EC245 International Financial Institutions and Policy

Term Paper

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Introduction

In this essay I am going to present a historical overview on the international monetary systems. I will start with the pre-first world war gold standard and the way it functioned and then I will focus on the gold exchange standard that operated from 1925 with its three problems that triggered the system's collapse in 1931. I will go on by illustrating how the interwar experiences shaped the two proposals: the British Keynes plan and the American White plan which were discussed at the Bretton Woods conference in 1944 and the terms of agreement in favour of establishing a new international monetary system. I will point out how the new system was supposed to work, as envisaged by its architects and I will explain the reasons why the system did not work as intended before 1958-1960.

Why was Bretton Woods system established at the end of the second World War?

The Gold Standard

Before the 1st World War, the **gold standard** "ensured stability and security in international trade" and relied on the Bank of England to supervise the system. (Lecture notes 1:3) Gold coins circulated along with national currencies and, in order to smooth international exchange, each country set its national currencies' parity in terms of gold (Lecture notes 1:3), in other words the gold content of two currencies would determine their exchange rate (Eun et al,2004:28). Central banks had the power to affect the gold market by exchanging national currencies for gold coins at an official value, thus supporting the parity. (Bordo et al,1993:115)

The **concept of convertibility** needs to be introduced which meant "the ability of banks to discharge their paper currency debts in gold" at a fixed price (Endres,2005:112). A currency was inconvertible when the issuing bank could not redeem it into gold while private markets were able to do so "at a different rate than that originally promised by the bank" (Endres,2005:112), making the rate of exchange "flexible and unstable". (Endres,2005:112)

Eun and Resnick (2004) acknowledge that the domestic money supply is affected by changes in that country's amount of gold. The balance of payments would work through the price-specie-flow-mechanism attributed to David Hume. It worked in the following way: if a country's exports were greater than its imports, payment in gold coins would enter its

economy raising prices of goods and lowering the value of the domestic currency. High prices of goods would make exports fall and imports rise leading to an outflow of gold from the domestic economy, thus balancing the trade. (Eun et al,2004:28)

Due to this automatic correction mechanism in the balance of payments, the exchange rates between large countries such as US, Britain, France and Germany did not experience significant changes throughout the gold standard period. (Eun et al,2004:28) But, in order for this mechanism to work, the governments themselves have to not interfere to modify the process. However, countries could not be obliged to follow the rules, so they were free to abandon the gold standard whenever their national interests were stronger and inconsistent with it. (Eun et al,2004:29) Therefore, Britain and other belligerents abandoned their commitment to exchange national currency in gold in 1914 - soon after its outbreak. When the war ended in 1918, the international payments mechanism had to be re-established because of the "growth of international indebtness" (Lecture notes 1: 4) (especially Britain's liabilities to US) and German reparations. (Lecture notes 1)

The Gold exchange standard

A **gold exchange standard** was established in 1925 when "Britain returned to the gold standard at the pre-war parity, followed in the next two years by most countries" (Bordo et al,1993:28). As to economize on gold (avoid a gold shortage), gold coins would not circulate anymore. Countries would hold reserves of "sterling, dollars or francs" (Lecture notes 1:5) and gold reserves would only be held in centres in London and New York. (Bordo et al,1993) It is important to note that no international institution which could ensure "international monetary stability and liquidity" (Lecture notes 1:5) was in place at the time because Bank of England lost its pre-war dominance and US had no equivalent institution.

The gold exchange standard lasted for a period of six years until its collapse in September 1931 when Britain ended sterling convertibility in gold. This happened due to **three problems with the gold exchange standard**: adjustment, liquidity and confidence. (Bordo et al,1993)

The **adjustment problem** rose from the asymmetry between surplus and deficit countries. Surplus countries (US and France) had undervalued parities while deficit countries (Britain) had overvalued parities. Surplus countries accumulated 53% of world's stock of

gold by 1924, so they tried to sterilize inflow of gold in order to avoid inflation by "matching inflows and outflows of gold" (Eun et al,2004:29) with a rise and fall in domestic money supply, thus offsetting changes in international reserves (Bordo et al,1993). Therefore, the automatic correction mechanism of the gold standard could not work. (Eun et al,2004).

The **liquidity problem** emerged because, with the current parities, there was insufficient stock of gold to "finance growth in world output and trade" (Lecture notes 1:6). As peripheral countries' reserves of key currencies (sterling, dollar) rose relative to their amount of gold reserves held at the centre, these countries would reduce their key currency reserves for fear of a convertibility crisis. (Bordo et al,1993) In Triffin's view, because gold coexisted with several key currencies (sterling and dollars) one could be immediately replaced with another. This played an important role in the "world cyclical downturn of 1929-1933" (Endres,2005:107) and sterling's (and other currencies') convertibility into gold was significantly weakened during this period. It also demonstrates that key currencies cannot act as international money or liquidity stabilizer in the reserves of a central bank for a long time, as Endres (2005) stated: "To rely on the questionable stabilizing capacity of a key currency would not provide the basis for a sound international financial order". (Endres,2005:107)

The **confidence problem** concerned the" shift of currency holdings between the two centres" (Bordo et al,1993:29) - London and New York, from the weak one to the strong one which progressively reduced confidence in the weak one. This, together with a shift between reserve currencies and gold for countries' fear of an "inability of the centre to convert their outstanding liabilities into gold at the fixed parity" (Bordo et al,1993:29), led to the "suspension of convertibility" (Bordo et al,1993:29) in 1931 first by Britain -which experienced large outflows of gold to the point where it could not maintain the gold standard anymore(Eun et al, 2004), then by US in 1933 and France in 1936.

The **collapse of the gold exchange standard** led to strong "fluctuations in exchange rates" (Lecture notes 1:6) and "beggar-thy-neighbour policies"(Lecture notes 1:6) with "competitive devaluations"(Bordo et al,1993:30) (each country trying to achieve a lower exchange rate than the other) that generated the Great Depression of the 30s.

The **perceptions of the interwar experience**, although not entirely correct, emphasised the case against floating exchange rates (which would only lead to speculation – based on the

French experience between 1922 and 1926) and against exchange controls. These perceptions formed the basis of the proposals at the Bretton Woods conference in 1944. (Bordo et al,1993:31)

The British **Keynes plan** was aimed at creating an "supernational central bank, the International Clearing Union (ICU)" (Bordo et al,1993:32) which would issue bancor money fixed in terms of gold in order to provide enough international liquidity. The countries' domestic currency par value would be set in terms of bancor and countries would hold accounts at the ICU in order to settle balances with other countries. (Bordo et al,1993:32) "Surplus nations would receive interest while deficit ones would get overdrafts on which they would pay interest". (Lecture Notes 2:3)There would be regulations for the behaviour of debtors (who exceeded the quota) and creditors and permanent capital controls against speculation. Pressure was placed on creditor nations because bancor credit was unlimited. (Bordo et al,1993:33)

The American **White plan** was aimed at the stability of exchange rates through a United Nations Stabilization Fund created with each country contributing a quota of gold and domestic currency fixed in terms of unitas -"an international unit of account worth ten gold US dollars" (Bordo et al,1993:33). "Deficit countries would draw resources by selling their own currencies for those of other countries" (Lecture Notes 2:4) thus their balances would increase while those of creditor countries would decrease. (Lecture Notes 2:4) White viewed "imbalance as a problem only of the deficit countries". (Dammash: 5) Therefore, there were penalties for debtor countries which exceed the quota and "less pressure was placed on creditor nations" (Bordo et al,1993:33).

A **compromise** was reached between US and Britain and their interests (although US dominated the conference). The compromise was driven by shared idealism of promoting world peace, common knowledge and understanding of the inter-war problems. (Bordo et al,1993)

An **International Monetary Fund** would be created which would "promote international cooperation, full employment and rapid economic growth, maintain fixed exchange rates, avoid competitive devaluations, provide a multilateral payments system, eliminate exchange

restrictions and provide resources to meet the balance of payments disequilibria". (Lecture notes 2:5)

The **par value system** in terms of gold or dollar had to be maintained within 1% margin on either side. The parity could be changed through devaluation only in case of a fundamental disequilibrium, definition of which was never clarified. Devaluations which were greater than 10% needed the IMF's permission. Therefore, the Bretton Woods system was that of an adjustable-exchange rate peg system. (Bordo et al,1993)

Multilateral payments meant that members had to make their currencies convertible within three years and avoid multiple exchange rates. Capital controls were allowed. (Bordo et al,1993)

The **Fund's resources** were contributed 1/4 in gold and 3/4 in domestic currency with conditions of use by deficit countries to prevent accumulating soft currencies and depleting hard ones. The Fund had the power to specify the currency in which the repayment was required and if there were not enough resources of a specific currency, it would "ration its use by discriminatory exchange controls" (Bordo et al,1993:36).

The Fund had less **power** over the domestic policies of members than its architects intended, but enough to greatly influence the international monetary system. (Bordo et al,1993)

The Fund would be managed by a board of governors who would make major policy decisions "such as approving a change in parity" (Bordo et al,1993:36) and major changes were subject to the majority of votes which in turn depended upon the member's quotas. (Bordo et al,1993)

How the system was supposed to work

It was never specified exactly how the system was supposed to work, but it can be inferred that currencies were to be treated as equal – all countries had to "maintain their par values by intervening in the currency of all other countries" (Lecture notes 2:6), countries would use their international reserves or draw resources from the Fund to finance short-term payments deficits – for medium-term disequilibrium monetary and fiscal policies would be used to change aggregate demand, for a fundamental disequilibrium, parities could be

changed so as to restore equilibrium and capital controls were to be used to prevent speculation (Bordo et al,1993).

What were the main factors preventing it from functioning as its architects intended before 1958-60?

In fact, all major currencies except the dollar were not convertible and were subject to exchange controls and even more controls on trade, leading countries to resort to bilateral agreements on trade. There was a shortage of dollar because US accumulated two thirds of the world stock of gold by 1945 through devaluation in 1934 and by receiving payments for wartime expenditure from other countries, depleting Europe and Japan's gold and dollar reserves. Facing this situation, IMF pressured countries to adjust their parities immediately, but instead of parities that reflected the after-war situation, most major European countries had overvalued parities by adopting pre-war parities which led to massive payments deficits. (Bordo et al,1993)

The Marshall Plan provided Western Europe with almost $13 billion between 1948 and 1952 in order to help them expand their economies by restoring export capacity and ultimately creating stability. The Organisation for European Economic Co-operation (OEEC) would allocate funds to countries according to the size of their current account deficits. In turn, recipient governments would provide matching funds in domestic currency for investment. As a result, by 1952, Europe had achieved a 39% increase in industrial production and a doubling of exports. (Bordo et al,1993)

The European Payments Union (EPU) established in 1950 by OEEC countries acted as a "commercial bank clearing house" (Bordo et al,1993:43) because at each month's end, "members would clear their net debit or credit position with all the other members" (Lecture notes 3:3). "The unit of account for these clearings was the US dollar, but settlement could be made in dollars, gold or credit". (Bordo et al,1993:43) EPU managed to reduce the volume of payments transactions which contributed to the gradual "liberalization of world trade" (Lecture notes 3:3), becoming the "centre of a worldwide multilateral settlement area" (Bordo et al,1993:43).

Due to the Marshall Plan and European Payments Union (EPU), by 1955 the currencies of Western Europe countries were virtually convertible and their accounts showed a surplus. (Bordo et al,1993)

The decline of the sterling and the 1949 devaluation

In the interwar years, sterling was a key currency in relation to the dollar and it was expected to remain like this after the 2nd World War, but under the Bretton Woods period it started to decline. The 2nd World War left Britain with large balance of payments deficit for which sterling was not convertible into dollars. While sterling's importance as a reserve currency became weaker, the dollar's one grew stronger to eventually become "official international money" (Bordo et al,1993:47).

In 1949, Britain devalued the sterling in an attempt to recover its economy and reduce its deficits, but this also reduced its credibility as a key currency. The devaluation was important for the Bretton Woods system because, together with the Marshall Plan, helped the European countries achieve a surplus, which was an important step towards restoring convertibility. It also revealed a weakness in the Bretton Woods system: authorities would wait long enough before changing the parities, so that they made sure it was a case of fundamental disequilibrium, in other words that the change was really needed. But by delaying the decision, speculators would also be aware that devaluation was inevitable and would provoke a run on the sterling (so that they would not lose), which happened in the summer of 1949. (Bordo et al,1993) The system thus encouraged speculation. (Lecture notes 3:4)

IMF's Loss of Prestige

The IMF and the International Bank for Research and Development were designed to provide loans to help countries with their short or medium term balance of payments disequilibrium (Bordo et al,1993:35) and help with the post-war reconstruction problem. But the amount of resources that the countries needed in the late 40s was far greater than what these two institutions were able to provide. (Bordo et al,1993:204) The Marshall Plan and the EPU provided a "more effective immediate mechanism for promoting recovery" (James,1996:83) and OEEC and the Bank for International Settlements – agent for EPU" emerged as competing sources of international monetary authority. "(Bordo et al,1993:45)

The Fund did very little to achieve multilateralism before 1952, although this was one of its key objectives. Because it urged countries to declare their parities too soon, the crisis associated with the 1949 sterling devaluation created resistance by monetary authorities to changes in parity, which changed the nature of the system from an intended adjustable peg to a fixed rate regime. (Bordo et al,1993)

France devalued the franc in January 1948 so as to economize on scarce hard currency and created a multiple exchange rate system, against the Fund's regulations. Therefore it was denied access to the Fund's resources until 1952. However, France ended the multiple exchange rate system in October 1948 and received Marshall Aid, so the Fund's censure had little effect. (Bordo et al,1993)

Britain's devaluation in 1949 breached some of the regulations because the Fund received only a 24 hour notice and the size of the devaluation was greater than 10%, so it had to be approved by the Fund. This demonstrated "the Fund's inability to deter a major power from following its sovereign interest" (Mundell, 1969 in Bordo et al,1993:46). Canada decided to float the Canadian dollar in 1950, but assured the Fund that it was a temporary action. In fact, it lasted until 1961(Bordo et al,1993).

Starting from the late 50s, each currency was anchored to the dollar and indirectly to gold, thus the system "evolved into a variant of the gold-exchange standard, the gold dollar standard" (Bordo et al, 1993:49). The adjustable peg system evolved into a fixed exchange system with no effective adjustment mechanism and the three problems of the interwar period re-emerged. US followed monetary expansion instead of pursuing price stability and this triggered worldwide inflation. Eventually, US decided to "suspend convertibility of the dollar into gold for official transactions" (Lecture notes 6:4) in August 1971. In June 1972"sterling was allowed to float" and the fixed exchange rates system finally abandoned. (Lecture notes 6:4)

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