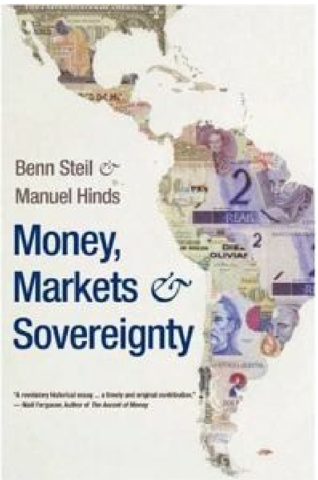

Book Money, Markets & Sovereignty

Benn Steil and Manuel Hinds
Yale UP, 2009

Recommendation

Globalization remains always controversial, especially during a severe recession. Its philosophical, political and economic history is a complex tangle, but globalism's current expression is even more complicated, weaving in everything from gold to monetary policy to nationalism. Council on Foreign Relations experts Benn Steil and Manuel Hinds have written a high-level, dense, but ultimately rewarding book for dedicated students of globalization. They contend that the U.S. Federal Reserve Bank faces a tough challenge managing the U.S. dollar as both a national and a global reserve currency. This book outweighs other popular texts on globalism in its scholarship, topic range and intellectual arguments. The authors make such a formidable case that critics will have to ratchet up their rebuttals dramatically. *BooksInShort* highly recommends this work to policy makers and executives involved in globalization, but note: The book presumes more than a passing acquaintance with economic theory.

Take-Aways

- Globalism – the belief that the exchange of goods, services and ideas is a net positive for humanity – is an ancient notion that predates nation-states.
- Civilization first coined money about 2,500 years ago as a medium of exchange.
- From the time of the Stoics, who incorporated business into their philosophy, commerce has driven law and society.
- Liberalized trade led to the gold standard, which increased globalization while reducing national sovereignty.
- The Bretton Woods conference pegged the U.S. dollar to gold after World War II.
- In 1971, when claims exceeded its gold supply by 300%, the U.S. cut the gold-dollar link.
- The swaps and options markets operate outside of any one nation's control.
- Critics who charge that globalization weakens local cultures assume that governments impose customs and traditions.
- Nations that insist on "monetary nationalism" suffer volatile capital flows and inflation.
- The U.S. faces a conflict managing the dollar both domestically and internationally.

Summary

Globalism: Yesterday and Today

Globalism, the concept that foreign trade benefits individuals and groups, dates as far back as ancient Greece and predates the rise of nation-states. In modern times, analysts blame vast global capital flows, which operate independently of any state supervision, for market volatility, currency collapses and economic inequality. Contemporary globalization critics assert that supranational market actions have replaced national sovereignty itself.

> "Were it not for the regular recurrence of devastating national financial crises...resistance to globalization would be far less virulent and carry far less resonance."

Globalization advocates tout technology's capacity to produce the best outcomes for society, including its unprecedented ability to foster human interaction and connect the world's information hubs. This positive view of globalism picks up on the earlier philosophies of John Stuart Mill and Adam Smith, which in turn echo back to ancient history. Globalization and its essential element, commerce, emerged conceptually after the death of Aristotle in 322 BCE. The Stoics incorporated a philosophy of commerce into their moral theory. Unlike the Greeks, who regarded man as a component of the state, the Stoics considered the individual's intrinsic worth independent of one's title or role. The laws of nature, based on universal reason and not on local custom, governed business and social interactions. The Romans adopted this way of thinking, which well suited the Roman Empire's expanding overseas trade.

"Today, economic 'sovereignty' has become the rallying cry of the anti-globalization movement."

The 18th-century philosopher David Hume advanced the practical application of natural law, recognizing that commercial exchanges provided the basis for a society's system of justice. The natural law concept – that law is "discovered by judges rather than created by rulers" – came to fruition in the U.S. Constitution and the Declaration of Independence.

"Trade is much older than states; indeed, it is older than agriculture itself."

Globalization's foundation rests on common law, which evolved from natural law precepts. Based on the 12th century's "Lex Mercatoria" – a privately developed set of trade rules and arbitration procedures commonly accepted before the rise of nation-states – common law governed exchanges between merchants on land and sea. As Europe's commercial class grew, nascent countries took in the tenets of common law for their jurisprudence systems; England's Magna Carta of 1215 incorporated the Lex Mercatoria's principles. Much later, the U.S. Uniform Commercial Code crystallized the idea that in America business dictated the law, not vice versa.

"The glue that melded the Greek and barbarian peoples under the Macedonians and Romans was commerce."

The power of commercial transactions to define conduct among nations, unfettered by sovereign legislatures, continues. Today, private arbitration clauses show up in 90% of cross-border transactions. A tenfold increase in the number of business arbitration boards worldwide since the 1970s demonstrates the rapid expansion of nongovernmental private law. One example: the over-the-counter market for swaps and options. This $454 trillion (notional value) market operates from no central location, and its legal governance stems from a 32-page privately produced document, downloadable for free.

The Antiglobalists

The case against globalization is not new; Karl Marx made it in the 19th century. Critics charge that:

- **"Globalization violates sovereignty"** – Opponents accuse globalization of forcing countries to abrogate their sovereignty and charge that entities such as the International Monetary Fund and the European Union force their rule over individual nations. But this argument fails to consider that countries have been subject to conditions imposed by other entities, such as creditor nations, for centuries.
- **"Globalization undermines culture"** – This misleading notion assumes that a nation's values are homogeneous and dictated by a governmental authority.
- **"Globalization makes the world unequal"** – In fact, statistics show that the gap between rich and poor grew from the 16th century to the early 20th century, preglobalization, and that these differences further widened between 1914 and 1950, when governments mandated trade and commercial limits to counter globalization. For individuals, income inequality has declined since the 1970s.
- **"Globalization destroys nations"** – The argument that by introducing free market concepts to multiethnic nations, globalization causes social upheaval makes the mistake of confusing globalization for a lack of democracy in these countries.
- **"Globalization's benefits are 'just theory'"** – Economic gains from free trade go largely unnoticed, while jobs lost to outsourcing seem like obvious evidence of a mistaken policy. Evidence supporting globalization just isn't as immediately obvious.

Money and Gold in Globalization

Money, which societies introduced about 2,500 years ago as a medium of exchange, has been made of copper, gold, silver, bronze and iron. Financial tyranny preceded political tyranny, as rulers took control of mines and coin minting. Despots, such as the Roman emperor Nero, discovered they could cut their debts and increase their revenues by diluting coins with base metals or reducing their weight. In addition, counterfeiting and changes in prices, supply and demand caused exchange rates to fluctuate wildly, producing inflation and monetary instability.

"Coins freed people of their dependence on their local tribe, allowing them to roam ever farther with confidence that they would have...the means to feed, clothe and protect themselves."

To eliminate confusion, governments pegged their currencies to a single commodity, often gold. Britain became the first nation to adopt the gold standard in 1816, at about the same time that it took up a free trade policy. Britain limited money in circulation to gold coins or certificates, allowed citizens to turn their gold over to the government to melt into coins and permitted the free-flowing export of currency. Thus, government became the sole source of money, though it gave citizens the protection of being able to convert their coins into gold if they believed the authorities mismanaged their monetary responsibilities. Gold-backed pound sterling became "the first global currency in history," and Britain became the world's financial hub until World War I. Its account surplus helped finance development around the world.

"In the common law tradition, life comes first, and law follows in train according to the expectations established by repeated social interactions."

The world's adoption of the gold standard – Germany went on the standard in 1871 and the U.S. in 1873 – gave governments the tools to manage the rate of money creation and contraction, both domestically and internationally. While the gold standard was not perfect, it curtailed runaway inflation and stabilized prices. On the other hand, it also forced nations to give up some of their sovereignty.

The Fall of the Gold Standard

As global trade increased from the 1870s to the early 1900s, the gold standard's fatal flaw became apparent: deflation. In 1913, "prices were still lower...than they were 40 years earlier." Britain, to finance its part in World War I, issued more pounds sterling than it had gold, and chose, as did other countries, to defer its currency's convertibility. By that time, the U.S. had become a net creditor, holding most of the world's gold reserves. Compounded with Britain's anemic economic growth in the 1920s, the pound sterling lost its prime position as the global currency, ceding its place to the U.S. dollar.

"The U.S. economy is 50% larger than that of all developing nations combined."

The gold standard became untenable and, in 1922, an International Monetary Conference resolution created the "gold exchange standard," substituting foreign currencies for gold in central bank deposits. Each country – both depositor nations and central banks – could "double-count" the currency as part of their respective gold reserves. Thus, each nation could increase the money in circulation in its home market. Political disputes complicated this "credit pyramiding"; countries could now exercise sovereign financial muscle, since they were no longer tied to strict gold accounting. Economists Irving Fisher and J.M. Keynes promoted "monetary sovereignty" as a way for nations to protect themselves against economic depressions in other countries.

> "Even China's economy is only the size of California's and Florida's combined."

Economic sovereignty worked when only a few major countries claimed it, but failed miserably when all nations assumed it. In the aftermath of World War I, national industries that had grown to supply domestic needs in wartime could not all compete in a peacetime trading arena. Rather than allow these companies to disappear, countries set strict protectionist trade policies and tariffs. These actions dramatically decreased imports, leading to history's largest drop in world trade and, many experts contend, adding to the Great Depression.

> "Legitimacy is the cornerstone of stable government, and rulers established legitimacy by demonstrating appropriate reverence for the law and the ability to enforce it."

After World War II, 44 nations participated in the Bretton Woods conference, organized to address trade issues, international financial flows and problems regarding free trade within the global monetary structure. The resulting Bretton Woods system reintroduced a gold exchange, this time pegged to the U.S. dollar, and it established the International Monetary Fund to administer the scheme. Beginning in the late 1950s, however, the same problems that emerged in the 1920s with respect to the gold-exchange standard reappeared; double-counting currency reserves meant expanded credit and inflation. By 1971, foreign claims against U.S. gold reserves exceeded supply by 300%. Rather than devalue the dollar, the U.S. detached its currency from gold entirely. By 1976, the world's main currencies floated freely, without any gold backing.

"Monetary Nationalism"

Thanks to freer trade, cheaper transportation costs and dropping communications charges, corporations can produce, sell and ship goods from anywhere in the world. Developing countries, which supply the raw materials and low-cost labor globalization demands, import U.S. dollars and euros into their home markets, creating a problem for central bankers and politicians who want to protect their currencies. Furthermore, currency instability deters foreign investors.

> "A dollar was once redeemable for a fixed amount of precious metal, but has for four decades now been redeemable only for near-worthless metal – pennies, nickels, dimes and quarters."

National central banks, which must manage their internal money supplies, find that international capital flows interfere with their ability to control domestic interest and exchange rates. This dichotomy in national and international currency markets leads to fiscal volatility within domestic economies. Countries that want to shield their currencies cling to monetary nationalism and seek to isolate themselves by erecting capital barriers. However, in an increasingly open world order, "the closed national economy is a dead-end street." In practice, the results are noteworthy: Iceland, which leans toward monetary nationalism, suffers wide variations in capital flows and inflation, while nations like Ecuador, Panama and Greece, which use the dollar or euro as their currency, do not.

> "What Charles de Gaulle once called America's 'exorbitant privilege,' printing the world's reserve asset, is one which America will in the future have to do far more to sustain."

Throughout history, the desire for greater trade among countries demanded a common standard of exchange, gold. Both trade and gold fueled globalization and reduced national sovereignty. When President Richard Nixon severed the gold-dollar link in 1971, however, that set in motion a split between the two mainstays of a nation's economic policy: trade, which was spreading globally, and money, which was "resubsumed under the umbrella of state economic sovereignty." Tensions between the forces of globalization and monetary nationalism are inevitable.

Re-Evaluating U.S. Sovereignty

The U.S.'s creditor nations increasingly grumble about the dollar's relatively weaker position, particularly in the aftermath of the Great Recession. Many question the U.S. dollar's continued role as the world's currency. As the globe's economies increasingly intertwine, nations are torn between wanting monetary nationalism and needing liberalized trade and investment policies. Each approach has appealing elements, but these dueling systems precipitate economic and political disagreements. The U.S. is in the precarious and conflicted position of being both issuer and protector of the world's fiat currency. The Fed exercises principles of monetary sovereignty to manage its domestic fiscal policy, but, at the same time, it has a responsibility to maintain confidence in the dollar. To achieve both, the Fed should adopt a modified legal framework that accepts the dollar's dual purpose. Though such an explicit avowal strikes some as a renunciation of America's economic sovereignty, without the world's faith in the dollar, the U.S. would lose its ability to manage its internal financial affairs, making its sovereignty a moot question.

About the Authors

Benn Steil is senior fellow and director of international economics at the Council on Foreign Relations. **Manuel Hinds**, the author of *Playing Monopoly with the Devil*, served two terms as El Salvador's minister of finance.