

# International Financial Integration

Competing Ideas and Policies  
in the Post-Bretton Woods Era

Anthony M. Endres



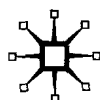
# International Financial Integration

Competing Ideas and Policies in the  
Post-Bretton Woods Era

Anthony M. Endres



palgrave  
macmillan



© Anthony M. Endres 2011

All rights reserved. No reproduction, copy or transmission of this publication may be made without written permission.

No portion of this publication may be reproduced, copied or transmitted save with written permission or in accordance with the provisions of the Copyright, Designs and Patents Act 1988, or under the terms of any licence permitting limited copying issued by the Copyright Licensing Agency, Saffron House, 6–10 Kirby Street, London EC1N 8TS.

Any person who does any unauthorized act in relation to this publication may be liable to criminal prosecution and civil claims for damages.

The author has asserted his right to be identified as the author of this work in accordance with the Copyright, Designs and Patents Act 1988.

First published 2011 by  
PALGRAVE MACMILLAN

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries

ISBN 978-0-230-23226-6      hardback

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

A catalog record for this book is available from the Library of Congress.

10	9	8	7	6	5	4	3	2	1
20	19	18	17	16	15	14	13	12	11

Printed and bound in Great Britain by  
CPI Antony Rowe, Chippenham and Eastbourne

# Abbreviations

BIS	Bank for International Settlements
BW	Bretton Woods
CPI	consumer price index
EC	European Community
ECB	European Central Bank
ECU	European currency unit
EMU	European Monetary Union
EMS	European Monetary System
ERM	European exchange rate mechanism
EU	European Union
FAO	Food and Agriculture Organization
GDP	gross domestic product
GNP	gross national product
IBRD	International Bank for Reconstruction and Development
IFI	international financial institution
IFIAC	International Financial Institution Advisory Commission
IFO	international financial order
IFS	international financial system
ILLR	international lender of last resort
IMF	International Monetary Fund
LDC	less developed country
LLR	lender of last resort
NBER	National Bureau of Economic Research
OCA	optimum currency area
OECD	Organisation for Economic Cooperation and Development
SDR	special drawing rights
WB	World Bank
WHO	World Health Organization

# Preface

This book is the outcome of five years' research and reflection. It represents a sequel to my *Great Architects of International Finance: The Bretton Woods Era* (London and New York: Routledge, 2005). The present volume takes up the intellectual history and comparative ideas approach from the demise of the Bretton Woods System in 1971 until the end of 2000. For the post-Bretton Woods era, I employ a different procedure than the chapter-by-chapter individual-economist focus in my study of the Bretton Woods era. Here the chapter treatment is by major questions and issues in the international financial system. The topics chosen for the following chapters are as follows: the reactions of leading economists to the collapse of the Bretton Woods system; exchange rate regime choice; capital account convertibility issues; international financial and economic crises; ideas on the changing role of the IMF in the post-BW era and currency consolidation issues.

Each chapter draws on significant contributions by economists to the debate on international financial integration and international monetary reform. The ideas of economists are reviewed and compared, including those of nine Noble Laureates: Milton Friedman, Friedrich Hayek, Paul Krugman, Robert Lucas, James Meade, Robert Mundell, Paul Samuelson, Joseph Stiglitz and James Tobin.

I will compare and contrast the diverse ideas, practical proposals and policy implications arising from the work of prominent economists in the field of international finance and international monetary economics. Different and oftentimes competing ideas will be organized into 'trajectories of thought' – a notion introduced in Chapter 1 that is intended not only to capture economists ideas, philosophical and methodological orientations at any particular point in the post-Bretton Woods era; it also functions to establish commonalities with other economists and trace movements in various lines of thought over time.

The main purpose of this monograph, from my own perspective, is to underscore the importance of intellectual structures in the quite modern history of international finance. The subjects of international finance and international money are now highly technical sub disciplines in economics and are not easily accessible to non-specialists. The most popular methodologies in these fields are formal modelling, usually coupled with sophisticated empirical and econometric testing of propositions

about one or other relationship in the international realm. By contrast, it is unusual to employ a comparative ideas approach in these fields. In the final chapter I set out in more detail what I mean by 'intellectual structures' and compare this idea with other more popular methodologies used when historically-minded economists treat international monetary problems. Here I am thinking of economic historians' bread-and-butter techniques for studying historical structures: reasoning by historical analogy and counterfactual analysis. These techniques will not be employed here.

By comparison with the contributions of economic historians, this book is unashamedly focused on comparisons of economic doctrines in historical perspective. By 'doctrines' I mean, following Joseph Schumpeter (1954), economists' explanations of the workings of the international financial system or particular dimensions of that system, based on some unifying principles, reasoning styles and research methodologies. What finally turns economists' explanations into a fully-fledged doctrine is a set of policies advocated on the basis of those principles, reasoning styles and methodologies.

Early drafts of some parts of this book have been presented at the History of Economic Thought Society of Australia Conference, University of New England, 2003; the Society for Heterodox Economics Conference, University of New South Wales, 2007; the Colloquium on Market Institutions and Economic Processes, New York University, 2008; Monash University Economics Seminar Series, 2006 and the Freedom to Choose Conference, University of Notre Dame, Fremantle, 2010. I am greatly obliged to conference and seminar participants for comments and advice. I am also indebted to Grant Fleming for previous joint work on economic thought and research agendas in international agencies which has especially benefited discussion in Chapter 6 on the IMF. Certain parts of the book draw on previously published work. I acknowledge permissions granted for use of this material from the following: Duke University Press for 'Frank D Graham's Case for Flexible Exchange Rates: A Doctrinal Perspective', *History of Political Economy*, 40(1), 2008, 133–67, and John Wiley and Sons for 'Currency Competition: A Hayekian Perspective on International Monetary Integration', *Journal of Money Credit and Banking*, 41(6), 2009, 1251–64.

I have also had the benefit of working with David Harper at NYU on developments in the theory of capital, and it is out of this joint work that the idea of 'thought trajectories' arose and was found useful in the following chapters. More broadly, I am indebted to the support of colleagues in the History of Economic Thought Society of Australia over a

period of 25 years. In many different ways they have underscored the importance of studying the intellectual history of economics at a time when that subfield has been unjustly relegated to minor status in university economics curricula and, in many cases, it has disappeared altogether. The present fad of locating economics faculty in business schools rather than either the humanities or social sciences, seems largely to have been responsible for this trend.

As usual I am indebted to friends and family who have variously suffered and in some cases benefited, from my self-enforced social isolation while working on this study. I am especially grateful to the two Amandas: Amanda Tong for research assistance and for preparing the bulk of the manuscript and Amanda Sun for efficiently reshaping and formatting the final manuscript into a form suitable for publication.

Melbourne, April 2010

# Contents

<i>List of Tables and Figures</i>	vii
<i>Abbreviations</i>	viii
<i>Preface</i>	ix
<b>1 A Qualitative Framework</b>	<b>1</b>
The political economy of international monetary organization	1
International financial integration: Meaning and implications	5
Trajectories of thought on international financial integration	9
Key dimensions of thought trajectories on international financial problems: Stylized examples	11
<b>2 Economists' Initial Reactions to the Demise of the Bretton Woods System</b>	<b>16</b>
Introduction	16
The case for a new synthetic international money	17
Alternatives to an IFO based on synthetic international money	23
Choosing an IFO post-1971: Broad criteria	32
<b>3 Controversy Over Choice of Exchange Rate Regime</b>	<b>38</b>
A tripolar choice problem	38
An idealized market-determined system for exchange rates	40
Hayek's perspective on currency internationalization and exchange rate regimes	44
Early arguments against intermediate regimes	52
Limiting variability: Cases for intermediate regimes	55
Ronald McKinnon's grand currency reform scheme	65
Conclusion	69
<b>4 Choice of Capital Account Regime: When to Liberalize?</b>	<b>73</b>
International liquidity and creditworthiness issues	73
Why liberalize capital accounts? The sceptical view	76
Sequencing capital account liberalization in a planned reform process	86
Choosing a freer capital account regime	91
Conclusion	99

<b>5</b>	<b>International Financial Crises: Ideas and Policies</b>	<b>101</b>
	Early post-Bretton Woods discussion: The Minsky-Kindleberger framework	101
	Paul Krugman's characterization of international financial crises	106
	Joseph Stiglitz on crises causes and policy responses	114
	Crises from the vantage point of eclectics and pragmatists	121
	Pro-market approaches to crises and crises resolution	127
<b>6</b>	<b>The IMF: Post-Bretton Woods Era Functions and Reform Issues</b>	<b>137</b>
	Introduction	137
	Some models and ideas informing IMF functions	139
	Further doctrinal support for IMF programs and policy	150
	Main criticisms of IMF functions and the tarnished 'Washington Consensus'	155
	The IMF as an international lender of last resort?	160
	Summary and conclusion	168
<b>7</b>	<b>Currency Consolidation and Currency Unions</b>	<b>172</b>
	Introduction	172
	Robert Mundell's ideas on common money in the post-BW era	175
	The theoretical optimum: Proposals for a world currency	181
	The sceptics on currency and monetary unification	187
	Economic integration following monetary unification and the currency consolidation process	196
	Currency consolidation as (ultimately) a market-driven process	199
	Conclusion	204
<b>8</b>	<b>Epilogue</b>	<b>207</b>
	Historical structures in the IFS: The limits of reasoning by historical analogy	207
	Intellectual structures: Why the contest of ideas on the IFS matters	211
	Some typical thought trajectories on the IFS in the post-BW era	217
	Postscript: The IFS and the significance of economists' ideas	223
	<i>Bibliography</i>	225
	<i>Index</i>	243

# List of Tables and Figures

## Tables

2.1	Alternative IFOs (or regionally-based IFOs) as at 1975	28
3.1	Polar Cases for Exchange Rate Regimes	52
8.1	Broad Thought Trajectories on Dimensions of International Finance 1971–2000	218

## Figures

3.1	A Tripolar Exchange Rate Structure	39
-----	------------------------------------	----

# 1

## A Qualitative Framework

### **The political economy of international monetary organization**

The ideas of economists proposing either to construct, or change or reform international financial arrangements are by their very nature informed by underlying doctrines. Those doctrines make assertions about how the international economy functions, and incorporate methodological preconceptions on how to collect, interpret and evaluate evidence on the international economy. As well, economic doctrines usually embody specific policies and practical suggestions for change and reform. For economists the 'political economy' of international monetary organization differs sharply in content from 'international political economy' – a subject of prime concern to political scientists intent on analysing international monetary relations, international politics and diplomacy, and the deeply political aspects of inter-governmental relations that play vital roles in making international monetary systems (Best 2005; Cohen 2008a and 2008b).

The ideas of economists on international monetary organization are classifiable as 'political economy' in the sense that term is used by Joseph Schumpeter (1954, p.38). Our orientation in this work is inspired by Schumpeter's notion of economic doctrine as a form of political economy. The practice of Schumpeterian political economy involves articulation of economic doctrines about the international economy. Economic doctrine is constituted by a 'comprehensive set of economic policies' advocated by their proponents, 'on the strength of certain unifying principles'. The choice of 'unifying principles' will entail some selection, some judgements as to what is correct, right or appropriate for certain reasons and (perhaps) as to what is suggested (or even compelled)

by the evidence in any real case. Naturally, policy prescriptions and suggestions have a normative ('what should be done') orientation. Various 'unifying principles', belonging to what Schumpeter calls different economic doctrines, will imply correspondingly different methodologies ('how to analyse', 'how to interpret' etc) and core philosophies that turn on beliefs and conventions (rather than resolvable, fully testable, scientific propositions) held by a particular economist.

The political economy of international monetary organization comprises ideas on the:

1. core framework of an international financial order (IFO) and
2. structure and operating details (the everyday rules, conventions etc) of an actual international financial system (IFS).

When we speak of the international monetary system we are concerned with the mechanisms governing the interactions between trading nations, and in particular the money and credit instruments of national communities in foreign exchange, capital, and commodity markets (Mundell 1972, p.92).

When economists consider an IFO they usually address the

framework of laws, conventions, regulations and mores that establish the setting of the system and the understanding of the environment by the participants in it. A monetary order is to a monetary system somewhat like a constitution is to a political or electoral system (Mundell 1972, p.92).

The dictates of the IFO in the abstract are not always followed or matched in an observable, real, operating, IFS (Gilbert 1980). For example, the Bretton Woods IFO established in 1944 and revised during the 1944–1971 period, differed markedly from the way the Bretton Woods IFS in fact operated (Bordo 1993, p.37; James 1996; McKinnon 1996a, pp.42–4, 77).

Harry Johnson (1972a), a leading 'Chicago School' monetary economist in the 1970s, distinguished two traditions of international monetary analysis. The first, akin to Schumpeterian political economy, is the 'political-economic approach', though it goes beyond Schumpeter's narrower conception of normative economic doctrines. Johnson's 'political-economic approach' to the subject allows for national and international politics and diplomacy in the formation of ideas and policies on international monetary organization. The second tradition of thought iden-

tified by Johnson is concerned with 'scientific-theoretical' work in the realm of international finance. The 'scientific' approach enables economists who are 'usually clever enough at concealing their emotions within the trappings of scientific analysis to pass for dispassionate experts' (Johnson 1972a, p.408). For example, the concept of an automatic, self-disciplining international financial system guided by underlying, stable market processes may have been 'discovered' or at least elaborated scientifically by David Hume over two centuries ago. It could be regarded as a description of the operation of the classical gold standard IFS (Hume's celebrated 'price-specie flow' mechanism). As such it was a scientific theory, proposing causal connections in that classical IFS though it presupposed (some would say, advocated) certain central bank policies or rules that allowed such an automatic system to operate. The scientific theory of the IFS based on the gold standard imposed (or advocated) automatic rules for the conduct of monetary policy by central banks. Similarly, original architects of the Bretton Woods IFO established in 1944, held an underlying doctrine about the workings of the international economy that lead to presupposing, imposing (or indeed advocating) the 'fictitious equality' of national currencies (Johnson 1972a, pp.409–10).

Unlike Johnson, we are not especially interested in the ideas of the international monetary economists surveyed in the following chapters that wish to expand and elaborate the pure logic of the IFO and an associated, evolving IFS, in a vacuum; establishing key causal relationships in the international economy is one thing, suggesting reforms and changes quite another. These two thought operations – so-called 'scientific' knowledge generation and policy analysis – are rarely, if ever prosecuted independently, especially in respect of the economists surveyed in the following chapters. More usually the scientific approach is used actively to inform policy analysis. The economists' ideas we wish to focus on do not comprehend all the new developments, policies, policy options and so on, in a completely dispassionate manner, that is, without any advocacy whatsoever. While informed by research using modern measurement techniques, improved data collection methods and creative imagination, the views of economists will always be propounded from a viewpoint. For instance, economists will target key components for reform in an existing IFS, or will identify defects in aspects of the IFS that other economists may regard as virtues. Alternatively, economists will always see trade-offs when assessing different proposals for the IFS: trade-offs between one reform and another, between immediate dangers or postponed dangers in persisting with a particular

international financial rule, operation or convention, or between risks in a particular arrangement or practice – some economists perceiving the risks to be small and less serious, others appreciating the risks as large and more consequential. In any case, the viewpoints of economists include underlying, preferred methodological and philosophical positions on the core, inherently untestable beliefs about aspects of international, cross-border, financial interactions and their ongoing integration or disintegration.

The following chapters will draw on prominent contributions by economists to the debate on international financial organization and system reform. The principal objective is to provide a historical perspective on the political economy of international financial organization, on the ideas, plans, schemes, and policies offered by a selected group of economists. Emphasis will be placed on comparing alternative viewpoints, on providing an account of competing ideas and policies on the basis of what they claim to do, rather than on what they should do or what is right or wrong with those ideas and policies. The reader is left to decide these questions, that is, to judge what proposals and plans are superior or preferable. As Schumpeter (1954, p.40) tells us in connection with studying different doctrines in political economy:

There would be no sense in speaking of a superiority of Charlemagne's ideas on economic policy as revealed by his legislative and administrative actions over the economic ideas of, say, King Hammurabi; or of the general principles of policy revealed but the proclamations of the Stuart kings over those of Charlemagne; or of the declarations of policy that sometimes preface acts of Congress over those Stuart proclamations. We may of course sympathize with some of the interests favoured in any of those cases rather than with the interests favoured in others, and in this sense array such documents also in a scale of preference. But a place of any body of economic thought in any such array would differ according to the judge's value judgments, and for the rest we shall be left with our emotional or aesthetic preference for the various schemata of life that find expression in those documents. We should be very much in the same position if we were asked whether Gauguin or Titian was the greater painter...And the same thing applies of course to all systems of political economy.

In Schumpeterian spirit, the following discussion will be motivated by the idea that the comparative study of economists' viewpoints is fruit-

ful. Directly judgemental comparisons will be avoided in favour of illuminating and comparing philosophical undercurrents and specific orientations toward the 'facts' thrown up by the international financial system. As such, comparative research of this kind can assist in reasoned reflection on disagreements among economists over the operation and organization of the IFS. As well, comparing alternative viewpoints will enlarge our understanding of the deeper bases of certain policies and reforms proposed by the economists concerned. In this field, the main purpose of taking a comparative ideas approach is therefore

to find out whether we can identify the differences in factual and normative assumptions that can explain the differences in prescription for solving the problems of the international monetary system. Presumably we all use logic. Hence, if we arrive at different recommendations, we must differ in the assumption of fact or in the hierarchy of values. To identify and formulate these assumptions would...be a major step toward a better understanding of the conflict of ideas (Machlup and Malkiel 1964, p.7).

### **International financial integration: Meaning and implications**

What has been stated so far is that the scope of this book will be restricted to doctrinal issues treated in a comparative-historical perspective. There is no intention here to offer a comprehensive account of the main events in the IFS, its changing organizational form and structure, during the period 1971–2000. There is no doubt that the ideas, proposals and policies of economists will be influenced by, and frequently are reactions to, those events. Economic historians have already documented these events fully for the period under review (e.g. Solomon 1999; Gray 2005). Knowledge of main events in the IFS post-1971 will be taken for granted. The contest of ideas will be the focus of attention. We intend to do intellectual history not economic history.

The purpose of this investigation is to uncover the central tenets underlying the main ideas on reform of the IFS in an era marked by increasing cross-border financial integration. Popular discussion during the period 1971–2000 became fixated with the term 'globalization' to describe a wave of quite liberal economic and social reforms that included freer international trade and capital movements; increasing cross-border harmonization and coordination of macroeconomic and social policies; greater coordination of financial and securities market regulation, media

and communications regulation, labour and consumer safety standards, the integration of global business supply chains and so forth. The catch-all term 'globalization' therefore went well-beyond international financial integration. The post-BW era brought with it

improvements in communication and transportation technologies [that] undermined the old [BW] regime by making international economic integration easier. International trade agreements began to reach behind national borders; for example, policies on antitrust or health and safety, which had previously been left to domestic politics, now became issues in international trade discussions. Finally there was a shift in attitude toward openness, as many developing nations came to believe that they would be better served by a policy of openness (Rodrik 2000, p.184).

Rather than 'globalization' economists have more usually opted for the term 'economic integration' and 'international economic integration'. The latter describes the process relevant to economists' domain of interest. In practice, economic integration can take many different forms. Broadly defined, international economic integration is a harmonizing process operating across national borders, coordinating or unifying economic practices and policies: monetary policy, currency policy, fiscal policy, financial market regulations, industrial competition policy, tax systems, legal codes etc. By policy harmonization and coordination we mean the management and occasionally significant modification of national policies in recognition of economic interdependencies among nations. Integration may describe a process of giving freer scope to markets in allocating labour, capital, goods and services across borders but that is a liberal idea (Rodrik 2000). In general, economic integration suggests a phenomenon with continuous gradation and many dimensions (Haberler 1964; Belassa 1969; Machlup 1977; Rodrik 2000).

The term 'integration' in practice is in one sense neutral because it could mean increasing use of governmental, administrative controls across borders or increasing reliance on market forms of resource allocation. International economic integration may imply less inter-governmental intervention in economic affairs or more intervention. Furthermore, policy coordination between nations could simply turn on practical measures creating common economic goals, sharing economic information, collaborating on economic forecasts, and jointly choosing the timing and magnitude of particular policy actions

(Cooper 1985, p.1222). In these instances there would be a degree of economic integration; it may not, however, imply more or less government interference, more harmonized policy rules, or policy activism in the international realm. Equally, it need not entail exclusive use of market processes in trade and capital flows (Bryant 1995). As Jeffrey Sachs and Adam Warner (1995, p.2) explain, integration 'means not only increased market-based trade and financial flows, but also institutional harmonization with regard to trade policy, legal codes, tax systems, ownership patterns, and other regulatory arrangements'. The terms of any economic integration proposal or policy have to be carefully defined, since they would not always or only include more market-based liberalizations; they may quite possibly involve sophisticated trade-offs between market-based and administrative mechanisms. Yet it should be noticed that Sachs and Warner conclude by observing that the actual trend in international economic integration during the post-Bretton Woods era had been toward adopting market-based processes:

The world economy at the end of the twentieth century looks much like the world economy at the end of the nineteenth century. A global capitalist system is taking shape, drawing almost all the regions of the world into arrangements of open trade and harmonized institutions. As in the nineteenth century, this new round of globalization promises to lead to economic convergence for the countries that join the system (1995, pp.62-3).

There is also a sense in which 'integration' could be regarded as a value-loaded term. Sachs and Warner mention the danger of assuming that the choice of market processes as a vehicle for integration is a guaranteed route to higher levels of economic performance and ultimately economic convergence. They document the 'profound risks for the consolidation of market reforms in Russia, China, and Africa' and the loose, fragile nature of various international economic and financial agreements among the major industrial nations (unlike the more solid nature of the BW Agreement). Other economists might envisage cross-border policy harmonization as potentially counterproductive, indeed disintegrating if it meant creating more artificial barriers to the movement of capital, labour or international trade in goods and services. Others may object to a prominent role for the operation of market forces across national borders because they consider them as disintegrating over some chosen time horizon or disintegrating insofar as their anticipated consequences