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Who Adjusts? (Beth Simmons)

Introduction:

During the years between the First and Second World Wars, some states broke the gold standard requirements of currency stability and liberal trade. Instead, they adjusted to the balance of payment deficits by devaluing and erecting barriers to trade which disrupted trade, impoverished trading partners, reduced global welfare and exacerbated the Great Depression. Simmons argues that the reasons that states broke away from the accepted economic norms, which caused an international economic crisis in the interwar years, were due to domestic political factors.

The requirements of the gold standard were—(1) states had to make their balance of payments a higher priority than their domestic economy; (2) states had to maintain reasonably open trade relations in order that the gold standard adjustment could take place; (3) exceptional finance had to be provided by either the central banks or private banks from surplus countries in order to maintain fixed rates. However, these requirements maintained an external balance which was at a cost to the level of domestic economic activity.

Chapter 2:

Evidence suggests that where governments could not make credible commitments to avoid inflation, the result was capital flight, inflation and incipient deficit in the current account. "The implications for an international monetary regime based on gold were clear: where commitments to avoid inflation and maintain external balance were unbelievable, pressure for devaluation and protection mounted" (p. 11). During the prewar years, this credibility was never in question and there were two main reasons for this—

1. There was very limited domestic political opposition to the gold standard: there was little political resistance during the 19th century to the importance that the gold standard placed on external balance even when this was achieved at the expense of the domestic economy. This was mainly due to exclusionary politics and laissez-faire political tenets which did not hold the state responsible for the economic welfare of its citizens.

2. There was prompt and significant international bank collaboration in times of crisis: there was little doubt that the occasional foreign exchange crisis would be handled cooperatively among the three major money centers of Europe (London, Paris and Berlin). Publics believed that the international community's support for the gold standard was inviolable.

However, in the interwar years there was a shift in the balance of power between classes that challenged the institutional and philosophical supports of externally oriented monetary policies. There was a recognition for the rights of workers, extension of franchise and revolution in labour organization and industrial action. This resulted in fragile governing coalitions which were tempted to try and engineer stimulation and devalue the currency. "Moreover, the war and the nature of the peace had sown conflicts that were manifest in international monetary relations" (p. 30). War debts and reparations poisoned relationships and differing ideas over the merits of the gold standard versus the gold exchange standard retarded cooperation.

There were three norms of gold standard adjustment: (1) external balance took priority over the domestic economy; (2) liberal policies were preferred over external controls (3) fixed exchange rates had to be supported with international liquidity. There were 5 variables which signalled to economic agents that these principles of monetary policy making could no longer remain isolated from rising political demands—(1) regime type: shift from elite based politics to inclusive mass politics; (2) political orientation of party in power: the representation of the working class in mainstream politics; (3) labour unrest: to make exports competitive, states must be able to lower their cost, a large part of which is the cost of labour; (4) government instability: which would lead to the temptation of giving into short term economic boost measures such as devaluation; (5) central bank independence: when monetary institutions are independent of government they may decide not to deflate.

Chapter 3:

Simmons posits a model which suggests five factors that undermine the ability of the government to implement conservative monetary policies:

1. The market's judgement about the credibility of the regime: are regimes that have recourse to repression more likely to be able to achieve their announced monetary goals?

2. The market's judgements about policy makers' preferences: for example markets react differently to promises of governments of the Right versus those of the Left.
3. The market's judgements about policy makers' time horizon: the prospect that the government will not be in power much longer.
4. The market's judgements about institutional monetary constraints: government commitments are suspect because of the known desire to increase employment and output. This credibility may be weakened further if the central bank is perceived as the government's ally.
5. The government's and market's judgements about market distortions: this implies labour unrest etc.

After testing the model, Simmons concludes that the three political variables that significantly affect a government's credibility with respect to monetary policy are: (1) the political stability and expected longevity of the government; (2) the way markets reacted to politically manipulable banks and (3) the extent of labour unrest. The role of the Left/Right only partially fitted expectations while the difference between democratic and non democratic regimes had negligible effects.