dragging the economy downward. It was widely blamed for general

economic stagnation and for the specific banking policies that provoked popular outrage. Argentina's fortunes rose dramatically, and fell even more dramatically, with its currency policies.

Many people who find currencies confusing or boring may be surprised that exchange rates could be responsible for such striking developments. But the Argentine events are not alone in illustrating the importance of currencies and currency policies to economics and politics—and to people's everyday lives. A couple of weeks after Argentine society exploded into violence over the exchange rate, and halfway around the world, came another, unrelated but equally remarkable, currency development. Twelve European countries abandoned their national monies, some of which had existed for centuries. In place of the Deutschmark, franc, lira, and other currencies, they adopted the euro (€), a common European currency. The creation of the euro dominated European politics and economics for most of the 1990s, and the early 2000s were spent consolidating, managing, and expanding the new currency.

Then, in 2008, the global financial crisis hit the eurozone. The international economic slowdown brought a European borrowing boom to an end and plunged the continent into recession. In the ten years that followed, the eurozone crisis dragged the entire European economy down into stagnation, threatened the existence of the euro itself, contributed to Britain's decision to exit the European Union (EU), and overall, constituted the gravest threat to European integration since the EU's formation. European currency politics—the euro's rise, creation, evolution, and crisis—have been central to the continent's political economy for 40 years. Argentina and Europe are not alone: in many countries, currency policy is one of the most hotly contested economic and political issues.

National governments have pursued very different policies toward their national currencies. Today, most governments choose among three monetary paths. One option is to give up the national currency in favor of another money—as has occurred in a number of Caribbean and Latin American countries, which have adopted the U.S. dollar, and in most European countries, which have adopted the euro. Other governments have tied the national currency's value to that of another country, such as the dollar or the euro (as we will discuss in more detail). Finally, many governments continue to maintain a separate national currency whose value is allowed to change in response to markets and other forces.

How and why do governments choose any one of these three monetary paths? The international monetary

order has also varied enormously over the years. As we saw in Chapter 1, from the 1870s until 1914 most of the world's major economies were on a classical gold standard that tied their currencies together. After World War II, a revised version of this approach, the Bretton Woods monetary system, reigned until 1973. Since then, international and regional currency arrangements have been in flux.

Thinking Analytically about International Monetary Relations

This chapter makes several points about the interests, interactions, and institutions associated with international monetary policy. First, within each country there are many actors who have an interest in the country's monetary affairs, which leads to conflict over the appropriate currency policy to pursue. We will see, briefly, how national currency policies are set and which groups have a stake in those policies.

In addition to individual national choices, there are important global monetary issues. Indeed, international monetary affairs—the interrelationships among national monies—are central to the international economy and thus to world politics. Stable relations among national currencies allow actors in one country to make payments to actors in other countries, making it easier for goods, people, and capital to move across borders—all important forms of international interaction. Just as it is hard to imagine national economies without national money, it is hard to see how the modern world economy could function without some arrangement for cooperation in the use of money among countries.

Yet, while national governments supply national monies, there is no international government to organize international monetary affairs. Virtually everyone has an interest in the existence of a functioning international monetary system, but different arrangements benefit some actors more than others. This disparity leads to disagreements about how such a system should be organized. How is such a quintessentially governmental function as the provision of currencies carried out at the global level in the absence of global government?

What Are Exchange Rates, and Why Do They Matter?

A national monetary system allows for the convenient exchange of goods, services, and capital. It is a classic public good (see Chapter 2): it benefits everyone, but because people cannot be excluded from its benefits and charged for them, there is little incentive for private firms to provide it. This is why national governments typically determine the currency, print bills, mint coins, and control the money supply. It is also why governments try to instill trust in the national currency. Almost everyone in a country can agree on the desirability of a recognizable, trustworthy national money and stable prices.

But in addition to a currency's domestic use, it exists in relation to other national currencies. For example, the U.S. dollar can be used not only to buy goods and services in the United States, but also to buy euros, Canadian dollars, and Mexican pesos, among other currencies. The price of a national currency relative to other national currencies is its **exchange rate**, and like other prices, the exchange rate can go up or down. When the dollar goes up in value against some other currency—such that, for example, a dollar can buy more pesos—it is said to strengthen, or **appreciate**. When the dollar's value goes down against that of some other currency—such that, for example, a dollar can buy fewer pesos—it is said to weaken, or **depreciate**, or to be **devalued**.

When a country's currency appreciates, it is more expensive for foreigners to buy the country's goods and services; when the currency depreciates, it is cheaper to do so. The most direct experience that many people have with currency movements is as tourists or, if they live near a national border, with prices around the border. American travelers to Europe find, for example, that when the dollar is strong, local prices in Europe seem relatively low. The hotels they stay in, the restaurants they go to, and the souvenirs they purchase are relatively inexpensive. When the dollar weakens, however, local prices get much higher.

For example, in March 2017 an American staying in an Italian hotel that charged €100 a night would have paid about \$105 a night, because the euro was worth \$1.05; a year later, with the euro worth \$1.24, the same hotel room at the same euro price would have cost 124 a night. Over the course of that year, the dollar had depreciated by about 18 percent against the euro, so goods and services in euro countries, such as Italy, cost 18 percent more. (See Figure 9.1 for an indication of how the value of the dollar has fluctuated against an average of other currencies.)

The same is true of goods bought and sold across borders. If a currency goes up or down, the prices that foreigners pay for goods priced in that currency rise or fall as well. So, a pair of Italian shoes that cost €100 in Italy in March 2017 could have been exported to the United States and sold for about \$105 (plus shipping costs), while a year later, after the dollar had depreciated by about 18 percent, the same €100 Italian shoes would have sold for \$124. When the U.S. dollar is weak against other currencies, foreign goods are expensive to Americans; however, when

exchange rate

The price at which one currency is exchanged for another.

appreciate

In terms of a currency, to increase in value relative to other currencies.

depreciate

In terms of a currency, to decrease in value relative to other currencies.

devalue

To reduce the value of one currency relative to other currencies.

FIGURE 9.1 The Value of the U.S. Dollar, 1975–2016

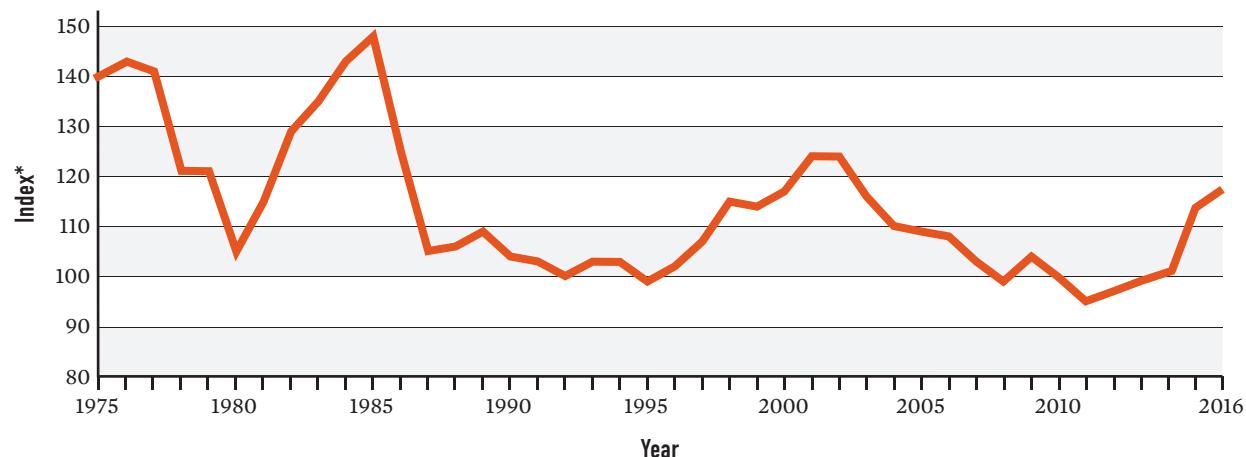


Figure source: World Bank, World Development Indicators, <http://data.worldbank.org/> indicator (accessed 11/13/17).

*Real effective exchange-rate index. The real effective exchange-rate index is a measure of the value of the dollar against a weighted average of the currencies of the United States' major trading partners. The base year, 2010, is given the value of 100. Higher values indicate a stronger (more appreciated) dollar relative to the world's major currencies, and lower values indicate a weaker (depreciated) dollar.

the U.S. dollar is strong against other currencies, foreign goods are inexpensive to Americans.

Although the attractiveness of a given country to foreign tourists is not particularly important to most nations, the attractiveness of that country's goods, services, and investment opportunities is crucial. Thus, the exchange rate is a very important part of a country's international economic relations.

How Are Currency Values Determined?

Like other prices, an exchange rate goes up or down in response to changes in supply and demand. Many factors can affect supply and demand for a national money. Perhaps the most relevant is relative interest rates. As we saw in Chapter 8, foreigners considering investing in a country weigh relative interest rates; if U.S. interest rates are higher, investments in the United States are more attractive (everything else being equal).¹ But in order to invest in the United States, investors need dollars. Higher interest rates make it more profitable for people to put (or keep) their money in the country, so higher interest rates increase the demand for the currency and lead to its appreciation.

Of course, the relationship works in the opposite direction as well: if people want fewer dollars, the dollar's exchange rate will go down. Lower interest rates can lead to a depreciation of the currency, just as higher interest rates can lead to an appreciation. More generally, if foreigners want to invest in a country, they have to buy its currency; so if there is a lot of investment in an economy, demand for its currency will rise and the exchange rate will tend to appreciate. When foreigners invest heavily in the United States, all else equal, the dollar strengthens.

1. For convenience, we ignore trade-related sources of currency movements. It should be clear that anything that makes a country's goods and services more attractive to foreigners will increase demand for the country's currency and lead to an appreciation (and vice versa).

The relationship between interest rates and the value of the national currency is particularly important because governments routinely raise and lower interest rates as part of their **monetary policy**. Indeed, monetary policy is a powerful tool of national governments, which attempt to affect macroeconomic conditions—unemployment, inflation, overall economic growth—by manipulating monetary conditions.

In most developed countries, national monetary policy is implemented by a **central bank** (for example, the Federal Reserve in the United States). Central banks most commonly affect monetary conditions by raising or lowering interest rates. If the central bank wants to stimulate the economy, it lowers interest rates. Lower interest rates make it easier for people and companies to borrow, and allow the economy to expand. If the central bank wants to restrain the economy, typically because prices are rising and there is concern about inflation, it raises interest rates; this makes it harder to borrow and restrains demand.

Because interest rates also affect the exchange rate—higher interest rates make the currency more attractive and tend to raise its value—national monetary policy can also have a powerful impact on the value of the national currency. And this too can be a tool of national economic policy. For example, if a government wants to stimulate demand for its country's products in world markets, it can lower interest rates so that the currency depreciates. The weaker currency makes local goods cheaper to foreigners and spurs exports; it also makes foreign goods more expensive to local residents and reduces imports. In this way, a monetary policy that weakens the currency can help the nation's producers. Of course, a weaker currency means that citizens can buy less with their money, so the government has to choose which effects it finds most appealing.

Allowing the Exchange Rate to Change

There are other choices facing a national government with respect to its currency. Among these, the most important is whether and how to let the exchange rate change relative to others. The simplest choice is whether to “fix” the exchange rate or let it “float.” A **fixed exchange rate** is one whose government promises to keep the national money at some established value in terms of another currency or in terms of a precious metal such as gold.

During the period of the classical **gold standard**, from the 1870s to 1914, a country's government “went on gold” by promising to exchange its currency for gold at an established rate (in the United States, it was one troy ounce of gold for \$20.67). This move made the country's currency equivalent to gold and interchangeable at a fixed rate with the money of any other gold-standard country. Much of the world, as a result, essentially shared one currency. Gold-backed money invested by Germans in Japan, or by Belgians in Canada, would be paid back in equivalent amounts of gold-backed money. Contracted prices would not fluctuate, for exchange rates did not change.

A government that commits itself to a fixed exchange rate also commits itself to the policies necessary to maintain the set rate. For example, if the currency was poised to depreciate against other currencies, meaning the exchange rate would

monetary policy

An important tool of national governments to influence broad macroeconomic conditions such as unemployment, inflation, and economic growth. Typically, governments alter their monetary policies by changing national interest rates or exchange rates.

central bank

The institution that regulates monetary conditions in an economy, typically by affecting interest rates and the quantity of money in circulation.

fixed exchange rate

An exchange-rate policy under which a government commits itself to keep its currency at or around a specific value relative to another currency or a commodity, such as gold.

gold standard

The monetary system that prevailed between about 1870 and 1914, in which countries tied their currencies to gold at a legally fixed price.



The U.S. dollar was backed by gold from 1879 to 1933, meaning that the government needed to own enough gold to cover the dollars in circulation at a predetermined exchange rate.

floating exchange rate

An exchange-rate policy under which a government permits its currency to be traded on the open market without direct government control or intervention.

Bretton Woods monetary system

The monetary order negotiated among the World War II Allies in 1944, which lasted until the 1970s and which was based on a U.S. dollar tied to gold. Other currencies were fixed to the dollar but were permitted to adjust their exchange rates.

adjustable peg

A monetary system of fixed but adjustable rates. Governments are expected to keep their currencies fixed for extended periods but are permitted to adjust the exchange rate from time to time as economic conditions change.

fall, the government might raise interest rates to have money keep coming into the country—in other words, so that foreigners would buy the country’s currency. This increase in demand for the currency would make the exchange rate go back up to the set level.

At the other extreme is a **floating exchange rate**, under which a currency’s value is allowed to change more or less freely, driven by markets or other factors. This is the regime currently in place for most major currencies, including the U.S. dollar, the Japanese yen, and the euro. If a government chooses this exchange-rate regime, the price of the currency moves around in line with changes in supply and demand. Map 9.1 on p. 394 indicates which countries worldwide follow fixed versus floating exchange-rate regimes.

There are intermediate steps between a fully fixed currency and a freely floating one. A government can allow its currency to vary, but only within limits, or it can fix the exchange rate for short periods, changing the currency’s value as desired. This

approach avoids some of the costs of each system but also forgoes some of the benefits. At the global level, the **Bretton Woods monetary system**, which followed the classical gold standard and prevailed from 1945 to 1973, was something of a compromise. It was based on a fixed rate and a gold standard for the United States and on a “fixed but adjustable rate” for other currencies that were on a dollar standard. This system of fixed but adjustable rates (an **adjustable peg**) required that governments keep currency values fixed for relatively long periods but permitted them to alter (“adjust”) currency rates if and when they found it desirable to do so.

In practice, the Bretton Woods monetary system meant that the U.S. dollar’s value could not change (it was fixed at \$35 per ounce of gold). Other governments also fixed their currency against the dollar, but the national government of a country other than the United States could devalue or readjust its currency’s value if it felt a change was necessary. Typically, such changes were infrequent, occurring once every five to seven years. The Bretton Woods monetary system was seen as a middle ground between gold-standard rigidity and complete unpredictability. As under the gold standard, exchange rates were stable enough to encourage international trade and investment. As under a more flexible system, the exchange rates could be varied as necessary, albeit rarely.

As these examples indicate, a national government’s decisions about the exchange rate often depend on international monetary conditions. While national policies are important, from the standpoint of international economics and politics more generally, it is the *global* nature of international monetary relations that is most relevant. We will return to these international issues later in the chapter. First, however, we evaluate the potential for *domestic* conflicts of interest over exchange-rate policy.

Who Cares about Exchange Rates, and Why?

A national government's decision about its exchange rate leads the country to take other policies to support its decision. Both the initial currency policy and the other economic measures needed to sustain it affect different domestic groups differently. This disparity can lead to disagreement over the appropriate currency policy to pursue.

Governments

A government deciding what to do with its currency must consider important trade-offs and domestic interests that are often in conflict. One dimension of conflict involves whether the currency should be fixed, floating, or in between. Each choice helps some domestic actors and hurts others.

Fixed exchange rates, such as the gold standard or a peg to the dollar, provide currency stability and predictability, which greatly facilitate international trade, investment, finance, migration, and travel. Under the gold standard, businessmen, investors, and immigrants did not have to worry about changes in exchange rates or about major impediments to moving money around the world. The stimulus to trade was substantial; being on gold in this period is estimated to have raised trade between two countries by 30–70 percent.² Generally speaking, a fixed currency provides stability that facilitates international economic exchange; it also provides a monetary anchor that keeps prices stable. A fixed currency is thus very much in the interest of those engaged in cross-border trade, investment, finance, and travel, as well as those who want to keep inflation low.

However, there are costs to fixing the exchange rate, so some people and governments are strongly opposed to it. By definition, a government on a fixed exchange rate is committed to maintaining its currency's value, even if economic conditions could be improved with a change. A fixed rate reduces or eliminates a government's ability to have its own independent monetary policy, which can be costly. For example, if an economy is in recession, a common economic policy response is to lower interest rates and thereby promote borrowing to expand consumption and investment. This move stimulates the economy, as mentioned earlier, and may help alleviate the recession.

But if a country is on a fixed exchange rate, its interest rates are dictated by the need to keep the currency's value constant. For example, the government will raise interest rates if the exchange rate threatens to depreciate, in order to encourage investors to buy the currency. This is the case even in difficult economic

2. See, for example, A. Estevadeordal, B. Frantz, and A. M. Taylor, "The Rise and Fall of World Trade, 1870–1939," *Quarterly Journal of Economics* 118 (May 2003): 359–407; and J. Ernesto Lopez-Cordova and Christopher M. Meissner, "Exchange-Rate Regimes and International Trade: Evidence from the Classical Gold Standard Era," *American Economic Review* 93, no. 1 (2003): 344–53.

MAP 9.1 Exchange-Rate Regimes, 2015

Today, several of the world's major economies, including the United States and Japan, allow the value of their currency to float independently. However, exchange-rate regimes around the world span a wide spectrum, from those that have given up their national currency, such as countries in the eurozone, to those that peg the value of their currency to the dollar, the euro, or other currencies. Countries with a "crawling peg" or "managed floating currency" can be considered to have a floating exchange rate, though with some limits on changes in the value of the currency.



Arctic Ocean





A currency exchange-rate board, like this one in Tehran, Iran, is a familiar site for the foreign traveler. Travelers to foreign countries find that their money goes further when their country's currency is strong relative to the local currency. The same is true when goods are traded across borders; buyers find that foreign goods are less expensive when their own currency is relatively stronger.

times, when there can be strong pressures for the government to allow the currency to depreciate so as to make the country's goods more attractive to foreign consumers. The government's commitment to a fixed exchange rate makes this impossible.

A fixed exchange rate, of course, makes the central bank—the institution charged with running domestic monetary policy—much less influential, and central bankers may have reservations about giving up their ability to control interest rates. More generally, producers of goods that compete on import or export markets might want the government to be able to change the currency's value so that it becomes easier for them to sell their products. But this is impossible with a fixed exchange rate.

Both of these fixed-currency constraints were at work in the run-up to the 2001 Argentine crisis, and in the eurozone crisis that began in 2008. In 2001, the Argentine peso had been tightly fixed to the U.S. dollar for 10 years, but the Argentine economy was in great distress. There were powerful pressures for the government to address broader economic conditions—in particular, to lower inter-

est rates and to depreciate the currency so that Argentine goods would become more competitive on international markets. To carry out this strategy, the Argentine government needed to loosen the peso's link to the dollar. But at the same time, many Argentines did not want to see the peso's value change; among them were millions of homeowners whose mortgages were in dollars and who would have had to pay substantially more in pesos if the currency was devalued. With powerful interests on both sides, the Argentine government was paralyzed.

Members of the eurozone faced a similar instance of the constraints of a fixed exchange rate after 2008. As the global financial crisis deepened and the European debt crisis worsened, some countries that used the euro, such as Greece, Ireland, Spain, and Portugal, faced severe economic difficulties. If those countries had had their own national monies, they could have loosened monetary policy and depreciated their currencies. This action would have made their goods cheaper for other countries, increasing the amount of goods they exported, and thus bringing more money back into the country. By selling more, their economies would have grown faster, and perhaps they could have exported their way out of recession. But these nations were part of a multicountry currency union, whose monetary and exchange-rate policies were set in Frankfurt by the European Central Bank (ECB) on behalf of the entire eurozone. This meant that the governments of these nations simply did not have the tools of monetary and exchange-rate policy in their arsenals as they attempted to confront the crisis.

The problems that a fixed exchange rate caused for the Argentine and eurozone governments demonstrate one important advantage of a floating exchange rate: it gives a government more freedom to pursue its own monetary policies, as it is not hampered by the need to keep the exchange rate fixed. But this advantage is countered by the fact that floating exchange rates can move around a great deal, which can impose costs on those engaged in international trade and investment, and which more generally can impede international economic exchange. Volatility (that is, frequent significant shifts) in currency values almost certainly makes international trade and investment, travel, and finance more difficult.³

Consumers and Businesses

Different actors have different interests, and often conflicting views, about how the national currency should be managed, depending on their position in the economy. Those whose economic activities are entirely domestic are likely to favor a floating exchange rate because they are indifferent to currency fluctuations but want the government to be able to affect the national economy as necessary. Those with international economic concerns have an interest in a fixed currency because too much volatility in exchange rates can be harmful to their activities.

Just as people, firms, and groups may have conflicting interests over whether a currency should be fixed or floating, actors' interests may also differ over a currency's desirable value (that is, whether it should be stronger or weaker). Government policy can have a powerful impact on whether a currency's value rises or falls in the short and medium run, which in turn can affect important domestic interests.

A strong exchange rate allows consumers and others to buy more of the world's products, thereby increasing national purchasing power. But there is a trade-off: a strong exchange rate makes domestic goods more expensive to foreigners, which harms national producers who compete with foreigners on local or world markets. This is why manufacturers and farmers typically complain about a strong currency: it leads to a surge of cheaper imports, and it dampens exports.

For example, the U.S. dollar appreciated by more than 50 percent between 1981 and 1985. This rise in value was associated with a big increase in Americans' purchasing power and ability to buy goods from the rest of the world—all of which contributed to a sense of prosperity among American consumers. However, the strong dollar led to a flood of cheaper imports into the United States and made U.S. exports more expensive to foreigners. As a result, serious problems arose in American manufacturing industries, and 1.5 million manufacturing jobs were lost.

The strong dollar was particularly damaging to firms that either sold many of their products abroad or competed with imports; it led the president of one such firm, Caterpillar Tractor, to call the strong dollar “the single most important trade issue facing the U.S.” Under this pressure, in 1985 the Senate passed a unanimous

3. The specific constraints on exchange-rate policy are known as the Mundell-Fleming conditions, after the two economists who pioneered the approach. They imply, simply put, that in a financially integrated country, the government must choose between a stable exchange rate and an independent monetary policy; it cannot have both. See, for example, Jeffry A. Frieden, “Invested Interests: The Politics of National Economic Policies in a World of Global Finance,” *International Organization* 45, no. 4 (Autumn 1991): 407–31.

resolution calling on the administration to depreciate the dollar.⁴ Eventually, the dollar did decline, and complaints subsided.

A weak currency gives a big boost to national producers. This is why countries that are trying to encourage exports—such as many developing countries—typically keep their currencies weak. It is also why manufacturers and farmers, who compete with foreign producers both at home and abroad, have an interest in a relatively weak exchange rate. But there is a trade-off here too: a weak currency reduces national purchasing power, making consumers worse off. As the dollar declines, Americans can buy fewer of the world's products—and tourists cannot afford foreign vacations so easily. Declines in a currency's value and increases in prices of foreign goods can also contribute to overall price rises and inflation.

Both strong and weak currencies have advantages and disadvantages, and there is no particular reason that one or the other is better for a country. A strong currency helps consumers (and tourists) but hurts producers who compete with foreigners; a weak currency helps producers but hurts consumers. These conflicts of interest make currency policy controversial within countries and can make governments sensitive to the domestic political and economic effects of their currency arrangements.

Such conflicts are evident when the possibility arises that a government might devalue its currency. Because the devaluation makes foreign goods more expensive and domestic goods relatively cheaper, it is in the interests of national producers. But the devaluation also reduces consumers' ability to buy goods and services. In this context, it is perhaps not surprising that governments in democratic systems typically avoid currency devaluations or depreciations in the run-up to elections, for fear that the negative impact on consumers will cost them votes.⁵

A government's interest in exchange-rate policy depends on the structure of its economy, its interest groups, and its political system. In a country with many firms and individuals engaged in economic activities across borders, the government is likely to face powerful pressure to stabilize or fix the currency's value. This is why the smaller economies of Europe that were extremely open to trade with other European countries (the Netherlands, Belgium, Luxembourg, Austria, Ireland) were among the strongest supporters of the creation of the euro. However, some larger European economies that traded and invested less across European borders (like France and Italy) were less enthusiastic.

This is also why, in the Western Hemisphere, small countries that are tightly tied to U.S. trade, investment, and tourism (such as Caribbean island nations, El Salvador, and Panama) have been the most likely to adopt the U.S. dollar or to fix their currencies to it. Larger, more self-sufficient economies (like Mexico and Brazil) have typically allowed their currencies to vary.

One currency policy that has been the source of much controversy in recent decades is the tendency of some governments to keep their currency very weak over

4. Jeffry A. Frieden, "Economic Integration and the Politics of Monetary Policy in the United States," in *Internationalization and Domestic Politics*, ed. Robert O. Keohane and Helen V. Milner, 127–30 (Cambridge: Cambridge University Press, 1996).

5. S. Brock Blomberg, Jeffry Frieden, and Ernesto Stein, "Sustaining Fixed Rates: The Political Economy of Currency Pegs in Latin America," *Journal of Applied Economics* 8, no. 2 (November 2005): 203–25.

long periods of time in order to stimulate their exports. The most prominent example is that of China, which after 1979 organized its development strategy around the promotion of manufactured goods for export. A major part of this strategy involved keeping the Chinese currency, the renminbi, artificially weak. The export promotion policy was very successful, and China has become one of the world's greatest exporters.

But if the government had let the dollars its exporters earned come back into the Chinese economy, they would have been used to buy renminbi for local purchases, and the renminbi would have appreciated against the dollar. This, in turn, would have made Chinese exports less attractive on world markets. So the Chinese government used a series of measures to keep its currency depreciated. It controlled capital flows and the domestic market for foreign currency, and it held very large reserves of dollars overseas (keeping them from coming back to China to be spent).

The Chinese government's currency policies were very successful at promoting the nation's exports. But they created problems both at home and abroad. Within China, the weak-currency policy effectively taxed consumers to benefit export producers. An artificially weak renminbi meant that Chinese residents had artificially low purchasing power. There were complaints from Chinese consumers and the country's growing middle class that the average Chinese person had not gotten the full benefit of the country's rapid economic growth and that disproportionate benefits had gone to the export producers.

Another set of problems was international: China's trading partners, in particular the United States, complained with increasing vehemence that the artificial weakness of the renminbi was an unfair trading practice. This dispute threatened to break into open trade conflict between the United States and China on many occasions since 1990. (For more on recent developments, see "Controversy" on p. 400.)



Countries with unstable economies may choose to fix their currency's value to that of a more stable currency, like the U.S. dollar or the euro. Other countries have no national currency at all. In Zimbabwe, for example, the U.S. dollar is the most widely used of the country's legally acceptable currencies.

CONTROVERSY

Should Countries Be Allowed to Manipulate Their Currencies?

During his 2016 campaign for the presidency, Donald Trump promised that, as president, he would “label China a currency manipulator” within his first 100 days in office.^a In April 2017, however, just before the hundredth day of his term, President Trump announced that he would not, in fact, follow through on this threat. Why had then candidate Trump been concerned about China manipulating its currency? What did his threat to label them manipulators imply? Why did he not carry out his promise? More generally, what is currency manipulation, and should it be discouraged, even punished, by other countries or by international institutions?



Applying the Concepts

A country may have an **interest** in “manipulating” its currency, or intervening in currency markets to alter the currency’s value, in order to give its producers a competitive advantage in international markets. This policy often leads to bitter **interactions** between the

country and its trading partners, who resent the policy’s impact on their own producers. There are domestic and international **institutions** in place that are meant to address currency manipulation. Nonetheless, the issue remains controversial: some leaders and analysts believe that national governments should be permitted to set their currency’s value as they wish.

Controversies over currency manipulation typically arise when a government sells its own currency (and buys other currencies) in order to weaken its exchange rate. A weaker (depreciated) currency reduces the price of domestic goods to foreigners and makes it more attractive for foreigners to buy the country’s goods. Many developing countries purposely keep their currencies weak because

they want to stimulate exports. East Asian countries, in particular, have often kept their exchange rates artificially depreciated as part of their attempts to encourage domestic manufacturers to produce for world markets. Japan, South Korea, and Taiwan have all pursued this strategy at different points in their histories.

Most governments oppose currency manipulation by their trading partners. Although their own consumers benefit, they usually face a backlash from domestic producers, who, when confronted with cheaper imports, demand that their government do something to relieve the competitive pressure on them. As a result, nations often strongly criticize countries that manipulate their currencies. In some cases, these conflicts lead to threats of retaliation and other countermeasures.

After China opened to the world economy in 1979, and especially after 1990, there were many accusations that it was manipulating its currency—the *renminbi*—in order to give Chinese manufacturers an advantage in world markets. Most analysts would agree that Chinese government policy did artificially weaken the renminbi. Chinese export manufacturers benefited from this policy because it enabled them to sell more of their goods abroad. Producers who competed with Chinese exports—including many European and American manufacturers—believed they were harmed by China’s policy. Chinese consumers were also hurt by a weak currency, because it reduced their purchasing power, and European and American consumers benefited because they could buy Chinese goods more cheaply.

a. “Donald Trump’s Contract with the Voter,” https://assets.donaldjtrump.com/_landings/contract/O-TRU-102316-Contractv02.pdf (accessed 10/10/17).



In an effort to avoid conflicts over currency manipulation, the IMF and the World Trade Organization (WTO) have rules against it. Despite the importance of these international institutions, however, they have little enforcement power in this realm. These issues are usually dealt with in bilateral interactions between the country accused of manipulating its currency and that country's trading partners.

American interactions with countries that it considers to be currency manipulators have often been conflictual. Under then existing U.S. law, the Treasury Department found that Japan was a currency manipulator in 1988, Taiwan in 1988 and 1992, and China between 1992 and 1994. In these cases, the United States put pressure on the countries to stop the practice, and eventually the Treasury Department found that the manipulation had ceased. But complaints persisted, especially as China's exports to the United States continued to grow.

A 2015 law gave the U.S. government more tools to punish alleged manipulators, including the ability to cut off some government funds to the country in question and the option to reevaluate existing trade agreements. When Donald Trump promised to label China a currency manipulator, he was threatening to impose these, and potentially other, sanctions on a country that he regarded as harming American economic interests.

Why didn't Trump follow through? For one thing, by the time President Trump took office, most economic analyses indicated that China was not trying to weaken its currency. In fact, the Chinese government appeared to be trying hard to prevent weakening of the renminbi. For another thing, the Trump administration felt that labeling China a currency manipulator would interfere with its own efforts to secure China's cooperation in dealing with an increasingly troubling problem: North Korea's acquisition of nuclear weapons. For both economic and diplomatic reasons, then, President Trump did not label China a currency manipulator.

The broader question remains: Should international institutions, or individual governments, try to punish a government for manipulating its currency? After all, many analysts believe that poor countries should have weak currencies to stimulate exports and production more generally, and consumers in rich countries benefit when they can buy more inexpensive goods from weak-currency countries. Others, however, argue that a government that artificially weakens its currency is putting unfair competitive pressures on producers in other nations, thereby potentially provoking protectionist retaliation.



China has faced accusations that it was artificially weakening the value of its currency, the renminbi.

To some extent, currency manipulation is simply a clash of interests. It helps exporters in the country whose currency is weak, and it helps consumers in other nations. These benefits come at the expense of producers in other countries, and of consumers in the manipulating country. Normally, currency manipulation might simply be the source of conflictual interactions within and between countries. However, when the country accused of manipulating its currency plays a large role in international trade—such as China, or Japan in earlier years—conflicts over currency manipulation can spill over into trade conflicts. To the extent that these disagreements become a source of friction in international trade and other economic relations, they may be of broader international importance.

Thinking Analytically

1. Which groups within the United States are most likely to be harmed by Chinese currency manipulation to lower the value of the renminbi? Why? Are there U.S. groups that benefit when the renminbi is weaker relative to the dollar?
2. Why might China have decided at a certain point that changing course and propping up the value of its currency was in its economic interest?
3. When it comes to the role of international institutions, what are some arguments for their punishing currency manipulators? What are some arguments against their doing so?

National currency policy implicates contending interests and complex institutions within countries. As disputes over China's currency indicate, the matter is doubly complicated because one government's exchange-rate policy inevitably affects other countries' policies. This observation takes us to the international level, where national governments with interests in conflict, and in common, interact over the structure of the international monetary system.

International Politics and International Monetary Relations

A monetary system is crucial to any modern economy; this is also true of the international economy, which requires some institutional arrangement to permit trade, investment, and other payments across borders. A *national* monetary order provides predictability in the value of a trusted money and thus in the prices of goods; this is widely seen as one of the core functions of the institutions of national government. An *international* monetary order does the same for prices across borders—which means that it has to provide predictability in currency values.

If traders, investors, tourists, and others had no idea what exchange rates would be tomorrow or next week, they would be very reluctant to engage in exchange across borders. For the international economy to work well, there must be some predictability to currency values so that people can reasonably expect that the dollar or peso they are earning today will be worth something tomorrow.

A stable and predictable monetary arrangement that allows firms and people to compare prices and transact business from one nation to another benefits almost everyone. Governments and people tend to share a desire for a general commitment to a common international monetary order. In this sense, a common regime is a Pareto improvement over a world in which there is no agreement on global monetary relations; that is, it makes all countries better off—or at least as well off—and none worse off. Agreement on a monetary regime thus has many features of a public good: everyone benefits if there is a smoothly functioning way to carry out international economic transactions.

As with most public goods, however, the provision of this monetary order is not automatic or easy. Since there is no one global institution to provide a global monetary order, a functioning order requires conscious efforts by individual national governments to alter their policies, or to contribute funds to stabilize currencies, or to otherwise help sustain the system. In the absence of a world government and a world money, many institutional arrangements have emerged to provide this global public good. Under the classical gold standard of the nineteenth and early twentieth centuries, gold was the common denominator for international transactions. Under the Bretton Woods monetary system, which prevailed from 1945 to 1973, the dollar was the centerpiece of the monetary order.

But there can be disagreements over the nature of the international monetary system and every country's place in it; the different actors in the international political economy may have conflicting interests about the kinds of international

monetary institutions they would like to see in place. Governments and people often differ on the standard they would prefer. During the days of the classical gold standard, for example, many people and governments—including some powerful political movements—preferred a silver standard to a gold standard.

Supporters of silver typically believed that if silver, which was plentiful, served as money, prices would be higher than they would be with gold, which was scarce. Adoption of a silver standard rather than a gold standard, they believed, would thus help raise the prices of goods they produced. By the same token, during the decades of the Bretton Woods monetary system, Americans were quite satisfied with a system that put the dollar at its center, but Europeans were less enthusiastic. International monetary relations are infused with this tension between sources of conflict and reasons for cooperation.

International Monetary Cooperation and Conflict

Just as there are conflicting interests within countries over national policy, there are trade-offs and conflicts of interests among countries over international monetary arrangements. It can be difficult to organize collaboration among governments to provide the public good of international monetary stability, because there are powerful incentives to free ride on the efforts of others. Governments of smaller countries might reason that their contributions are too trivial to matter and thus not participate; if enough governments follow this path, cooperation will break down. For example, a global fixed-rate system such as the gold standard can facilitate international trade and investment, but the government of a small country might decide that it can benefit from the global system without fixing its own currency and tying its hands. If enough countries take this route, the system will collapse.

A successful international monetary regime depends on interactions among the governments of the world's major economies. The behavior of these governments sets the standards for the regime as a whole, and they need to address problems as they arise. However, governments also face major temptations to "cheat" on their international monetary commitments. In a fixed-rate regime, for example, one government might decide to devalue in order to make its producers' goods more competitive on world markets. Other countries might respond by also devaluing to allow their producers to match.

The result is akin to the undesirable outcome of a Prisoner's Dilemma game (see the "Special Topic" appendix to Chapter 2, on p. 83). If every nation engages in competitive devaluations, all currencies end up being devalued, and nobody gains any advantage. Meanwhile, the currency turmoil can throw international monetary relations into disorder and uncertainty, thereby interfering with normal economic activities.

Interactions among national governments, facing incentives both to cooperate and to enter into conflict, have determined the character of international monetary relations, including the emergence of global and regional monetary institutions. In the following section, we take a closer look at the evolution of international monetary arrangements over the past couple of centuries.

international monetary regime

A formal or informal arrangement among governments to govern relations among their currencies; the agreement is shared by most countries in the world economy.

International Monetary Regimes

National government decisions to float or to fix their currencies interact to create an **international monetary regime**—that is, an arrangement, which may be formal and institutionalized or informal, that is widely accepted to govern relations among currencies, and that is shared by most countries in the world economy. There may also be regional monetary regimes that prevail in particular geographic regions, such as in Europe with the euro.

The existence of a generally accepted international monetary regime has clear benefits for the international community in general, since it facilitates international economic exchange. It may come, however, at the cost of national sacrifices, as we will see. First we will define the characteristics of international monetary regimes.

International monetary regimes have two principal features. The first makes clear whether currency values are expected to be fixed, floating, or a mix of both. As discussed already, the classical gold standard and the Bretton Woods monetary system were international fixed-rate regimes (although the Bretton Woods monetary system allowed for occasional adjustments). The contemporary regime is based on floating rates; there is no general agreement that national currency values should be fixed.

The second feature of an international monetary regime is agreement about whether there will be a mutually accepted benchmark against which values are measured—some common base or standard to which currencies can be compared. Three such standards have been used over time: a commodity standard, a commodity-backed paper standard, and a national paper currency standard.

A *commodity standard* uses a good with value of its own as the basic monetary unit. Typically, this good is a precious metal such as gold or silver. Under the classical gold standard that prevailed from the 1870s until 1914, for example, all major national currencies had a fixed value in terms of gold, and they could be exchanged freely on the basis of their gold equivalent. This was a fixed-rate regime based on gold as the commodity standard.

A *commodity-backed paper standard* is similar to the Bretton Woods monetary system that prevailed from 1945 to 1973. Under such a regime, national governments issue paper currency with a fixed value in terms of gold (or some other commodity). This is one step removed from a pure gold standard, as it requires that governments be able to commit credibly to stand ready to redeem the currency for gold. Nonetheless, under such a standard, national currency values are comparable because they are all expressed in terms of a common commodity: gold. Under the Bretton Woods monetary system, the U.S. dollar was fixed to gold, while all other currencies were fixed to the dollar.

Under a *national paper currency standard*, national currencies are backed by only the commitments of their issuing governments to support them. In this context, people want to know that the government will act to ensure that the national currency continues to be valuable. This may not mean committing to a fixed rate; it does mean committing to the currency not losing so much value as to become undesirable. Foreigners who hold dollars or euros, or who accept promises to pay in dollars or euros, do so with the expectation that even if exchange rates do change, dollars and euros will continue to be valuable national monies. Typically, only a

few major currencies are used for international exchange—usually, the currencies of the world's most important trading and financial powers. This is the system that has prevailed since 1973. Today, most international exchange is measured and conducted in the dollar and the euro.

A Short History of International Monetary Systems

The modern international economy has experienced all three of these kinds of international monetary regimes.

The Gold Standard Under the classical gold standard, most of the world's major economies had gold or gold-backed currencies tied together at exchange rates that did not change for decades. The portion of the world that was on gold—which eventually came to include every major economy except China and Persia—effectively had a common money: gold.

The stability of the classical gold standard relied on close ties among the three leading financial powers of the day—Britain, France, and Germany—along with support from smaller European nations. For example, when the 1890 collapse of Barings, a major British bank, threatened to destabilize the London markets, the central banks of France and Russia lent large sums to the Bank of England. The mere knowledge that enough money was available to address the problem helped calm investors. In 1898, the British and French helped stabilize German financial markets; a few years later, the Austrians helped calm the Berlin market. And at least seven more times between 1900 and 1914, the French stepped in to assist the British in order to stabilize the gold standard.⁶

The gold standard provided currency stability and predictability, which greatly facilitated international trade, investment, finance, migration, and travel. Most of the world's governments and many countries' citizens agreed that this common monetary standard was generally beneficial. Such confluence of interests among the major financial centers allowed them to interact cooperatively to sustain the gold standard for many decades.

However, the costs to being on gold made some people and governments less enthusiastic. As we saw in our discussion of a fixed-rate system, a government on the gold standard gave up its ability to run its own independent monetary policy, which implied a serious loss of economic policy influence. In the United States, the gold standard was very controversial; in fact, the 1896 presidential campaign was largely fought around it. William McKinley and the Republicans ran in favor of maintaining the American commitment to gold, but many Americans were hostile to the gold standard. The anti-gold forces, led by the Populists, wanted the government to take the dollar off gold and put it on silver at a different rate.

The move to silver would have accomplished two things: it would have devalued the dollar, making American exports more competitive, and it would have

6. For a classic account of the gold-standard era and the interwar collapse of the gold standard, see Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* (New York: Oxford University Press, 1992).

raised American prices. Farmers in particular liked the idea of a devaluation, as many of them produced for export markets. They, and others, also liked the idea of raising prices, as many of them were heavily indebted, and an increase in prices could have reduced their debt burden (the debts would have remained the same, while prices for farm products would have risen). Therefore, the Democratic Party and the Populists united around William Jennings Bryan, who famously said to gold supporters, “You shall not crucify mankind upon a cross of gold!”

Bryan lost in 1896 and again in 1900 and 1908, although the anti-gold movement he represented remained strong. (See “What Shaped Our World?” on p. 407 for more on this episode of U.S. history.) Nonetheless, there was enough domestic political support for the international cooperation necessary to sustain the gold standard that it was solid and extensive for almost 50 years, from the 1870s until 1914.

In the 1920s and 1930s, attempts to restore the classical gold standard were largely unsuccessful. Most countries did go on gold again after World War I ended, but the sort of international monetary cooperation that had allowed the classical gold standard to succeed had become difficult to organize. Countries such as France and Germany were on very poor terms diplomatically, which created an atmosphere of distrust that impeded efforts to negotiate monetary collaboration. As interests diverged, interactions among the major financial players became more hostile.

This failure to cooperate in the 1920s was exacerbated by the Great Depression, which began in 1929. Faced with massive crises, governments were unwilling to forgo an economic policy that might allow them to alleviate the suffering of their citizens. After 1929, virtually all the governments that had gone on gold in the 1920s went back off it as they tried to resuscitate their failing national economies. The result was a floating-rate system based on paper national currencies. This system led to a great deal of currency volatility and instability, including many competitive devaluations, and probably contributed to the overall collapse of the international economy in the 1930s. In any case, monetary disorder was overwhelmed by the economic and military conflicts of the 1930s and 1940s.

The Bretton Woods Monetary System As World War II drew to a close, the United States and Great Britain led the victorious Allies in designing an international monetary order—called the Bretton Woods monetary system because the agreements were negotiated at the Bretton Woods resort in New Hampshire—that represented a fundamental reform of the gold standard.⁷ The Bretton Woods monetary system was organized around the U.S. dollar, and the dollar was tied to gold at the fixed rate of \$35 per ounce. While other currencies were tied to the dollar, and thus indirectly to gold, they were permitted to be adjusted as necessary.

This system was seen as a middle ground between gold-standard rigidity and interwar insecurity. Like under the gold standard, exchange rates were stable

7. The term *Bretton Woods System* is sometimes used to describe the post–World War II international economic order more generally; we use the term *Bretton Woods monetary system* more narrowly to describe the currency order.

The Wizard of Oz and the Gold Standard

The gold standard was a central institution of the late nineteenth and early twentieth centuries. This international monetary system, and political battles over it, was so prominent that one of the most famous children's stories of all time may well be a parable about the politics of exchange rates in the gold-standard era.

The book *The Wonderful Wizard of Oz* was first published in 1900; it was turned into the film in 1939. The story chronicles the adventures of Dorothy, a girl from Kansas whose house is swept up in a tornado and transported to a magical place populated by munchkins, witches, and other strange creatures. The Good Witch of the North counsels Dorothy to follow the yellow brick road to the Emerald City and seek the help of the Wizard of Oz to return home to Kansas. The Good Witch also gives Dorothy a pair of magic slippers. Dorothy skips along the yellow brick road and meets a brainless scarecrow, a tin man without a heart, and a cowardly lion. Together, this motley team battles the Wicked Witch of the West to gain access to the venerable wizard. At the end of the story, they realize that the wizard is a fraud, but fortunately the Good Witch reappears and informs Dorothy that she can return home simply by clicking together her magic slippers.

What does *The Wizard of Oz* have to do with exchange-rate politics? A little background on the gold standard will help to elucidate the symbolism in the story.

Institutions Starting in the 1870s, the U.S. government officially agreed to exchange dollars for gold at a fixed

rate of one ounce of gold for \$20.67. This institution was intended to facilitate international trade and financial flows. However, one problem with this policy was that the domestic money supply was fixed to the availability of gold. If businesses produced more goods and services but the stock of gold remained steady, then prices would fall. This was indeed the case throughout much of the 1880s and 1890s. Because the United States was on the gold standard, it was not able to lower interest rates or allow the currency to depreciate, both of which would have boosted prices and stimulated the economy.

Interests Falling prices harmed nearly everyone, but they were especially harmful to farmers who sold their grain on world markets and borrowed money from banks to finance their operations. With the price of grain declining, farmers had difficulty earning enough to repay their debts. Industrial workers also faced tough times as unemployment increased. The dire economic conditions of the 1890s helped to fuel the populist movement, led by Democratic presidential candidate William Jennings Bryan. He wanted to replace the gold standard with an alternative system that would help increase the money supply—in particular, a system that included silver, a much more plentiful commodity. Bryan ultimately lost the 1896 election to William McKinley, a Republican who supported the gold standard.

Interactions With this background in mind, it is easy to see the symbolism in *The Wizard of Oz*, which was written just a few years after the 1896 election. Dorothy, representing the naive American public, believes that her problems will be solved if she simply follows a winding road paved with gold bricks. She meets a scarecrow (a farmer), a tin man (an industrial worker), and a lion whose roar masks his cowardice (Bryan). When Dorothy finally meets the Wizard (McKinley), she realizes that he is a fraud. In response, she simply clicks her slippers together to transport herself back home. In the original book, the slippers were silver.

The symbolism in *The Wizard of Oz* (note that oz is an abbreviation for ounce) reflects the political and cultural importance of different monetary systems.



Representatives of 44 countries met at the Bretton Woods conference in 1944 and negotiated a new monetary system organized around the U.S. dollar. After the turbulence of the interwar years and World War II, the Bretton Woods monetary system succeeded in bringing stability to currency values.



enough to encourage international trade and investment. Unlike under the gold standard, governments other than the United States could change their currencies' values as needed, although frequent changes were frowned upon. The Bretton Woods monetary compromise kept currency values stable and currency markets open, contributing to the growth of international trade and investment while allowing national governments to pursue national policies in line with national conditions.

Like the gold standard, the Bretton Woods monetary system relied on collaboration among its leading members. It was sustained in large part because the Western allies after World War II saw it as an important component of their economic and military alliance structure, just as the West's willingness to undertake international trade liberalization was related to its geopolitical alliance. There was thus a confluence of both economic and noneconomic interests among Western nations that facilitated cooperation. This cooperation was reminiscent of that which prevailed during the classical gold standard: under Bretton Woods, as under the gold standard, for example, it was common for the world's major national central banks to lend money to each other in times of crisis.

Under the Bretton Woods monetary system, the International Monetary Fund (IMF) was established as the principal institution to monitor interstate interaction on exchange rates. During this period, the IMF was charged with overseeing currency relations and with providing support to countries in need of short-term assistance in keeping their exchange rates stable. The IMF made information available to members and provided standards of behavior that countries were expected to follow with respect to their currencies. The backing of the major Western financial powers, along with the institutional support of the IMF, was central to the stability of the Bretton Woods monetary system.

Eventually, however, international monetary cooperation failed because of fundamental disagreements among countries. By the early 1970s, the U.S. government was unwilling to make the sacrifices necessary to keep the dollar fixed to gold. President Richard Nixon felt that the Bretton Woods commitments constrained American economic policy more than was acceptable. The U.S. government felt itself too restricted by the rigid link between the dollar and gold, eventually breaking that link in order to give itself more monetary independence.

Today's International Monetary System Since 1973, international monetary relations have been based on floating exchange rates among a small number of major currencies, typically those of the principal industrial and financial nations (especially the United States, Japan, Germany, and Great Britain). While today's international monetary system does not depend on explicit commitments to fixed exchange rates, its orderly functioning still requires the major national governments to work together, especially in times of crisis.

And although the IMF was originally designed to monitor and assist the functioning of a modified fixed-rate international monetary order, the fund has remained important even after the shift to floating rates. When the major governments believe that exchange rates are fluctuating too wildly, they can coordinate their monetary policies to try to reduce these wide swings; the IMF sometimes serves as the venue for discussions about this sort of coordination. At times, currency problems in developing countries have led the major financial powers to intervene to attempt to stabilize exchange rates and keep a crisis from spreading; again, the IMF frequently participates in such attempts at crisis management and sometimes leads them.

Different alignments of national interests, and different patterns of strategic interaction among states, help account for different international monetary outcomes. It is striking that both the gold standard and the Bretton Woods monetary system each relied in major ways on the leadership of one country—Great Britain and the United States, respectively. Nonetheless, the participation of other major financial and monetary powers was needed to keep the systems going, so a sense of common interests was also crucial. As the collapse of both systems indicates, such participation can be difficult to sustain. It can be impeded by fundamental disagreements over how to share the costs of stabilizing the system or by a lack of trust among governments that the commitments of others will be honored.

Today's world of floating exchange rates presents a related set of problems. While the major powers do interact, generally cooperatively, to try to avoid major monetary disturbances, exchange rates still fluctuate quite widely. Since 1980, for example, the U.S. dollar has risen and fallen by very large amounts against other major currencies. While few people in the United States seem overly worried about this volatility, in smaller countries that trade more with the rest of the world, these currency fluctuations can be widely unpopular.

The current system is not monolithic (as was the gold standard) or organized (as was Bretton Woods), but it does have some clear defining features. Countries can allow their currencies to float freely, and large countries typically do; but smaller countries appear less enthusiastic about this currency volatility, and they often link

their currency to that of a larger nation or bloc. The absence of an established global monetary system has, in fact, led some countries to try to develop regional monetary systems that can at least stabilize exchange rates among groups of countries.

Regional Monetary Arrangements: The Euro

In the absence of a global agreement on stabilizing currencies, some countries have tried to work out regional arrangements. Where countries can resolve problems of cooperation, a more orderly system can be maintained regionally even as it disintegrates globally. This was the strategy pursued by most of the members of the European Union after the collapse of the Bretton Woods monetary system. Most EU countries trade and invest a great deal with one another—an arrangement that leads them to want to limit exchange-rate fluctuations. Starting in 1973, they committed themselves to stabilize exchange rates among EU member countries and eventually to work toward a common currency.

But the road to the euro was not an easy one, for both domestic and interstate political reasons. Within countries, some interests were often less than enthusiastic about a common monetary policy. In practice, fixing EU exchange rates meant pegging them to the German currency (the Deutschmark), for Germany was the largest economy in the European Union and had a long-standing commitment to keeping its currency, as well as its prices, stable.

In countries with higher inflation than Germany had, pegging the currency to the Deutschmark meant that governments would have to bring inflation down. The typical approach was to raise interest rates and implement austerity measures, such as restraining wages and cutting government spending. In France and Italy, labor unions and public employees, especially, felt that their interests would be sacrificed to the currency peg. It was not until 1985 that supporters of a fixed rate won out in these two countries. In Great Britain and Sweden, there were even fewer supporters of a fixed rate, and for most of the period these two nations kept their distance from the growing currency union.

At the regional level, interactions among the governments of the European Union were complex and often conflictual. Because other EU currencies were fixed to the Deutschmark, Germany's monetary policy had to be followed by other countries. This arrangement was satisfactory as long as they all agreed on the course of German policy. In 1991, however, in the aftermath of the reunification of the eastern and western parts of Germany, the German central bank was very concerned about inflation. To restrain prices, it raised interest rates very high. This measure, taken for entirely domestic reasons, forced the rest of the currency bloc to make a difficult choice. They could raise interest rates and drive their economies into recession; or they could keep interest rates low, in which case money would flow out of their countries, toward Germany's higher interest rates, and force them to leave the peg. The eventual result was a currency crisis (discussed in more detail shortly)—and the decision by many EU members to break the Deutschmark link.

Movement toward currency union continued, nonetheless, because there was a domestic consensus in most EU countries on the desirability of stabilizing currencies—even at the cost of giving up a national policy and even, in many cases, a

powerful national symbol, the currency. The next move was to plan for a common currency, the euro, to be managed by a common ECB. This measure appealed to countries other than Germany, because it meant that European monetary policy would be made by a European, rather than a German, central bank and would presumably take European conditions as a whole into account.

Germany went along for several reasons. First, the ECB was to be based in Frankfurt, and its constitution was drafted so as to ensure that it would be very similar to the German central bank. These facts helped allay German fears that the new institution would stray too far from the low-inflation principles that Germans preferred. Second, Germany itself wanted a reduction in currency volatility in Europe, and it was clear that other EU members would not accept a continuation of the Deutschmark-based system. Third, the creation of the euro and the ECB was connected to a broad array of cooperative ventures among EU member governments on a wide range of issues. Just as economic cooperation between the United States and western Europe was facilitated by their military alliance, monetary union among western European countries was facilitated by the fact that they had come to cooperate in so many other dimensions, from trade policy and antitrust law to foreign policy.

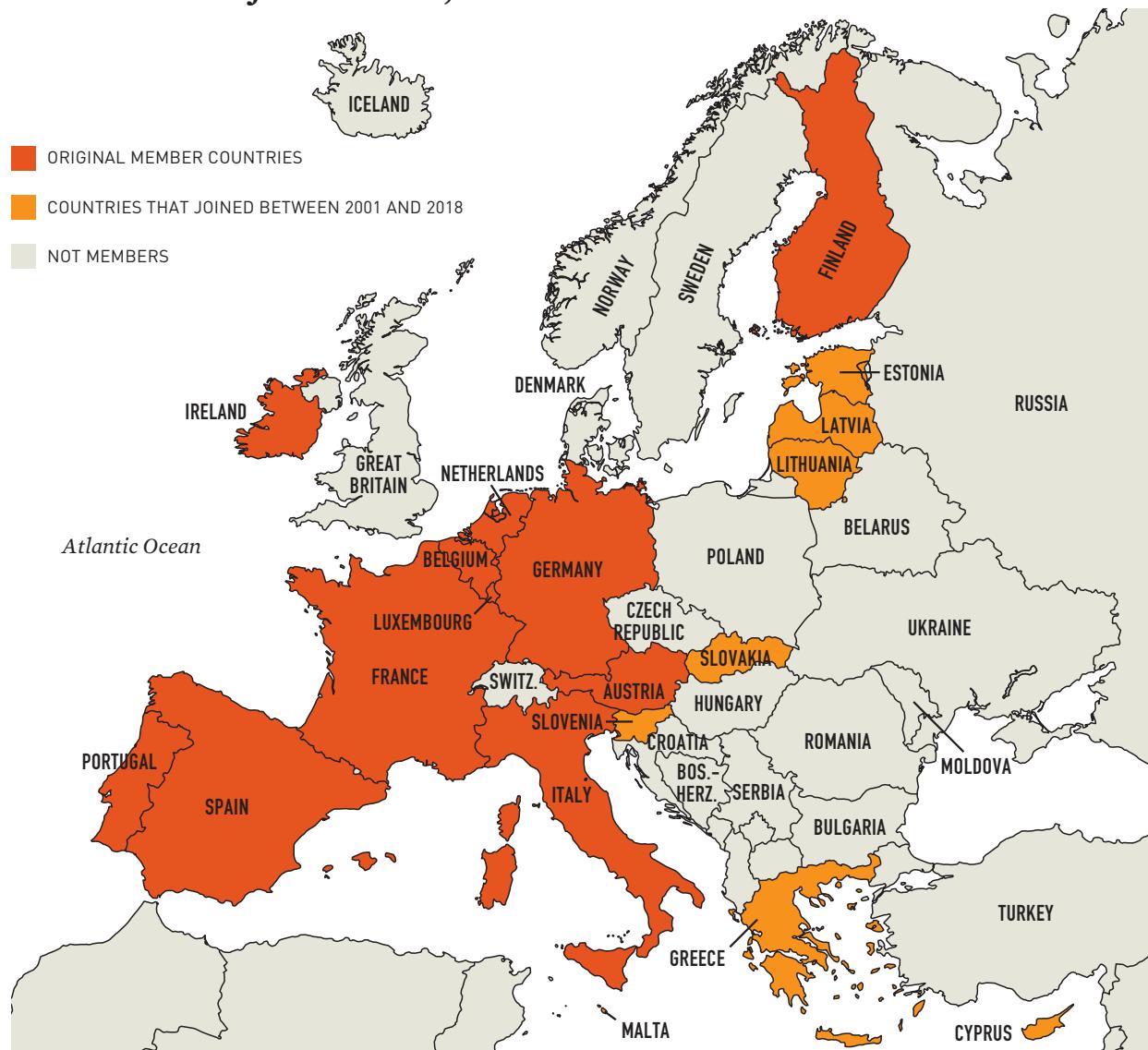
The combination of gradually emerging domestic consensus within most EU member countries and increasingly cooperative interaction among EU governments led to the adoption of the euro and its successful introduction as Europe's circulating money in 2002. As of 2018, 19 of 27 EU members share the euro, which is used by nearly 350 million people. (See Map 9.2 for members of the eurozone in 2018.)

The United Kingdom, which has voted to leave the EU, was never a eurozone member. Denmark has not adopted the euro but has fixed its own currency against the euro very tightly. Sweden remains outside the eurozone, as do six other, newer members of the European Union in central and eastern Europe (Bulgaria, Croatia, the Czech Republic, Hungary, Poland, and Romania). Many in these countries are wary of how eurozone membership would restrict their ability to manage their own monetary policies. This wariness has been heightened by the fact that the eurozone itself was recently wracked by a crisis that threatened its very unity (discussed shortly).

The creation of this regional currency union reflected the interests of many countries to stabilize their exchange rates in a time of turbulence. There are several other such regional currency arrangements. For example, 14 central and western African countries share a common currency, which is pegged to the euro; and eight Caribbean island nations and territories share a common eastern Caribbean dollar, pegged to the U.S. dollar.

Many other countries deal with concern over currency volatility by pursuing unilateral measures, such as adopting another currency (for example, Panama, Ecuador, and El Salvador use the U.S. dollar as their currency) or linking their currency to that of another country. All these strategies are aimed at achieving the desired balance between currency stability and policy independence—either on one's own or in collaboration with other national governments. While they may succeed in reducing threats to individual countries or groups of countries, these strategies do not address problems at the global monetary level, which some analysts regard as a matter for concern. Nor do they address the continuing problem of spreading currency crises, to which we turn in the next section.

MAP 9.2 *Members of the Eurozone, 2018*



What Happens When Currencies Collapse?

Even those who pay little attention to international monetary affairs notice the occasional spectacular currency crises, such as those that affected Europe in 1992–93 and again in 2011, East Asia in 1997–98, or Argentina in 2001. Indeed, currency crises have been a frequent feature of the modern international political economy. They are one of the more dramatic effects of national currency policy. Currency

crises have been closely related to the financial and debt crises discussed in Chapter 8 and have been associated with all-encompassing economic and political upheavals.

Currency crises usually result when government exchange-rate commitments are not fully credible. In this sense they are analytically comparable to crises in military affairs that result when the threats and promises of governments are not fully credible (see Chapter 3). In the case of currency affairs, when private economic actors do not believe the promises of a government with respect to its exchange rate, they can react in ways that cause a major crisis.

Effects on Government

Up to now, we have assumed that when a government fixes its exchange rate, it stays fixed until the government decides, on its own, to alter the arrangement. But we also know that it can be economically and politically difficult for a government to sustain a fixed currency, because a government with a fixed exchange rate may not be able to undertake monetary policies desirable to address national economic conditions.

This was the problem in Argentina in 2001, when the tight dollar-peso link made it virtually impossible for the Argentine government to reverse a three-year recession. It was also the problem in a number of countries in the eurozone in the aftermath of the crisis that began in 2008, for the fact that they had given up their national currencies made it very difficult for them to act to ease the impact of the Great Recession. In these circumstances, expectations that the government will not be able to sustain its commitment to a fixed rate or to membership in a currency union can create concern among economic actors about the future course of the currency. And this concern can feed on itself until it becomes a panic.

A typical currency crisis follows a fairly predictable trajectory. In order to reap the benefits of a fixed currency, the government commits itself to a particular fixed exchange rate—a peg to gold, the dollar, or the euro at a specific rate. This move presumably has all the advantages we have identified, but it also imposes costs. Over time, for some reason, the government faces economic and political difficulties in maintaining a fixed exchange rate. Perhaps the local economy is doing poorly, or exporters are clamoring for a devaluation that will make their goods more attractive abroad, or the country's main exports are losing markets to competitors.

As the government faces increasing pressures to devalue the currency, people begin to lose faith in the government's commitment to keep the exchange rate stable. This unease gives investors strong reasons to sell the nation's currency. After all, nobody wants to hold on to an asset, in this case a currency, that is going to lose value. So, investors at home and abroad start converting the local currency into more reliable foreign currency. The government usually continues to assure the public that the exchange rate will be maintained, in an effort to keep people from selling the currency. But as doubts about the government's credibility grow, more and more people may go to the banks to exchange their local currency for more reliable dollars or euros.



When the Argentine government devalued the peso in 2001, many homeowners whose mortgage was denominated in dollars saw the value of their debt triple compared to their salary (paid in pesos) in a span of just two months. This result fueled public anger.

The government itself is torn. On the one hand, there are powerful domestic interests in favor of keeping the currency's exchange rate where it is. Companies and others that have borrowed in a foreign currency, for example, are anxious to make sure the national currency is not devalued. For those with foreign-currency debts, a devaluation would increase the cost of their debt by requiring more of the national currency to buy the foreign currency they must use to repay the debt. In addition, a devaluation would reduce national purchasing power—an unpopular move with consumers, who would have to pay more for many goods as a result. On the other hand, there are good reasons to allow the currency's value to drop: it might alleviate economic distress and help national farmers and manufacturers compete with foreigners. ("How Do We Know?" on p. 415 looks at the decision to devalue the currency in several European countries.)

At the same time, sustaining the fixed rate can be very difficult. The government would have to take some action to convince people to hold on to the national currency rather than buying dollars or some other foreign currency. Most commonly, a government trying to convince investors and others to hold on to the national money has to raise interest rates in order to make the local currency more attractive—and raising interest rates is likely to exacerbate the country's economic difficulties.

Eventually, the government runs out of time, money, or patience, and the currency is devalued. A drop in a currency's value may have a positive effect by helping national producers compete with foreigners. But it also usually has some very powerful negative effects. Anyone in the country with substantial foreign-currency debts, including the government, faces serious trouble. As the local currency drops in value, the burden of foreign-currency debt rises.

In early 2002, the Argentine peso's value dropped from one to the dollar to three to the dollar in two months, so a \$1 million debt went from being a 1-million-peso debt to a 3-million-peso debt. In such circumstances, large numbers of debtors go bankrupt, which in turn leads many banks to fail because their customers cannot pay their debts. A recession almost always ensues, which can even turn into a deep financial and debt crisis. Indeed, most currency crises eventually turn into broader banking crises. This scenario has been repeated hundreds of times, from the nineteenth century through the present in developed and developing countries.

International Repercussions

The international aspect of currency crises can be particularly troubling. Currency crises can be transmitted from one country to another as uncertainties about one country feed uncertainties about others. Investors looking at countries that are

HOW DO WE KNOW?

Devaluation or Depression in the European Union

When the global financial crisis hit in 2008, governments in central and eastern Europe had to figure out how they would respond. These nations had recently entered the EU, and many of them were on track to adopt the euro. Most had currencies that were tightly tied to the euro.

As the world economy spiraled downward, each faced a serious exchange-rate policy choice. On the one hand, in order to move forward toward adoption of the euro, the government could hold fast to its peg to the euro. However, doing so would restrict it from adopting an independent policy, such as devaluing its currency. And this was a major restriction; one of the typical recommendations for small open economies in crisis is to devalue in order to make national goods more attractive on world markets and stimulate exports. On the other hand, if the government chose to devalue, it would forgo the opportunity to join the eurozone.

Political scientist Stefanie Walter analyzed the political economy of this choice.^a She focused on the interests at play in different central and eastern European societies and, in particular, on their citizens' debts in foreign currency. In the Baltic states of Estonia, Latvia, and Lithuania, for example, between 60 and 90 percent of total loans were in foreign currency. A devaluation would have dramatically increased the cost of this debt. If a Latvian homeowner took out a €100,000 mortgage in 2005, this would have been equal to about 70,000 Latvian lats (at the then current exchange rate of 1.00 lat to €1.42). But if the lat had been devalued by 30 percent (so that the lat and the euro were approximately equivalent), the mortgage would have increased in local value to about 100,000 lats.

TABLE A *Foreign-Currency Debt and Currency Depreciation*

	LOANS IN FOREIGN CURRENCY ^a	MAXIMUM DEPRECIATION OF NATIONAL CURRENCY ^b	REAL GDP GROWTH RATE, 2009 ^b	CHANGE IN UNEMPLOYMENT RATE, 2007–10 ^b
Latvia	88.4%	1.2%	-17.7%	13.3%
Estonia	85.3%	0%	-14.3%	12.2%
Lithuania	64.0%	0%	-14.8%	13.5%
Poland	32.6%	43%	1.6%	0%
Czech Republic	13.6%	21%	-4.7%	2%

a. Martin Myant and Jan Drahokupil, "International Integration, Varieties of Capitalism, and Resilience to Crisis in Transition Economies," *Europe-Asia Studies* 64, no. 1 (2012): 1–33.

b. Stefanie Walter, *Financial Crises and the Politics of Macroeconomic Adjustments* (Cambridge: Cambridge University Press, 2013), Table 7.1.

In some other countries, citizens had not borrowed very much in foreign currency. In Poland, foreign-currency debts were barely 30 percent of the total, and in the Czech Republic there were few foreign-currency debts. People in these countries were less vulnerable to devaluation.

Walter argues that the countries whose economic interests were most vulnerable to devaluation chose to keep their currency peg (Table A). Lithuania, Estonia, and Latvia, in fact, underwent massive recessions; unemployment approached 20 percent, and GDP dropped by over 15 percent in just one year. Nonetheless, they held on to their euro dreams, and all three countries are now in the eurozone.

Poland and the Czech Republic, whose economic interests were less vulnerable to devaluation, opted to devalue their currencies. Their exports boomed, and as a result, they experienced little or no increase in unemployment. The Czech Republic had only a shallow recession, and Poland had none. On the other hand, both countries largely foreclosed their option to join the eurozone—a step they did not particularly favor in any case.

a. Stefanie Walter, *Financial Crises and the Politics of Macroeconomic Adjustments* (Cambridge: Cambridge University Press, 2013), 181–217.

economically or politically similar may believe that the collapse of one country's currency portends the collapse of others like it.

Throughout the nineteenth century, currency crises (often originating in the United States, then a heavily indebted developing country) had repercussions all over the industrialized world. When, in 1931, Austria was hit by a currency and banking crisis, the resulting fears soon affected neighboring Hungary, leading to a follow-on crisis there. Then the crisis hit Germany, then the rest of Central Europe, then Great Britain; eventually, most of Europe was brought down by a "contagious" currency crisis that almost certainly deepened the Great Depression.

In the past 30 years, there have been many rounds of currency crises. The first was associated with the less developed countries' sovereign debt defaults of the early and middle 1980s. In this case, the currency crises followed, rather than led, the larger financial crisis. As country after country found itself unable to sustain its currency's value in the face of massive debt problems, currencies collapsed as well. Since the early 1990s, it has become more common for currency crises to be the source of broader financial and economic difficulties.

Case Study: Europe, 1992 One of the first major modern currency crises affected European countries that were moving toward currency union. In this process, most EU countries had pegged their currencies to that of Germany, the Deutschmark. In 1991, the German central bank raised interest rates quickly and steeply to keep prices from rising after the eastern and western parts of the country had been unified.

This action presented the other European countries whose currencies were tied to the Deutschmark with a difficult choice. On the one hand, they could keep interest rates low, which would cause investors to pull their money out of other countries in favor of the higher German interest rates. As investors pulled out and sold the non-German currencies, these countries would eventually have to devalue their currencies against the Deutschmark and break the peg. On the other hand, the other countries could raise interest rates along with Germany, which would shove them into a recession made in Germany. In sum, German policy confronted European governments with a stark choice between continued membership in the Deutschmark bloc on the one hand, and avoiding a recession on the other. The rest of Europe was already mired in slow growth and double-digit unemployment, and there was little enthusiasm for more austerity measures that would slow inflation but also reduce wages and public spending.

In the summer of 1992, investors and currency traders began anticipating that Great Britain and Italy would not maintain their currencies' pegs to the Deutschmark. Investors sold off their holdings of these currencies, thus intensifying speculation that the pound and the lira would be devalued. The British and Italian governments pushed interest rates up to try to convince investors to hold on to their pounds and liras, but in the end, the cost seemed extreme, and both devalued their currencies. Foreign-exchange traders started selling off other currencies in the months that followed. Governments tried to hold on to the link to the Deutschmark

(at one point, the Swedish central bank pushed interest rates to 500 percent), but the cost was too high.

Eventually, six other European nations followed Britain and Italy in devaluing their currencies. The damage to monetary unification was repaired quickly and effectively enough to move forward with plans for the euro. But it was clear that even the world's richest nations were not immune to currency crises that could force governments to devalue and change policies. The perception began to grow that there might be a common interest in trying to limit the negative effects of currency crises, since they could be transmitted from nation to nation.

Case Study: Mexico Within a year of the European currency crisis, the idea that currency crises could cross national borders was brought home to Mexico. With the North American Free Trade Agreement (NAFTA) in effect, the Mexican government wanted to hold the peso steady against the U.S. dollar. And in the run-up to a hotly contested presidential election campaign, the government wanted to keep the peso strong and Mexican incomes high. But in January 1994, a rebellion broke out in southern Mexico, and in March, one of the ruling party's leading presidential candidates was assassinated. These events worried investors, who came to believe that the government's position was shaky. As the election year of 1994 wore on, the government struggled to maintain its commitment to the peso, both to uphold its reputation and, through the strong peso, to increase the purchasing power of Mexican consumers.

But currency traders did not believe that the government could hold to its promises. Investors became more and more skittish, and the narrowness of the victory won by the ruling Partido Revolucionario Institucional (PRI), or Institutional Revolutionary Party, in the August 1994 presidential election was not reassuring. The PRI's secretary-general was assassinated in September, further scaring investors, who worried that the new government would be too unstable to commit credibly to the currency peg.

As the new government took office in December, currency traders sensed they could take a "one-way bet" against the peso: if it was devalued, they would win; if it wasn't, they wouldn't lose. As the speculators sold off the currency, the government tried desperately to keep the currency stable, but a few days before Christmas 1994, it floated the peso—which promptly sank. Yet another government had been forced to devalue its currency.

Following the common pattern of currency crises leading to financial crises, Mexico was next hit by a crippling banking crisis as a result of the currency collapse. When the peso was strong, many banks and companies borrowed heavily in dollars. The devaluation of the peso triggered mass bankruptcies as the real cost of dollar debts soared. The peso's value dropped in the space of a month from about 30¢ to about 15¢, so the real burden on a Mexican company of a \$1 million foreign debt doubled from about 3.3 million pesos to 6.6 million.

Many indebted firms collapsed, followed by their domestic bankers, and within weeks the country was in the throes of a financial panic. The country's output

dropped by 6 percent, and inflation soared above 50 percent. The fallout of the Mexican crisis affected all of Latin America, which was plunged into recession.

Case Study: East Asia The next round of currency and financial crises was even more dramatic. In 1997, the East Asian economies were booming, as about \$50 billion a year flowed into East Asia from global financial markets, with tens of billions more in direct investment from multinational corporations. The region seemed well on the way to rapid economic development. But there were a few warning signs of slowing growth and a bubble in housing and financial markets. By 1996 and early 1997, exports were lagging, inflation was rising, and banks were taking on more and more debt. Soon, investors began to anticipate devaluations and started selling off East Asian currencies.

In a now familiar spiral, the movement away from the region's currencies became a flood, then a stampede, then a panic. The sell-off spread from Thailand and the Philippines to Indonesia and Malaysia, then to Taiwan and Korea. The size and efficiency of international financial markets seemed to facilitate the attacks by making it remarkably easy for investors to speculate against government attempts to defend their currencies. Joseph Stiglitz, then chief economist at the World Bank, gave an example of the process:

Assume a speculator goes to a Thai bank, borrows 24 billion baht, which, at the original exchange rate, can be converted into \$1 billion. A week later the exchange rate falls; instead of there being 24 baht to the dollar, there are now 40 baht to the dollar. He takes \$600 million, converting it back to baht, getting 24 billion baht to repay the loan. The remaining \$400 million is his profit—a tidy return for one week's work, and the investment of little of his own money. . . . As perceptions that a devaluation is imminent grow, the chance to make money becomes irresistible and speculators from around the world pile in to take advantage of the situation.⁸

As more and more investors did as Stiglitz described, expectations of devaluations grew. Since no investor wanted to hold on to currencies that would lose value, billions of dollars flooded out of the East Asian economies, and eventually governments were, in fact, forced to devalue. Within weeks of the initial attack, the currencies of Korea, the Philippines, and Malaysia dropped by 40 percent, that of Thailand by 50 percent, and that of Indonesia by 80 percent. The political fallout was also intense: the government of Thailand fell, and after more than 30 years in power, the Suharto dictatorship in Indonesia collapsed.

Case Study: Europe, 2011–2015 The most recent major currency crisis in Europe was different from the early-1990s crisis: it involved the threat that a multicountry currency union might break up. The member states of the eurozone have very different economies and have grown at different rates, but as long as the zone as a whole was growing, these differences did not cause many problems. When the

8. Joseph Stiglitz, *Globalization and Its Discontents* (New York: Norton, 2002), 94–95.

global financial crisis began in 2008, however, it put major strains on the very structure of the euro.

A group of eurozone member states—especially Greece, Ireland, Portugal, and Spain—had borrowed very heavily after the euro was created. Their economies had boomed, but at the same time, these debt-financed booms raised prices and wages and made it harder for these countries to compete. Faced with the worldwide recession, the major debtor countries had trouble servicing their debts. Soon they were in full financial crisis and had to be bailed out by their EU partners, to the tune of over a trillion euros (see Chapter 8).

As the debt crisis dragged on, it appeared that it might threaten some countries' membership in the eurozone. The hardest-hit member state, Greece, certainly might have benefited from the ability to devalue its currency—except that it no longer had a currency to devalue. And it was not clear that the other members of the eurozone were enthusiastic about Greece staying in. Indeed, in 2015, Greece appeared to come very close to being forced out of the eurozone, because of its continuing difficulties in servicing debts to banks and governments in other eurozone member countries. Nonetheless, the threat of the breakup of the euro helped push the eurozone's leaders toward a resolution of the crisis, involving a combination of painful austerity measures in the debtor nations, bailouts from the rest of the eurozone, and a small amount of debt restructuring. Thus far, the euro's unity has been preserved, but at a very high cost.

The dramatic economic and political effects of the crises in Europe, Mexico, Argentina, and East Asia, and of others in Turkey, Russia, Brazil, Venezuela, and elsewhere, caught the world's attention. So too did the fact that currency and banking crises could spread quickly from country to country, as they did in East Asia in 1997–98. This realization led many of the world's economic leaders to see these currency crises as threats to the international monetary order and the world economy more generally. One nation's currency collapse could be transmitted to others, to an entire region, or to the whole world. Currency and financial instability had, after all, lengthened and deepened the Great Depression of the 1930s. The currency crises of the 1990s and the early 2000s led many to believe that in a globalized financial system, such attacks had the potential to destabilize the entire world economy.

Containing Currency Crises

Concern that currency crises can have broad international effects makes attempts to counter them something of an international public good. Thus, major governments have a common interest in containing such crises—although, as with all



As a member of the eurozone, Spain didn't have a national currency to manipulate in the face of a growing financial crisis in 2011–15. Other EU countries required austerity measures in Spain as a condition of their support, leading many citizens of Spain to protest the euro.

public goods, there is often conflict over how to distribute the cost of providing such containment. This challenge has given rise to complex interactions in which governments, private investors, and international institutions both cooperate and contend over attempts to limit the damage caused by currency crises.

Indeed, over the past 20 years, governments of the major financial centers and the leading international financial institutions have often cooperated to try to slow the spread of currency crises. The IMF, other international institutions, and creditor governments have often mobilized tens of billions of dollars to try to support governments facing a currency crisis. The reasons for major governments to cooperate in the face of currency crises are closely related to the reasons for cooperation to address sovereign debt crises, as discussed in Chapter 8. Cooperation among national governments can help avoid, or mitigate the international impact of, currency crises; indeed, developed-country governments and the IMF have spent hundreds of billions of dollars since 1980 in attempts to control these crises.

However, such cooperation has not always been easy to organize and sustain. As with all public goods, there are incentives for each government to free ride and hope that other governments will pay the price of stabilizing the monetary order. Even more, many people believe that it is not a good idea to spend billions to support a failed or failing currency; such an effort may prop up undeserving governments and banks. This issue highlights the fact that currency crises can be controversial in domestic politics; governments are often blamed for allowing the crisis to take place, for not dealing with it effectively, or for inappropriately setting the currency in the first place.

Supporters have regarded these currency crisis interventions as striking examples of international cooperation to sustain the global monetary order, and with it the global economy more generally, with a quick response to avoid the proliferation of contagious crises. But critics have charged that taxpayers were being forced to bail out foolish investors and overextended governments, encouraging a continuation of irresponsible government and private behavior. The clash has largely pitted contending interests against one another (see Chapter 8 for similar debates over financial bailouts), and it is sure to continue. The mix of common interests and contentious issues ensures that currency crises, and controversies over them, will continue to plague many currencies and globalized financial markets.

Conclusion: Currencies, Conflict, and Cooperation

Argentines and Greeks are not alone in learning from experience that currency policy can make a significant difference to economic and political life. Over the past 20 years, billions of people in dozens of countries have experienced both the positive and negative effects of national currency policies. The exchange rate is controversial within countries because its impact differs among groups, firms, regions, and

individuals with competing interests. There are many who benefit if the currency is fixed, and others who are harmed. For every firm that gains as a currency depreciates, there is another that loses. This clash of interests, mediated through national political institutions, determines national attitudes toward the exchange rate.

International monetary relations too have a profound impact on international economic and political affairs. There is a reason that the classical gold standard and the Bretton Woods monetary system gave their names to entire economic eras: the ordering principles of these currency regimes were central to their respective international economies. Without functioning international monetary arrangements, global economic activity would be immensely difficult.

Governments have powerful reasons to collaborate in devising international monetary arrangements, but they also have significant interests that conflict. Inasmuch as an international monetary regime is a public good, governments have strong incentives to free ride and let others provide it; they also have strong reasons to try to make sure it is provided, and they have reasons to want the regime to be organized in ways favorable to themselves. Such a mix of incentives for cooperation and incentives to bargain hard characterizes the politics of international monetary relations today, as it has for centuries. This connection can be seen through the currency policy issues that are likely to preoccupy national governments, and the world community, over the coming years.

The first contentious issue has to do with the overall structure and functioning of the international monetary system, and also cooperation among the world's major financial and monetary powers. Many scholars believe that more organized collaboration among major governments is desirable to avoid future problems and crises. Certainly, there is a desire among many governments to collaborate in devising a new monetary order. Yet there are also powerful interests in conflict, since governments disagree about the desirable characteristics of such an order.

In the absence of global agreement on international monetary relations, many countries in specific geographic regions continue to devise regional currency arrangements. The eurozone remains intact, and some of the EU's newer members are still considering whether to join. Many countries in Africa and the Middle East have already linked their currencies to the euro or plan to do so. There have been similar proposals for informal or formal currency unions in Latin America, North America, and parts of Asia.

Because many governments find these regional proposals an appealing way to reduce currency instability, some observers have suggested that we may be heading toward a world of currency blocs: an expanded eurozone eventually including much of the Middle East and Africa, and parts of Asia; a dollar zone in the Western Hemisphere; and an East Asian currency area. The future of such arrangements depends both on the interests that governments have in developing them and on their interactions to pursue their monetary goals. Whether national governments come together on the global level to forge a new international monetary regime, or devise regional arrangements such as the euro, international monetary relations will profoundly shape the world economy.

Study Tool Kit

Interests, Interactions, and Institutions in Context

- There are many contending interests over monetary affairs within countries, which leads to domestic conflict over the appropriate currency policy to pursue.
- Although every country can set currency policy as it wants, the fact that exchange rates value currencies relative to one another means that outcomes are the product of interactions among countries' policies. As a result, countries may have reasons to cooperate with one another to create arrangements that are mutually beneficial.
- Virtually everyone has an interest in the existence of a functioning international monetary system. But different arrangements benefit some actors more than others, which leads to disagreement about how such a system should be organized and about how the burdens and benefits should be distributed among countries.
- International monetary institutions, such as the gold standard, the Bretton Woods monetary system, or the eurozone, can create rules that facilitate cooperation in international monetary policy.

Key Terms

exchange rate, p. 389

appreciate, p. 389

depreciate, p. 389

devalue, p. 389

monetary policy, p. 391

central bank, p. 391

fixed exchange rate, p. 391

gold standard, p. 391

floating exchange rate,

p. 392

Bretton Woods monetary system, p. 392

adjustable peg, p. 392

international monetary regime, p. 404

For Further Reading

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