International Trade and Monetary Systems

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History of the International Monetary System

Time Line of International Financial Orders

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The Rules of the Game

- The set of rules and other formal and informal incentives under which a dnancial system operates is called an order.
- An international monetary order is sometimes referred to in the international dnance literature as Rthe rules of the game,Ra term reportedly coined by John Maynard Keynes.
- A monetary order is to a monetary system somewhat like a constitution is to a political system.

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The Origins of the Gold Standard

- The Gold Standard of the late 1800s has its origins in the British Parliament's e, orts to prevent in$ationary monetary policy by the Bank of England at the start of that century.
- During the Napoleonic wars in the early nineteenth century, the Bank of England had printed large amounts of pound notes in order to dnance the war e, ort.
- The British government had to suspend convertibility of pound notes into gold in 1797 to make this possible.
- This increase in money caused in$ation, of course.

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The Origins of the Gold Standard

- After the end of the wars, the landowners and merchants that dominated Parliament sought to prevent future losses of purchasing power of their money by passing several acts that would e, ectively put Britain on the gold standard.
- First, the Coinage Act of 1816 authorized the government to mint gold coins in accordance with strict purity standards.
- In 1819 a law was passed requiring the Bank of England to make its pound notes redeemable into gold at the same dxed parity re$ected in the Coinage Act.
- Full convertibility into gold went into e, ect in 1821.
- Not surprisingly, in$ation came to an abrupt end.

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The Origins of the Gold Standard

- The rest of the world was not yet ready to adhere to the gold standard when Britain did.
- For example, in the early nineteenth century, the United States pursued a policy of bimetallism, which was the simultaneous circulation of both gold and silver coins.
- Only after 1870 did most other countries make their currencies freely convertible to gold.
- Only when all countries adhere to the gold standard order was the world on the gold standard.
- This occurred after 1870, and all major economies followed the rules until 1914.

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The Order of the Gold Standard

Under the Gold Standard, the order e, ectively followed by national governments required that they:

- Fix an oe cial gold price or parity for the national currency in terms of a fraction of an ounce of pure gold;
- Permit the free conversion of gold into domestic money and domestic money into gold at the parity price in unlimited amounts and without question;
- Eliminate all restrictions on foreign exchange transactions and allow the import and export of gold.

One of the rules under the order of the gold standard was that governments would return to convertibility under the old gold parity as soon as possible in the case of an emergency that required the temporary suspension of convertibility. Why was this rule important to the continued maintenance of dxed exchange rates during the gold standard?

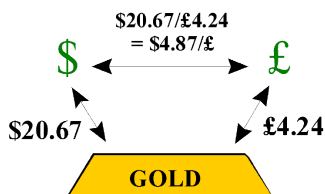
The Gold Standard

- A gold standard has a serious weakness, which is that revenue-hungry governments are tempted to issue more paper currency than they can back with the gold stored in their vaults.
- Suspicious holders of paper money could then panic and start a PrunRon gold, in which case the government would have to suspend convertibility of paper money into gold and e, ectively leave the gold standard.
- The Gold Standard was an order built on the faith that paper money and bank accounts could always be converted to pure gold at any time without restrictions.

Again, the Prules of the gameRof the gold standard: Could the system have worked if any one of the rules were not followed?

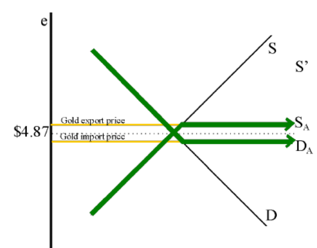
The Gold Standard and Exchange Rates

Fixed gold parities, free convertibility, and credible economic policies resulted in dxed exchange rates.



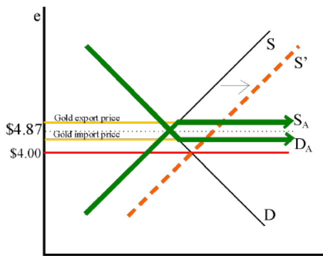
- For example, the British government set the pounds for gold parity rate at 4.24 pounds per one ounce of gold, and the U.S. government set its parity at the rate of $20.67 per ounce of gold.
- These two parities dedned the exchange rate to be 4.24 pounds per 20.67 dollars, or 1.00 = $4.87.

The Gold Standard and Exchange Rates



- The free export and import of gold was an important rule of the game.
- The potential movement of gold along with free convertibility kept exchange rates within a narrow band of the dxed exchange rate dedned by the cost of shipping gold (gold points).

The Gold Standard and Exchange Rates



- If the supply of foreign exchange increases from S to S', without gold standard rules, e falls to $4.00.
- Demanders of dollars will not sell pounds at e = $4.00; they will instead buy gold at the oe cial price of   4.24 per ounce, ship it to the U.S., and exchange it at $20.67 per ounce.
- This e, ectively gives them $4.87 for every pound, minus the expense of shipping the gold.

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Hume's Specie-Flow Mechanism

- The specie $ow mechanism and was drst described as far back as 1752 by David Hume, before the establishment of the gold standard.
- Hume's reasoning was used to argue that the gold standard was self-correcting.
- If a trade dedcit caused gold to $ow out of a country, its money supply would fall and prices would decline, thus restoring international competitiveness without changing the exchange rate.
- Similarly, a trade surplus would cause gold to $ow into the country, increasing the money supply, and eventually reducing exports and increasing imports.

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Milton Friedman said that a $oating exchange rate was simpler than a dxed exchange rate. Why and how does this apply to the gold standard before and after WWI?

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The Gold Standard

- The gold standard is often depicted as functioning in strict accordance with the rules of the game as described above. That is an oversimplidcation, however.
- Central banks often engaged in discretionary monetary policy.
- The central banks of the major countries did usually follow Bagehot's rule, so that central bank lending did not become a continued policy of expanding the money supply beyond what was prudent for maintaining credibility in convertibility.
- But, on a year-to-year basis, governments did not make the money supply change perfectly in line with the gold stock.

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The Gold Standard

- Exchange rates were not immediately in$uenced by $uctuations in money supplies and price levels because capital movements between countries in the late 1800s and early 1900s were very large.
- Especially important were the large $ows of capital from Great Britain to the newly settled economies of the world, such as the United States, Australia, Canada, and Argentina.
- Central banks, especially the Bank of England, routinely manipulated interest rates in order to in$uence international capital $ows.
- The Gold Standard period was also characterized by cooperation between governments when pressures developed against one or another currency.

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The Gold Standard

- The widespread conddence in the Gold Standard, which largely eliminated exchange rate risk.
- People were quite willing to shift large amounts of their wealth across borders.
- Such shifts in wealth were dependent on the continued expectation that governments would follow the order of the Gold Standard in the long run.
- Indeed, despite the variability in money supplies from one year to the next, in the long run prices did roughly respond to the supply of gold.
- Purchasing power parity was e, ectively maintained over the Gold Standard period.

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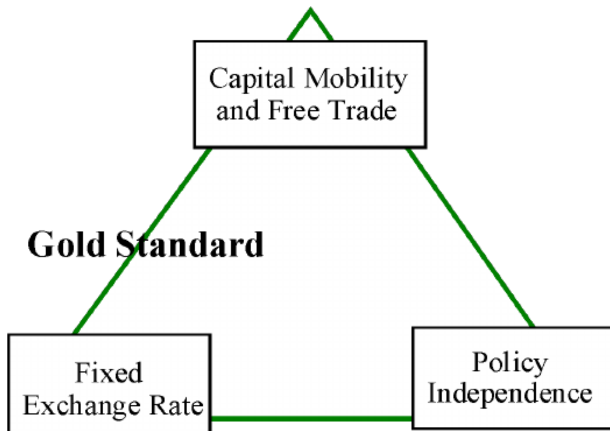
The Trilemma and the Gold Standard



Returning to the Gold Standard Under Changed Circumstances After World War I

- When World War I ended in 1918, foreign exchange markets expected the gold standard to be quickly reinstated.
- At the time of the armistice, the rates of the Netherlands, Spain, the United States, Great Britain and the Empire, Japan, France, Sweden, Argentina, Brazil, and Italy diverged remarkably little from the prewar pattern, considering the circumstances.
- However, a quick return to the gold standard was not possible.

Returning to the Gold Standard Under Changed Circumstances After World War I

- The United States had run very large trade surpluses and accumulated large amounts of gold during the war; other countries had little gold left in their vaults.
- In$ation during the war years meant that countries would have to de$ate if they were to return to the gold standard under the old parities.
- Keynes suggested that countries forget trying to return to the gold standard under the old gold parities and that they should set new parities and simply seek to maintain price stability at the higher price levels instead of de$ating.

The Treaty of Versailles

- The Treaty of Versailles between the Allied countries and Germany was signed in June of 1919 in the Paris suburb of Versailles.
- This treaty and the others signed with the other countries that fought on the side of Germany determined that Germany and its allies should compensate Britain, France, and its allies for their war losses.
- Losses due to Germany alone were assessed at $30 billion at 1920 prices, which was slightly more than double Germany's annual GDP at that time

The Treaty of Versailles

- A number of things had to happen for this scheme work:
  1. Germany would have to increase taxes or borrow from its citizens in order to cover its foreign reparations payments, and it would also have to run a large current account surplus with the allied countries in order to earn the British pounds, French francs, and Italian lira needed to pay war reparations.
  2. The allied countries would have to run current account surpluses with the United States in order to retire their debts with U.S. lenders.
- Unfortunately, political conditions in Germany, the allied countries, and the United States prevented things from unfolding in this required manner.

The Gold Standard After WWI

- The German government ran huge budget dedcits as it raised revenue with which to pay its reparations payment obligations.
- Allied countries in Europe increasingly restricted imports and e, ectively prevented Germany from running a current account surplus with which to dnance its reparations payments.
- And, the U.S. sharply raised tari, s after the war.
- Perhaps the most damaging economic policy decision by the US after WWI was its second increase in trade tari, s in 1930, which was the infamous Smoot-Hawley Tari, .
- By 1931 world trade volume had fallen by more than 50% from its 1929 levels. By 1933, it had fallen by about 70%.
- While protectionism certainly helped to turn the 1929 U.S. recession into the Great Depression, other factors also played a role.

Was the gold standard responsible for the Great Depression?

The Gold Standard After WWI

- Many economists blame the return to the gold standard for the perverse monetary policies that worsened the recession.
- They also blame the gold standard's rules of the game for quickly spreading the U.S. recession to the rest of the world.
- Indeed, the trilemma explains why a recession in one country would spread to others quickly.
- It may seem somewhat of a stretch to argue that the international dnancial order was the cause of the Depression and World War II.
- The Bretton Woods Conference in 1944 suggests that the leaders of the Allied nations had also concluded that the dnancial order was to blame.

Reversing the Financial Chaos

- After abandoning convertibility, many countries established what were referred to as exchange rate stabilization funds.
- Roosevelt pushed the International Trade Agreements Act through the Congress in 1934.
- The Roosevelt Administration also negotiated the Tripartite Agreement in 1936, which marked the dednitive end to the gold standard.

The Tripartite Agreement

- Under the Tripartite Agreement, the United States, Great Britain, and France decided to dx exchange rates between their currencies.
- The Tripartite Agreement did not envision a return to the gold standard; rather, it prescribed that central banks intervene in the foreign exchange markets to keep exchange rates dxed at agreed-to levels.
- There is not much di, erence between an order that requires central bank intervention in the foreign exchange markets and the order of the Gold Standard, but the agreement permitted the dxed rates to be changed under extreme circumstances.