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The political economy of international monetary arrangements

A well-functioning international monetary arrangement provides two things: monetary stability and a balance of payments adjustment mechanism. Each is economically important; both are politically controversial. Monetary stability among member states raises classic problems of public goods provision and the responsibilities of leadership. The balance of payments adjustment mechanism raises classic distributional issues. Both require domestic political support for the measures necessary to fulfill the international commitments of national governments – which may be hard to secure.

An international monetary arrangement can be said to be successful to the extent that its operation and results are acceptable to all major member states. Such an arrangement could presumably be improved if a Pareto-superior redesign were both available and politically feasible. Both dimensions – success and improvability – depend on political relations among the principal participants. And in turn, the willingness and ability of national governments to undertake the measures necessary to sustain and improve a monetary arrangement depend first and foremost on whether there is domestic political backing for them. If the policies necessary for the principal

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member states to sustain an international monetary arrangement are not supported by their domestic publics, the system will not be amenable to improvement, success, or survival.

Five decades after the final demise of the Bretton Woods fixed exchange rates, the international monetary system continues to evolve under the pressure of new shocks: to domestic politics, to geopolitics, to technology, to climate, and to public health, among others. The direction of change will depend on the interplay of these complex elements.

International monetary stability

International monetary stability is a global public good. As such, it is typically under-supplied. Very large actors, however, may have incentives strong enough that they will attempt to supply the public good on their own. In the case of global monetary stability, this attempt typically would take the form of providing a reliable anchor to which other currencies could link themselves, formally or informally, and more or less tightly. A stable anchor currency provides a focal point around which other monetary authorities can converge.

Stability implies reduced policy discretion. A monetary authority in a monetary arrangement with an explicit or implicit commitment to an anchor – whether the anchor is another currency or a commodity – limits or eliminates its policy autonomy and flexibility. The experience of the gold-standard era convinced virtually everyone that a commodity currency was too inflexible for any reasonable purpose, and national currencies are the anchor of choice.

A national monetary authority that commits to a monetary arrangement with an anchor currency enters into an implicit (or explicit) bargain with the anchor currency's monetary authority. The anchor authority is expected to take account of the impact of its policies on other countries – to internalize the external effects of its policy choices. In return, the anchor country is rewarded with a series of benefits: monetary autonomy, seigniorage, denomination rents, and other advantages to national banks and firms.

Commitments among nation states cannot be enforced by a third party, so they rely upon some level of mutual trust. Anchor-currency authorities trust other member states to cooperate to hold the system together; other member states trust anchor-currency authorities to be responsive to their concerns. International (by which I include regional inter-state) monetary arrangements break down when one or both dimension of trust erodes.

Trust among nations depends on expectations about the incentives faced by policymakers. While international agreements provide some such incentives, all national policymakers are first and foremost answerable to their domestic constituencies – whether those constituencies are an electorate, an elite, or special interests. Policymakers who do not act in accord with the preferences of their constituents will not be policymakers for very long. In this way, the nature and stability of an international monetary arrangement depends upon the domestic political pressures faced by policymakers in the arrangement's major players.

History provides many examples of how politics among nations, and politics within nations, affects the course of international monetary affairs. In the Bretton Woods monetary order as it evolved, member states were expected to treat dollars as "good as gold," as the foundation-stone of the system. The United States was expected to pursue monetary policies regarded as responsible by other member states – that is, in line with their monetary-policy preferences. Over the course of the late 1960s and early 1970s, both expectations were violated. As inflation in the United States increased by substantially more than in the country's major economic partners, the sentiment spread, as expressed by French President Georges Pompidou, "We cannot keep forever as our basic monetary yardstick a national currency that constantly loses value….The rest of the world cannot be expected to regulate its life by a clock which is always slow" (quoted in Frieden 2020, p. 345).

Toward the end of the Bretton Woods system, American domestic politics stood in the way of the U.S. government's taking the domestic macroeconomic measures necessary to bring inflation in line with the preferences of other member states. President Richard Nixon faced a potentially difficult shot at reelection in 1972. He believed – probably correctly – that his narrow loss in the 1960 presidential election was due in part to a restrictive Federal Reserve policy. As he remarked sardonically, "We cooled off the economy and cooled off 15 senators and 60 congressmen at the same time"(quoted in Gowa 1983, page 68). Nixon resisted pressures from abroad, and from within his Cabinet, to endorse austerity measures. In the meantime, other member states were increasingly unwilling to hold less valuable dollars in preference to more valuable gold. The political impasse was resolved when the Nixon Administration closed the gold window in August 1971 and effectively brought the Bretton Woods system to a close. From there, it was a short step to floating exchange rates for the major economies. While the system had its inherent weaknesses, American domestic politics delivered the blow that ended it.

A similar dynamic bedeviled the European Monetary System (EMS) in the early 1990s, which was, in practice if not in design, a Deutschemark-based monetary fixed exchange rate arrangement. In the aftermath of German unification and concern about the inflationary impact of unification-driven spending, the German monetary authorities pursued a highly restrictive policy, driving short-term interest rates from under 5 percent to nearly 10 percent. The economies of many of Germany's EMS partners were already slow, and unemployment was already high, so that Germany's monetary policy – devised for entirely domestic reasons – created serious political difficulties among many of the other member states. After a year and more of tension and recriminations, in summer 1992 the system was rent asunder as a series of EMS member states faced speculative attacks on their currencies and devalued heavily against the Deutschemark. The EMS was effectively dead, although the 1992 crisis in many ways accelerated the movement toward European monetary unification with the euro, which, it was hoped, would banish speculation-prone intra-EU fixed exchange rates. In 1992, however, German politics demanded strong measures to avoid inflation; politics elsewhere demanded resistance to steeply rising unemployment (above 10 percent in France and Italy, above 15 percent in Ireland and Spain). Once more, the contradictory necessities of domestic politics brought down an international (regional) monetary arrangement.

Neither Bretton Woods nor the EMS survived the anchor country's government breaking its implicit commitment to include the concerns of partner countries in its monetary policy formulation. In both cases, partner countries were unwilling to continue to participate with an anchor-country government on the same terms as before, and the anchor-country government was unwilling to bend its policies to the demands of its partners. This conflict highlights the fact that a successful monetary arrangement among national governments requires a level of trust on both sides – an implicit degree of monetary-policy cooperation. The collapse of both systems was probably not due to strategic opportunism – that is, purposeful attempts to game the system – but rather to the exigencies of domestic politics, which required that national policymakers pursue policies that satisfied national constituencies whose interests were not aligned with those of foreigners.

The broader, crucial, point is that international policy commitments can be very difficult to sustain domestically. American macroeconomic policies affect the rest of the world, but the rest of the world does not vote in American elections, which makes it hard for American administrations to take much account of the implications of its policies for the rest of the world. The exigencies of domestic politics require that the government and the Fed put America first, which may after all be the right thing to do democratically. Certainly there may be domestic support for more internationalist policies. However, it is worth remembering that even in the glory days of American internationalism in the aftermath of World War Two, support for America's role in the world, including in international monetary relations, did not garner domestic backing on the basis of its economic benefits to the U.S., but on the basis of its national security implications. It is after all difficult to convince people in the United States – or in any country – to make substantial sacrifices on behalf of a vague notion of international cooperation or global monetary stability. The same, for better or worse, is true of the distribution of the adjustment burden across countries.

The adjustment burden

Payments imbalances arise in any international monetary arrangement. Some are transitory; but given differences in saving rates, investment opportunities, and levels of financial and other development, some imbalances are long-lasting. Such imbalances may be sustainable for quite some time, but at some horizon – and in some common circumstances – they need to be addressed, and the imbalance redressed.

For a balance of payments adjustment mechanism to work there has to actually be adjustment. Along what margins adjustment takes place, and who does the adjusting, is another matter – and a topic open to political conflict (Frieden 2015). Although the "rules of the game" are rarely explicit, in principle both deficit and surplus countries make implicit commitments. Deficit countries commit to eventually address the causes of their deficits so that debts do not become excessive. Surplus countries commit to finance reasonable deficits in expectation that they will eventually decline – and they commit to reduce their surpluses (Walter 2013).

The burden of adjustment is typically asymmetric. Deficit countries have no choice but to adjust if new credits are increasingly expensive or unavailable. Surplus countries, on the other hand, are unlikely to find themselves under immediate pressure to reduce their surpluses. However, the continued accumulation of surpluses raises a series of potential problems. It may create incentives for borrowers to borrow excessively and for lenders to lend excessively; more generally, it can create conditions for global deflationary pressures and for financial instability. Long-standing surpluses can also create protectionist pressures in deficit countries, causing tensions in trade relations (see the chapter by Irwin).

Over time deficits become debts, and surpluses become credits. With a few exceptions (more later), deficit countries cannot have negative net exports indefinitely. In some cases, especially of poorer countries, borrowing is dependent on global conditions and lender sentiment can turn around quickly – so that debtors may face a sudden stop in financial inflows. In other cases, high levels of external debt may raise concerns about broader creditworthiness, leading to increased borrowing costs. Either way, the debtor-country government faces the need to adjust domestic policies to address the debt burden and reassure lenders that loans will be serviced. The history of international finance is littered with bitter debtor-creditor conflicts driven by disagreements over how adjustment costs should be allocated between debtor nations, in the form of austerity, and creditors, in the form of haircuts. Lenders can threaten to charge difficult debtors higher interest rates, or to reduce the amounts they are willing to lend – and they may have other retaliatory weapons (see, for example, Tomz 2012 and Tomz and Wright 2013). Debtors also have a powerful weapon: the threat of default (Ballard-Rosa 2020). There has been political conflict between international debtors and creditors for as long as there has been international lending.

To parallel the previous discussion, we might say that international financial stability is also a global public good, and that a well-functioning balance of payments adjustment mechanism is part of that. As in the previous case, however, the ways in which adjustments take place are not neutral. Indeed, they raise obvious distributional questions: should the principal burden of adjustment be borne by deficit or surplus countries? Perhaps even more controversial have been the *domestic* distributional conflicts that debt – and especially debt crises – bring to the surface.

The end of the Bretton Woods system can also be told as a story of disagreements about the way to adjust current account deficits (and surpluses). The American payments deficits of the late 1960s and early 1970s may seem trivial – in 1970 the payments deficit was $3.8 billion, equal to less than 0.4 percent of GDP – but they were enough to erode confidence in the willingness and ability of the U.S. government to restrain or reverse them. The Nixon administration rejected pressure from U.S. financial partners to reduce the deficit through more restrictive macroeconomic policies; rather than undertake domestic adjustment via fiscal and monetary restraint, the Administration chose to break up the existing international monetary order, devalue, close the gold window, and impose emergency tariffs and wage and price controls.

Substantial global macroeconomic imbalances developed in the early 2000s. OPEC and such other major exporting powerhouses as China, Germany, and Japan ran large surpluses while the United States, the United Kingdom, and peripheral EMU members ran large deficits. Despite warnings and some attempts, neither surplus nor deficit countries were willing to adjust. These imbalances, arguably, contributed to the Global Financial Crisis that began in 2007 and, especially, to the debt crisis that hobbled the Eurozone until at least 2015 (Frieden and Walter 2017). The pattern of surpluses and deficits within the European regional monetary arrangement, in particular, seemed clearly unsustainable, yet none of the member states appeared willing to undertake the adjustment measures necessary. Indeed, the very architecture of the monetary union encouraged the imbalances – until the unsustainable, inevitably, came to an end (Hale and Obstfeld 2016; Frieden and Walter 2017).

The domestic politics of balance of payment adjustment are almost always controversial and conflictual. Inasmuch as a well-functioning international monetary and financial system requires that the balance of payments adjustment mechanism be operative at some level, the ultimate value and success of the monetary order will depend crucially upon the nature of domestic politics in the major member states. Foremost among these major member states is the central, reserve, or anchor currency country – today, the United States.

The essential country and its politics

The central player in any realistic monetary arrangement is the issuer of the anchor currency. Today, of course, this is the United States. The reserve-currency role of the dollar holds many advantages for the country. Not least among them is that it appears able to run more substantial payments deficits than would otherwise be the case – which is another potential asymmetry in the adjustment process. The size of these deficits is limited only by the confidence others hold in the anchor-country monetary authorities – and by the presence of realistic alternatives. Today, especially in the absence of realistic alternatives, the world's appetite for safe American assets does not seem to constrain the ability of the United States to run payments deficits, and accumulate international debt.

However, inter-state commitments depend upon domestic political realities. This is especially true of the United States, which appears to have a particularly fickle electorate when it comes to international economic relations.[1] Certainly the ability to shunt macroeconomic responsibilities onto others is part of the "exorbitant privilege" of being the world's supplier of a monetary anchor, reserve currency, and safe asset. But global patience with American political instability and unreliability almost certainly has its limits.

Concern that an international monetary order depends upon an undependable foundation – American domestic politics – may lead some to hope for another better order. There is no doubt that we could design a wide range of superior ways of running the global monetary system; the real question is whether they might be politically acceptable to the major potential member states.

Can we hope for something better?

[1] This may well be due to the relatively closed nature of the U. S. economy, and the country's geographical isolation from its principal trading and financial partners. The pattern is hardly new; see, for example, Frieden 1988.

Is a Pareto improvement to the contemporary international monetary system available? Certainly a globally benevolent social planner could come up with many ways to make the current order better, on whatever dimension one might desire. But any such improvement would have to be politically acceptable to crucial publics within the major players. For this to be the case would imply a domestic political consensus willing and able to sacrifice something at the domestic level to encourage, maintain, sustain, and increase international macroeconomic collaboration. We have abundant evidence lately of the generalized lack of domestic political support for undertaking difficult economic measures solely because of their international implications. Indeed, attempts to get international commitments through an unwilling domestic politics can backfire.

The weaknesses of the current system are largely political. The goal of global monetary stability is hindered by uncertainties about the degree to which American policymakers are willing and able to consider the impact of American policy on the rest of the world. Whether that will change depends on domestic US politics – currently hardly a stable foundation for improvement. The smooth functioning of the balance of payments adjustment mechanism is hindered by a continued inability among the major players to agree on how to allocate the burdens of adjustment -- and even by the apparent unwillingness of most major countries to consider discussing the issue. Again, all this is primarily due to domestic political pressures and realities.

The domestic political economies of the world's major financial and monetary powers are the central constraints on the operation of the international monetary system. There needs to be domestic and international agreement on the measures necessary to sustain membership in the system – or leadership of it; and such agreement would be necessary for there to be any substantial reform. Whether this has to do with accepting the limitations imposed by the anchor country's policies, or the responsibilities of the anchor country itself; or agreeing on the distribution of the adjustment burden; or any other dimensions of relevance, such measures must be acceptable to domestic publics. The classical gold standard eventually disintegrated due to an inability to secure that domestic political agreement. The Bretton Woods system collapsed due to the requirements of American domestic politics. The European Monetary System, and later the euro itself, were nearly torn apart by conflicts between surplus and deficit countries over the appropriate, politically tolerable, responses to the macroeconomic conditions of the early 1990s and the early 2010s.

This history suggests that we should be realistically pessimistic about the possibility of getting the world's major financial centers to agree to major reforms of the international monetary system. The one opening for such a development might come if there were very substantial pressures to do so, politically internalized by the major political players within domestic politics – such as a profound global economic (and/or political) crisis. This is hardly something worth hoping for. More purposive attempts at international collaboration might help, by making domestic sacrifices more palatable and more appealing. But the sorry state of domestic political support for difficult economic measures needed to sustain global economic cooperation does not create much room for optimism. In light of international and domestic political realities, the current international monetary system is likely to be with us for the foreseeable future.

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