Week 6. International Finance. Eichengreen. 1996. *Globalizing Capital*.

Quick Summary: Eichengreen provides a historical account of the trend towards freely floating exchange rate system. He mainly argues that the rising capital mobility and the advanced technology have made it more difficult to maintain a pegged rate system. In the second half of the book, he starts with the Bretton Woods system (1944-1973), which was an attempt to rearrange the world economy after the war. It is different from the gold standard, which began before World War I and operated until late 1930s, in many respects (see below). However, the pressure from capital mobility made pegging exchange rate more difficult. As a result, countries abandoned the adjustable peg of the Bretton Woods system for a floating exchange rate, except for small developing countries that try to limit currency volatility. Several countries still adopt variant forms of peg currencies such as the Snake, the EMS, and the monetary union in Europe, currency boards, etc. Capital controls also slowly disappeared especially in 1980s. Only one main feature of the Bretton Woods system remains today, the IMF.

Chapter 4. The Bretton Woods System (1944-1973).

(There are examples of crises during this period as well but they all illustrate the countries' attempts to maintain pegged currencies.)

Characteristics of the Bretton Woods System. The Bretton Woods agreement was signed in 1944 with 45 member countries. This system departed from the gold standard in three fundamental ways: 1) pegged exchange rate becomes adjustable, subject to specific conditions (fundamental disequilibrium), in order to eliminate balance-of-payments deficits; 2) controls were permitted to limit international capital flows, which were disruptive during the interwar periods; 3) the IMF was created to monitor national economic policies and extend balance-of-payments financing to countries at risk.

In principle, these three elements complemented each other. Pegged exchange rate was feasible because of capital controls, while the IMF provided an extra line of defense for countries trying to maintain their pegged exchange rates but faced market pressures. However, these principles did not work together as well in practice. The adjustable peg turned out to be an oxymoron: parity changes, especially by the industrialized countries at the core were rare. The IMF's resources were dwarfed by the postwar payments problem. Capital controls were to only mechanism that seemed to function, but it was possible because the financial environment was allowable to do so. The Bretton Woods period was a period when governments intervened extensively in their economies and financial systems.

Several problems plagued the operation of the Bretton Woods system. Countries hung on to currency controls because of the missing conventional adjustment mechanism. The commitment to full employment and growth that was integral to the postwar social compact inhibited the use of expenditure-reducing policies. The deflationary central bank policies that had redressed payments deficits under the gold standard were no longer acceptable poltically. The IMF lacked the power to influence national policies and the resources to finance the payments imbalances that resulted.

Lessons of the Bretton Woods. First, changed political circumstances made it difficult for central banks and governments to eliminate payments deficits. The available adjustment mechanisms were inadequate, and the operation of pegged exchange rates in the presence of highly mobile capital was difficult. Second, the system continued to function because of cooperation among countries, which was absent during the late nineteenth century, when foreign assistance was available only when the stability of the system was threatened. It was possible because of the alliance among the US, Western Europe, and Japan during the Cold War. Other countries complied with the Bretton Woods in exchange for the US bearing a disproportionate share of the defense burden. Once the political circumstances changed in late 1960s and 1970s, with the European countries and Japan disagreeing over Vietnam spending and the asymmetry of

dollar power in the market. The political support from the international community receded, leading to the breakdown of the system. Third, cooperation in support of a system of pegged currencies will be most extensive when it is a part of an interlocking web of political and economic bargains. Such a web slowly disappeared in late 1960s and 1970s. Fourth, there was a lack of credible commitment. Cooperation among nations ran up against binding limits within each government: it was always doubtful whether the government would take measures required for currency adjustments.

Chapter 5: From Floating to Monetary Unification.

Before the end of the Brettons Woods system in 1973, the stability of exchange rate had been a major goal for central banks and governments. Monetary policy was used to peg the exchange rate except during exceptional and limited periods of war, reconstruction, and depression. However, the rising capital mobility had made pegging exchange rates more difficult. It increased the pressure on weak-currency countries seeking to defend their pegs. It heightened the reluctance of their strong-currency counterparts to provide support. The collapse of the pegged but adjustable rate system defined in the Bretton Woods left two extreme options available: floating or peg once and for all.

Still there have been different transformations of currency systems since the end of the Bretton Woods system.

1) European Snake. In the early 1970s, the European countries tried to collectively operate currency peg with 2 ¼ percent fluctuation bands. It was also one of the early attempts to integrate the European market. However, the Snake was difficult to operate because of the oil-price shock in 1973 and the 1974 commodity-price boom. It was also France's initiative to break away from dollar domination in the world capital market. As it turned out, German mark surged as a central currency as the Snake broke down, and European policies evolved around Germany's anti-inflationary policies.

2) European Monetary System (EMS). It was created in 1979 to limit exchange rate fluctuations. It was also a political reaction against Germany's domination of monetary policies in Europe. There was no mechanism to control German policies under the Snake, and members of the Snake then had no option but to leave the Snake if they wanted their monetary policy autonomy back. This German domination was also called "accountability deficit." Again, France tried to rectify the situation by setting up EMS with the goal of creating an EC body to which national monetary policymakers could be held accountable. However, the removal of capital controls at the end of 1980s made the EMS difficult to operate. A series of crises also forced the members of the EC to widen the fluctuation bands of the EMS from 2 ¼ to 15 percent in 1993.

3) Currency Boards. Another option after the Bretton Woods system was to harden the currency peg. A few countries – Hong Kong, Bermuda, the Cayman Islands, Argentina, and Estonia – established their currency boards. They adopted parliamentary statutes or constitutional amendments requiring the government or central to peg their currency to that of the trading partner. Currency boards were attractive in special circumstances: they were small, their banks were closely tied to institutions overseas, and hence could expect foreign support, they had underdeveloped financial markets, or they had histories of high inflation. The weakness of currency boards is the same as under the gold standard: limited scope for lender-of-last-resort intervention. Unless it has excess reserves, it is unable to inject liquidity into the domestic financial system.

4) Monetary Union. It is considered as another way to harden the peg. In 1991, European countries adopted a plan to establish a European Central Bank to assume control of their monetary policies, peg their exchange rates, and replace their national currencies with a single European currency.

Experience with Developing Countries. Floating rate was unattractive for countries with underdeveloped financial markets. It was unappealing to very small, very open developing countries. Many developing countries then pegged their currencies behind the shelter of capital controls. Over time, pegging has become increasingly difficult with these countries' efforts to liberalize financial markets. Although they enjoyed low inflation rates due to capital controls, international financial flows became more difficult to control.

Asian Crisis. Three lessons can be drawn from the crisis. First, countries with weak banking systems are particularly prone to currency crises. At the root of the Asian crisis was governments' manipulation of their financial systems to further their national development strategies. This saddled their banks with uneconomical loans and led the authority to extend them guarantees as a quid pro quo. Second, the Asian crisis provides another reminder of the speed and extent of contagion. Third, the Asian crisis illustrates the pressures making for greater exchange rate flexibility.

Conclusion. Eichengreen concludes that we will see currency blocs in the future as countries are trying to shield themselves from exchange rate volatility. With currency blocs, countries tie their currencies securely to that of a larger neighbor such as that in Europe with Germany. He predicts that the US and Japan will become the centers of such blocs.