

Bretton Woods European Economic Integration

Lecture 12

Textbook Account of BW

- With dollar pegged to gold, there existed a stable anchor
- Commitment to convert \$ to gold compelled US to follow policies of price stability
- Because other countries were linked to \$, they too followed policies of price stability (price-specie flow)
- Because exchange rates were pegged but adjustable, persistent payments imbalances were avoided
- IMF prevented opportunistic devaluation
- Capital controls reconciled policies to pursue internal and external balance

Some Uncomfortable Facts

- Adjustable pegs were almost never adjusted
- IMF surveillance was ineffectual
- Inflation was a growing problem
- System collapsed abruptly in 1971; 1973 move to floating rates
- Special arrangements of BW really in place from 1959-73 due to slow transition to convertibility

The Reality

- At first, external balance maintained by speed in which countries relaxed ex controls
- After 1958 (ex controls abolished), external balance was addressed via parity changes
- But capital mobility recovered with time
- This made parity changes more difficult, and they became infrequent
 - Investors would flee at first sighting of devaluation
- International support (through IMF) helped
- But system became rigid and brittle

Analytical Issue

- How good was performance of Bretton Woods?
- Did monetary stability encourage growth or vice versa?
- Why did capital controls work so effectively?
- What led to the ultimate breakdown in the system?

How good was performance of system?

- BW good for trade (expands faster than Y)
- Did little to encourage financial integration and to transfer resources to developing countries
- So answer depends on what you care about

What was causality between growth & monetary stability?

- Monetary policy much more stable than subsequently
- But other shocks (like commodity price shocks) were also smaller, especially in 1960s
- So this may have been another of those self-reinforcing positive feedback loops

Evidence on disturbances

What was the role of capital controls?

- Capital controls reconciled pegged rates with domestic policy autonomy
 - Recall the Impossible Trinity
- But they worked only because domestic financial markets were tightly controlled
- And leakages increased over time

What caused the breakdown of Bretton Woods?

- Was it deteriorating US competitiveness and failure to adjust?
- Triffin Dilemma?

US policy dilemma

- \$ was the anchor of the system
- US competitiveness deteriorated over time
 - Trade surplus moved toward deficit
- Money supply and budget deficits grew
 - Reflects Great Society programs & Vietnam War pressures
- Inflation results
- Fundamental unwillingness to address policy problems of external balance

Triffin Dilemma

- Growing world economy needed more liquidity
- Given inelasticity of gold supplies, this meant more dollars (should sound familiar).
- US provides these by running budget deficits
- But this created “confidence problem” (analogous to bank run problem)
 - More & more reserves piled up on smaller pile of gold at Fort Knox
 - So long as no one queued up to get gold, ok
- Led to creation of synthetic reserves, Special Drawing Rights (akin to Keynes’s bancor), but too late
 - China has raised this issue again this year!

Both views have merit

- US was fundamentally unwilling to adjust
- Even if it had, other countries, hungry for reserves, would have responded in kind, limiting the improvement in the US balance of payments and threatened the world with a deflationary crisis

Lessons for Today

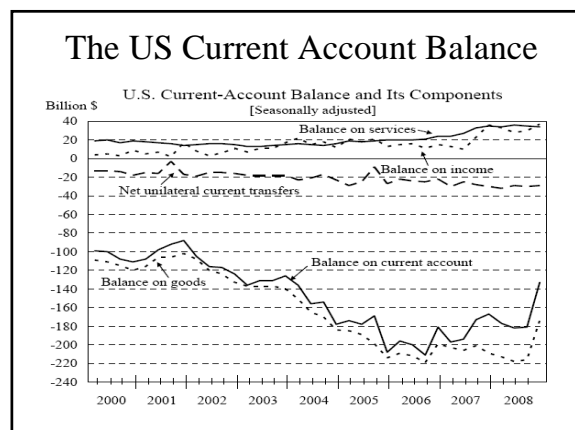
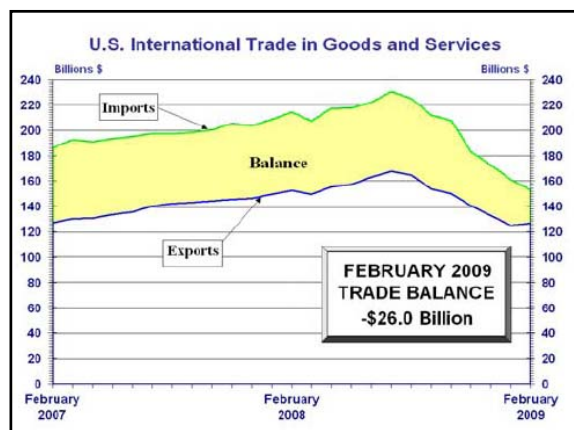
- Bretton Woods was not an intrinsically stable system
- It lasted as long as it did because capital flows were bottled up
- It benefited from a fortuitously stable environment
- It lacked an effective adjustment mechanism and stable supply of liquidity
- It epitomized political pressures that make it so hard to maintain exchange rate stability in today's world of high capital mobility

So where does that leave the world economy?

- Domestic financial market liberalization
- Catch up growth no longer exists to same extent
- Countries that maintained pegged but adjustable exchange rates all experience currency crises

Are we in a new Bretton Woods System today?

- 1960s: core was US & periphery was Europe and Japan
- Today, the core is still US, but periphery is emerging markets in Asia and Latin America
- Core still has "exorbitant privilege"
 - Issuing currency used as international reserves
 - Living beyond its means
- Periphery still committed to export-led growth & undervalued exchange rates to exploit catch up growth
 - Corollary: Periphery obtains low-yielding international reserves in core's currency (U.S. Treasuries)
- Today, there's a third bloc Europe
 - Has already exploited catch up growth
 - Doesn't have exorbitant privilege



Some suggest the modern BW can be maintained indefinitely

- U.S. continues to run CA deficits
- Financed by Asian/LA dollar accumulation
- Asian countries will resist dollar depreciation and BOP adjustment as that would worsen their trade accounts
- China has 200 million rural workers that can only be added to modern sector at a rate of 10-20 million per year so at least 10 more years

But incentives of individual countries are not aligned

- Under BW, collectively in interests of Japan & Europe to keep ex rates low and export their way to growth
- But each country had an incentive to convert dollars to gold if it thought it could get away with it
 - French did just this, but Germans held out at high costs
- Gold pool was the collective action solution
 - A cartel to maintain price of gold at \$35 per ounce
 - Cartel collapsed in late 1968 after French purchases became known

Today's Int'l Monetary System

1. Countries today are no different and won't subordinate individual interests to the collective good
 - Get out before they are the last and Sell \$ and diversify
2. Countries are more diverse today than Europe in BW era
3. There is now an alternative to \$\$ -- the Euro
4. Removal of capital controls makes it difficult to prevent mvmts in ex rates
5. Liberalization of financial markets means that investment flows now go towards assets as well as goods markets
 - Booms in assets

European Integration

- The European Union
- The Single Market
- The Euro or single currency



Why it matters

- Early instance of regional approach to trade liberalization
 - Is this approach compatible with multilateral approach?
- Unprecedented effort to move beyond trade liberalization to deeper integration
 - Will other regions follow?
 - North America? Asia? Mercosur?

Motivations over time

- No single answer valid for entire period
- 1950s & 1960s: to "disarm" the German economy (lock it peacefully into Europe)
- In 1980s, as a solution to high unemployment by exploiting economies of scale & scope
- In the 1990s, as a way of regaining competitive edge vis-à-vis US & Japan

Integrationist Tradition in Europe

- Political as well as an economic project
- Same tradition does not exist elsewhere
 - Asia, Latin America

Landmarks on the Road

- EPU in 1950 (liberalize CA)
- European Coal & Steel Community 1951
 - France, Germany, Italy, Benelux
 - “Critical industries” locked together to prevent war
- Treaty of Rome in 1957, with intent to create a Customs Union (EEC in 1958)
- Common Agriculture Policy in 1960s
- 1st enlargement: Denmark, UK, Ireland in 1973
- European monetary system 1979
- 2nd enlargement: Greece (1981) Spain, Portugal (1986)

More landmarks

- Single European Act in 1986
- Maastricht Treaty in 1992
- 3rd Enlargement: Sweden, Finland, Austria in 1995
- Monetary Union in 1999
- Single Currency (Euro) introduced Dec.31, 2001
- 4th Enlargement 2004: 10 countries
 - Czech Republic, Hungary, Slovenia, Slovakia, Poland
 - Baltic countries (Estonia, Latvia, Lithuania)
 - Island Countries (Cyprus, Malta)
- 5th Wave? Bulgaria, Romania (2007) & Turkey?

Features of Custom Union

- Eliminate internal tariffs
- Create a common external tariff
- Limit intra-European trade in products of “sensitive sectors” (agricultural goods primarily)

Effects of Custom Union

- Is it efficiency enhancing or not?
- Yes, if customs union leads mainly to trade creation
- No, if customs union leads mainly to trade diversion

Evidence of either?

- Some of both
- But trade creation appears to have dominated 1960s, 1970s, and today
- Why?
- Because Europe meanwhile reduced tariffs on imports from rest of world
- European regionalism was therefore beneficial because it was embedded in a set of global institutions (notably GATT) that meanwhile encouraged multilateral liberalization

Features of the Single Market (Single European Act)

- Tariffs already eliminated by mid 80s: Next step is to eliminate other impediments including:
 - Elimination of capital controls to forge a single capital market
 - Mutual recognition of technical credentials, portability of pensions to forge a single labor market
 - Elimination of subsidies for home industry
 - Mutual recognition of product standards
 - Tax harmonization
 - Deregulation of service industries (banking & insurance)
 - Persistent controversy over above items

Effects of the Single Market

- Economists' models much less definitive in measuring benefits
- Standard gains from trade framework suggests small effect: 1-2%
- "X-efficiency" view, operating through specialized inputs
 - Technological & organizational spillovers
- Pressure to remove excessive regulation
- Despite these uncertainties, most people's intuition is that benefits are substantial

Linkage to money

- We have seen that there is an argument that the benefits of the single market are large
 - Creating a market larger than US for investment & trade
- But do you need a single currency to reap the gains from a single market?
- Political scientists say Oui
 - Neofunctionalist spillovers



Basis for linkage

- A single currency is needed to enhance transparency and encourage factor mobility
 - Probably true, but of second order importance
- It is necessary to avoid arbitrary exchange rate changes to head off a political backlash against the single market
- And the removal of capital controls, part of the Single Market, makes it impossible to hold separate currencies stable, leaving monetary union as the only alternative
- Evidence on this follows

Political Dimension

- Preceding emphasizes economic rationales
- But monetary integration heavily driven by politics. Underscores political motivations behind the entire integrationist project
- Neofunctionalist spillovers redux: monetary integration requires fiscal integration, and fiscal integration requires political integration

Why it matters

- European Monetary Union unprecedented experiment
- Hard to think of another historical case where monetary union preceded political union
- World has too many currencies: will other regions therefore follow?

Motivations

- Political motivation
 - Monetary union is the key ingredient for bringing political union (Neofunctionalist spillovers)
 - Monetary union requires fiscal union, which requires political oversight...
- Economic motivation
 - Maintaining support for the Single Market Act requires stable exchange rates
 - Stable rates can only be achieved with monetary union
 - To understand this, look back at the 1992-93 currency crisis

Monetary Chronology

- The Snake (1972-1978)
 - Response to the breakdown of BW
 - Collapsed due to inadequate policy harmonization
- The EMS (1979-98)
 - More extensive credits
 - More successful policy harmonization
 - Old EMS (1979-86) relies on capital controls and permitted periodic interventions
 - New EMS (1987 -) saw removal of controls as a result of SEA and increasing rigidity (shades of BW)

Crisis Chronology

- Removal of capital controls ongoing from 1987 to 1992
- Delor Committee reported in 1990
- Maastricht Treaty agreed to in Dec.1991
- Danish ratification referendum failed in June 1992
- Turbulence broke out in August 1992
- UK and Italy driven from EMS in Sept
- Spain, Portugal, Ireland forced to devalue
- France also in spring/summer 1993
- Narrow bands widened in August

Explanation for Crisis

- Competitiveness problems
- High unemployment in Europe and lack of political will to defend system

Competitiveness Story

- Italian & UK currencies attacked because of fundamental overvaluation
 - Inflation too high
 - Exports inadequately competitive
 - Devaluation therefore unavoidable
- Obviously true for Italy
- But much less obvious for other countries. France was running lower inflation than even Germany

High Unemployment & Lack of Political Will

- High U → govnt's lack will to hike interest rates
- When currencies attacked, they surrender and devalue rather than raise interest rates further
- The cost of surrender was to jeopardize the Maastricht process. But after Danish referendum, there was the possibility that nothing remained to be jeopardized

What monetary options did Europe have?

- If competitiveness story correct → future crises can be fended off with better policies
- But if crises arise from “self-fulfilling” attacks, then crises can arise in absence of bad economic fundamentals
 - Narrow bands of the EMS were rendered unworkable by the removal of capital controls

Conclusion

- Stable exchange rates extremely hard to maintain under political democracy and high capital mobility
- Necessary to move back to greater exchange rate flexibility or forward to monetary union
- Broader integration left Europe with only one alternative

Framework for transition

- Maastricht Treaty (1991) & Three stage transition
- Stage 1 (1991-94): efforts at policy convergence & institutional adjustment (make central banks independent)
- Stage 2 (1995-8): further policy convergence in order to satisfy Convergence criteria
- Stage 3 (1999): full monetary union with single currency issued in 2002

Convergence criteria

- Budget deficit/GDP < 3%
- Public debt/GDP < 60%
- Low inflation rates (<1.5% above Euro avg)
- Interest rates close to European average
- Exchange rate stability maintained
- Rationale?
 - Filter to keep out countries with poor fiscal policies, whose inclusion would increase inflationary/bailout pressure on the ECB

Convergence Indicators in 1991

	Consumer Price Inflation (%)	Long-term Interest Rates (%)	Budget Surplus (% of GDP)	Gross Public Debt (% of GDP)
Belgium	3.2	9.3	-5.4	129.4
Denmark	2.4	10.1	-1.7	66.7
France	3.0	9.0	-1.5	47.2
Germany	3.5	8.6	-3.2	46.2
Greece	18.3	N/A	-17.0	96.4
Ireland	3.0	9.2	-4.1	102.8
Italy	6.4	12.9	-9.9	101.2
Luxembourg	3.4	8.2	+1.9	6.9
Netherlands	3.2	8.9	-4.4	78.4
Portugal	11.7	17.1	-5.4	64.7
Spain	5.8	12.4	-3.9	45.6
United Kingdom	6.5	9.9	-1.9	43.8
European Community	5.0	10.4	-4.3	61.8

**Table 1
The Maastricht Budget Criteria as of Mid-1997
(percent of GDP)**

	Budget Deficit (Limit = 3 percent)	Public Debt (Limit = 60 percent)
Austria	3.0*	71.3
Belgium	2.8*	127.2
Denmark	0.0*	66.8
Finland	2.0*	58.1*
France	3.2	57.8*
Germany	3.2	61.8
Greece	5.2	106.0
Ireland	1.2*	69.0
Italy	5.2	123.3
Luxembourg	N.A.	N.A.
Netherlands	2.3*	74.5
Portugal	2.9*	66.3
Spain	3.0*	69.8
Sweden	2.1*	77.3
United Kingdom	2.8*	54.1*

Expectations vs. Results

- Expected it would be limited to Europe's core (FR, GER, Benelux, perhaps Denmark)
- 11 countries were admitted
- Why?
 - Progress at fiscal consideration was faster than expected (in part due to EMU)
 - EU's consensus decisionmaking

Will EMU Work?

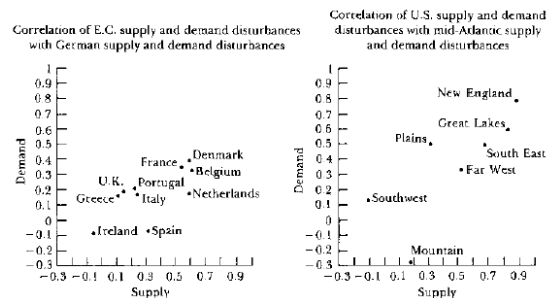
- Optimum currency theory focuses on:
 1. Asymmetric shocks
 2. Labor Mobility
 3. Fiscal Federalism
- On all accounts, Europe is not as good a candidate as the US for monetary union

Evidence?

- Asymmetric Shocks
 - Less correlation in supply and demand schedules in Europe than US
- Labor Mobility higher in US
 - Allows internal market to adjust to shocks
- Fiscal Federalism
 - EU budget much smaller than US 1.5% of GDP
 - More difficult to deal with regional shocks

Figure 1

Supply and Demand Correlations Across the U.S. and Europe



What conclusions follow?

- Europe is placing in one monetary straightjacket 11 economies subject to very different shocks and with limited adjustment mechanism
- But which of these OCA criteria are likely to be endogenous?
- And aren't the barriers to exit formidable?
 - make monetary union work?

Some keys to success

- Building credibility so that k flows are stabilizing
 - Greater consistency & transparency of ECB
- Letting automatic stabilizers work
- Worrying about financial stability as well as price stability
- Rationalizing the coordination of financial supervision with monetary policy (both information flows & policy actions)
- Letting the exchange rate float

Implications for the US

- The euro will be an international rival for the dollar
- ...but the dollar will not be toppled anytime soon
- The US will have a major counterweight in international forums
- ...but Europe will not speak with unified voice
- The world will increasingly organize itself into currency blocks, with the exchange rates between them allowed to float
 - Pegging versus floating for 21st C?
 - Sort of a misnomer