A Historical Perspective on International Monetary Arrangements: Opening Address

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Sometimes a historical survey is used to create a cushion of comfort and assurance: Surely we handle problems better than our short-sighted ancestors? But sometimes it also helps to show how difficult, intractable, and perennial many problems can be.

Proposals for international monetary reform come in two forms. First are the innumerable practical pieces of tinkering to make crises more soluble: better data (for instance, an improvement of the IMF's Special Data Dissemination Standards); more prompt and effective surveillance; bringing the private sector into workouts; the rewriting of bond contracts to allow the inclusion of provisions for rescheduling; or tax measures to control short-term capital flows. Second come the grand visions of institutional reform or reordering, frequently involving a need to remodel the relics of previous reforms. The current slogan for such discussion is "architecture." Sometimes the piecemeal tinkering is worked into a larger scheme for a general reordering in order to make it appear more politically or intellectually appealing.

Early Efforts at Reform

The specific debates currently conducted about the international monetary system are quite new, a response to the shocks of the 1990s (Mexico and East Asia), but the problems underlying these policy issues have been contested in some form or another for a very long period of time—at least since the beginning of "globalization," which is a much older process than is commonly believed and fundamentally dates back

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to the communications and transport revolutions of the mid nineteenth century, when the telegraph, the cable, and the steamship first reached across the oceans. It involved an increasing integration of capital, goods, and labor markets across national frontiers. But it also provoked many defensive and nationalistic reactions against the forces of internationalism.

Even the countries involved in these shocks do not appear to change: Mexico in the nineteenth century experienced a series of bankruptcies and defaults. Before the First World War, tsarist Russia provided a model of the political motivation behind foreign lending: French ministers encouraged the flotation of loan issues in Paris because Russia played an increasingly vital role in French foreign policy. In 1945, the debate about whether or not Russia would join the Bretton Woods institutions was central for the political survival of those bodies. Even the personalities don't change much: The Soviet memoranda pleading for membership in the Fund and the Bank were signed by a Mr. Gerashchenko, father of the current Russian central bank governor. The continuity of issues lies in the fact that many areas of the world want access to international capital. The combination of capital import and large concentrations of political power brings risks: The borrower, if big or powerful enough, ties the lender to both its interests and its fortunes.

The most fundamental discussion of today focuses on capital movements, which link the world economically and encourage the allocation of investment resources to the places where they can be used most productively. Capital flows have overwhelmingly positive results in terms of generally enhanced prosperity. But short-term movements, in large volumes, may be destabilizing and lead to herd behavior. The wish to limit short-term movements is by no means solely a contemporary concern. One of the reasons that countries already on the gold standard in the nineteenth century wished to create central banks (which are not necessary for the operation of the gold standard) was to find a mechanism to stop disturbances from short-term capital flows. The invention of the German Reichsbank, the predecessor of the Bundesbank, was a response to the financial crisis of 1873, and the Federal Reserve System itself was a delayed product of the crash of 1907.

Any contemplation of the longer history of proposals for a sweeping reform of the international financial system inclines the observer to rather pessimistic conclusions. It is not that reform per se is bad. (That is a view, of course, sometimes held. The early nineteenth century statesman Lord Liverpool once asked: "Reform? Why do we need reform? Aren't things bad enough already?") Nor was there any shortage of good ideas in these past discussions—there were actually quite a number, perhaps too many. And it is not even that in practice these ideas were not realized. The partial realization of previous reform aspirations has helped to produce a dense thicket of institutional clogging.

There is an old question: What is worse than not having your dreams come true? To be sure, to have them come true. When dreams develop, they may become a nightmare. The classic case for economics is Midas's gold. But the most common historical outcome is the partial realization of reforms.

Take the idea of creating stability and confidence, and avoiding speculative flows between different currencies or different metals, through the institution of a single world money, a vision now associated with Richard Cooper. The idea of a single world coinage was proposed by Napoleon III at the 1867 International Monetary Conference. He wanted to extend the principle of the single coinage that France had exported to the Latin Monetary Union to the rest of mankind. The Emperor's major financial official, Marie-Louis-Pierre-Felix de Parieu, concluded the conference with a statement that the aim of the meeting had been "to lay a sort of siege to the citadel of monetary diversity, the fall of which you would like to behold, or, at least to gradually destroy its walls, for the benefit of the daily increasing commerce and exchanges of every description among the different members of the human family."[1] The German representatives were happy to follow the Gallic lead, as were Americans looking for a way of stabilizing the dollar in the wake of the devastation of the Civil War. The proposals failed largely because the British parliament refused to contemplate the very small alteration in weight and value of the British pound that would have been needed to make the union. So instead, by the end of the 1870s, a multiplicity of national currencies, with different names and coinage weights, was linked through a common metallic standard. Having arrived at different national moneys, a more complicated management system was needed to handle their interactions.

Reform Efforts in the Interwar Years

The first systematic attempts to institutionalize international monetary cooperation came in the interwar years. At first central bank cooperation was informal: In particular, the Governor of the Bank of England, Montagu Norman, and the Governor of the Federal Reserve Bank of New York, Benjamin Strong, met surprisingly frequently (for the steamship age) and corresponded on terms of considerable intimacy. "You are a dear queer old duck and one of my duties seems to be to lecture you now and then," wrote Strong to Montagu Norman.[2] When Strong died in 1928, Norman looked for a way of institutionalizing such

[1] Cited in U.S. Congress (1879, pp. 875–76).
[2] Letter from Strong to Norman, May 1, 1927. Bank of England archive, G1/421.

a closely intense relationship, reaching out to Strong in his grave. He came up with the Bank for International Settlements.

Is it better to introduce reform before or after a major crisis? The rather dismal experience of the interwar years provides examples of both dynamics: The BIS is a case of a heroic attempt to learn *before* a crisis, while following the destruction of the Great Depression, a World Economic Conference in London tried to draw the lessons *after* a catastrophe, when the will to reform should have been much greater.

The task of the BIS thus lay in large part in crisis prevention. Norman saw the prime business of the new Bank as being the "centralization of international monetary relations, preventing excessive credit leading to overproduction and financing of excessive stocks and artificial maintenance of prices (rubber)."[3] (Norman was thinking of the abortive Stevenson scheme, which had made rubber exports dependent on the price, had briefly raised rubber prices, and then led to overplanting and a catastrophic price collapse during the Depression years.) The end of collaboration was to "evolve a common body of monetary doctrine," to "smooth out the business cycle, and to contribute toward a greater equilibrium in the general level of economic activity." The Bank should act to improve the international circulation of capital and provide an answer to the excessive amount of short-term capital moving internationally. One common diagnosis of the ills of the 1920s contrasted the long-term nature of prewar international capital movements with the volatile short-term flows of the 1920s (a debate reminiscent of some analyses of the ills of the 1990s). "To attract short-term capital to long-term markets is another task which can only be accomplished by identifying the policies of the Central Banks, by coordinating the movements of their discount rates, by increasing the control of each in its own market" (BIS 1935, pp. 42 & 45). The underlying idea was that the central banks might conduct a sort of operation of twist to bring down long-term interest rates and encourage longer-term investments.

France agreed about some of these goals. The French expert Pierre Quesnay saw the desirability of centralizing the statistical work of the various central banks in order to know more about the problems raised by international capital flows. But French thinking went much further and led to a proposal that the BIS should adopt a new gold currency (*grammor*) as a unit of account. The idea, characteristically French, goes back intellectually to Napoleon III's proposals for a world monetary standard at the 1867 International Monetary Conference. Stripped of the gold element, however, it also looks forward to Keynes's discussion of an artificial international currency, *bancor*, in the negotiations preceding

[3] Note on conversation between Quesnay and Norman, April 24, 1930. Bank of England archive, OV5/1.

Bretton Woods. The result would be that the defense of a currency in the case of a speculative attack would not require the sales of another currency (and hence the likelihood of transmitting the attack elsewhere).

The hopes were enormous. The BIS was the last great attempt to establish international monetary cooperation before the Second World War. But in fact the work of the Bank was quickly paralyzed because of the conflict between the two purposes of the bank (as a mechanism for transferring German war reparations, and as a forum for international financial cooperation), and because of the quick polarization between British and French views on how the Bank should approach the question of whether reparations were harming the world economy. By 1931 the Bank had in practice ceased to be able to operate effectively: Its attempt to stop the Austrian Creditanstalt crisis with a 100-million-schilling support operation is a classic case of "too little, too late." For the rest of the decade, the Bank degenerated into producing high-grade analysis and sound and sensible advice—the sure sign of a redundant institution. The failures of the BIS discredited central banks, and the idea of international central bank cooperation, for more than a generation. Unable to deal with the Great Depression, central banks now evolved a new mission for themselves, as administrators of ever more complicated exchange control systems.

The "lessons" of the Great Depression will always be controversial. For most contemporaries, politicians and economists, the most general lesson concerned the destabilizing character of short-term flows. This idea provided the basis for the great reform project that culminated in the Bretton Woods Conference.

Modern economic historians formulate their conclusions rather more cautiously: After all, the capital flows were responding to policy signals that revealed serious inconsistencies and structural weaknesses. I would put the lessons of the Slump in the following way. First, countries with high foreign debts and weak banking structures are vulnerable to deflationary shocks. Second, the mechanisms of financial contagion transfer the weakness to creditor countries with previously sound banking systems. Third, one obvious transmission mechanism was the fixed exchange rate commitment, which created a potential for nimble investigators to get high returns on short-term deposits with the guarantee—or the hope—that they could get out again. Does a diagnosis of the 1997 Asian crisis look much different?

The similarity of experiences raises the question that still confronts would-be reformers: When is the best time to think about reform? It might have been agreeable before the crisis, but then urgency about reform was insufficient. After the crisis, there were too many divergent views. An intellectual and political paralysis set in. After the havoc of the financial crises of 1931 and 1932, which made the Depression the *Great* Depression, the participants at the World Economic Conference in

London in 1933 agreed that the world economy was crippled by monetary chaos (competitive devaluations, the imposition of exchange controls) and by trade wars (the imposition of higher tariffs and quotas). In preparation for the conference, subcommittees were established to investigate each of these questions. But the monetary committee reached the conclusion that nothing could be done to stabilize money as long as free trade principles did not prevail. The trade committee believed that there was no point discussing trade liberalization without a prior currency agreement. John Maynard Keynes wrote after the end of the conference that it was inherently unlikely that 66 countries would agree on anything. Only a "single power or like-minded group of powers" could ensure that a promising plan would also be translated into reality (Skidelsky 1992, p. 482).

Postwar Efforts at Reform

This is, of course, the key to the success of Bretton Woods. Only 44 rather than 66 countries were represented, and for practical purposes there were only two. Perhaps one should say one. The negotiations preceding the conference looked like bilateral diplomacy between Britain and the United States, but of course the United States was massively preponderant, and in every decisive issue the solution eventually adopted was the American one. No controversy arose on the issue of capital movements; everyone agreed that they were unlikely to take place in the foreseeable future, and all the efforts were directed at achieving a current account liberalization. And, finally, there was a clear time constraint on the need to agree; the conference was held in July 1944, just after the Normandy landings, when it was clear that the European War would come to an end soon (most thought already in 1944). There was a need to have a postwar institutional framework before the postwar period actually began. The combination of the timing and the unique position of the United States in that period explain why it is impossible to achieve that dream of many reformers: "a new Bretton Woods."

But on a more modest scale, a bilateral approach to negotiation, in which one side was clearly more influential, has been the key to every subsequent successful negotiation. After the collapse of the par value system at the beginning of the 1970s, the major forum for negotiation was at first supposed to be the IMF's Committee of Twenty, which was intended to "consolidate all that earlier work and to build, as at Bretton Woods, a complete design for an international monetary system that would last for 25 years." In practice, the C-20 rapidly became merely a "multilateral monologue" (Morse 1974). The actual breakthrough came instead in discussions between the American and French Treasuries, which produced a formula that could then be used as a basis of agreement at the first summit (Rambouillet, November 1975) and the 1976 Jamaica meeting of the IMF.

A few years later, tortuous triangular negotiations on the future of the European monetary order took place between the United Kingdom, France, and Germany. These were suddenly simplified when Britain dropped out, and France and Germany could negotiate along lines that increasingly reflected a German view of the appropriate shape of the European Monetary System. In the 1980s, the intense cooperative phase of diplomacy between the Plaza and Louvre agreements was prepared by Japanese-American negotiation, in which currency and trade-opening agreements were bartered, each for the other.

The Need for Caution in Future Reform Measures

As regards the present, the conclusions from such a historical survey of debates on extensive reform are not comforting as to either the prospects, or the likely outcome, of grand-scale architectural remodeling. There may be a bilateral axis, which in the past has been the key to pushing new projects through, but we should also ask what the likely result would be.

At the end of the 1990s, the new bilateral relationship between Europe and the United States is still unclear and, as in the past, debates about trade measures continue to get confused with monetary and currency issues (for example, the search for a weaker euro as a way out of Europe's unemployment malaise). The greatest risk is that a solution which looks attractive to many European (and Japanese) businesses—a move in the direction of fixed exchange rates (coupled with a lower valuation relative to the U.S. dollar)—is exactly the wrong answer to the crises of most emerging markets. In this sense, the bilateralization of financial diplomacy, often the key to success in achieving any outcome at all, may produce a very bad outcome indeed for the world as a whole. The trade picture is obviously better and more hopeful than that of the 1920s, but—as then—the trade area is much more vulnerable to a multiplicity of political influences than is the making of monetary policy.

While many of the ghosts of the Great Depression are still with us, the fear of destabilizing capital flows is predominant. Some protective or regulatory measures are necessary to create sufficient confidence for the functioning of any international order. The danger is that the buildup of measures may be so substantial that there comes a moment—analogous to the time when water turns to ice—when the quantitative shifts turn into a qualitative shift, and the accumulated changes become harmful and destroy the international system. The adoption of protective measures during the Great Depression constituted such a moment. The legacy and the memory of that crisis—with the destructive effects of the collapse of international trade—highlight the danger that sometimes the remedies to problems are worse than the problems themselves.

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