Toward a Global Monetary Order

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> Throughout virtually all of human history, up until 1971, money was some form of valuable and durable commodity, or a claim on such a commodity.
>
> —Steil and Hinds (2009: 67–68)

I will begin by disputing that there is a global monetary system. We do not have a system in any meaningful sense. There are 182 independent currencies in the world. Some currencies are fixed in relation to other, larger currencies (e.g., the Hong Kong dollar to the U.S. dollar). Some currencies move within a band against other currencies (e.g., the Singapore dollar and the Chinese yuan). Many currencies float on foreign exchange markets, but few float freely. Four major currencies float against each other: the U.S. dollar, the euro, the pound, and the yen. Countries also change their foreign exchange regime (e.g., Mexico in recent decades).

The multiplicity and changeability of arrangements defies the use of "system," certainly not in comparison to arrangements of the past or possible arrangements of the future. Stability and certainty of expectations are not possible. The dollar still dominates, and one might suggest that "the Fed rules." But the Federal Reserve follows no rule, and is not the source of stability or certainty.

No one designed the global fiat monetary arrangements; the world stumbled into them. Global fiat money came about because of flaws

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in the prior global monetary arrangements and political considerations in the United States.

There certainly were advocates for the current system. They believed that fiat monies would work better than the gold standard. The problem is that all the supposed advantages have proved elusive, and the predicted deficiencies have been realized in practice. The issues were debated in the 1930s, and that debate remains surprisingly modern.

Monetary Nationalism

The theory behind current global monetary arrangements is monetary nationalism. It argues that each country should have its own money, and that the size of the national money stock should *not* be determined in the same way that money is distributed in different regions within a country. In the case of the United States, trade and capital flows among the states determine the share of the total money supply held by residents in each state. A truly global monetary order would work the same way across countries. That was basically how the classical gold standard worked in the 19th century (Hayek 1937: 4).

The world has not experienced the operation of the classical gold standard since the eve of World War I. Countries suspended convertibility during the war, that is, they denied their citizens and foreigners the opportunity to exchange national currencies for gold. Central banks financed government wartime spending by printing money. Consequently, prices rose.

After the war, there were price deflations of varying magnitudes. These were exacerbated by the decision of some countries, notably the United Kingdom, to return to gold convertibility at the prewar parity. Economists as diverse as Ludwig von Mises and John Maynard Keynes, as had David Ricardo 100 years before, advised against the return to convertibility at prewar parity. Their advice was ignored (Hayek 1937: 44).

The post-WWI system was a form of the gold-exchange standard. Central banks economized on their gold reserves, which created chronic payments problems among the central banks. Creditor countries were pressured not to demand gold reserves from debtor countries (Meltzer 2003: 137–270). *The fundamental problem was not gold, but its undervaluation relative to national currencies.*

The amount of undervaluation differed in different countries. Gold constrained but did not determine the supply of national currencies. There were already elements of monetary nationalism within the system. Gold flows were often "sterilized"—that is, offset by changes in national money supplies independent of the gold flows (Friedman and Schwartz 1963: 284–85, 291).

The system collapsed in the wake of the Great Depression. Country after country suspended convertibility. In the past, such suspensions were limited to wartime and viewed as temporary. In the 1930s, the breakdown of international trade and investment flows mimicked what happens in wartime. Some view that breakdown as prelude to the next war.

The world (or at least the United States and Europe) found itself with fiat currencies. The question was whether there would be a return to a gold standard. There were efforts for such a return. Some economists preferred to make virtue out of necessity and made the case for monetary nationalism as the new global monetary system.

Monetary nationalists thought the system would produce a number of benefits. Avoiding price deflation loomed large, and Hayek (1937: 7–8) regarded that "as the only argument on which the case for monetary nationalism can be rationally based." Fear of deflation, then as now, is a dominant concern. But it is surely suspect, as the example of the United States illustrates.

Money flows constantly among the 50 states, redistributing shares of the national money supply. Scarcely anyone knows it is happening (White 1998: 394; Steil and Hinds 2009: 95–96). Importantly for this discussion, changes in the share of the national money supply do not produce regional or state inflations and deflations. Prices, at least of traded goods, are left unaffected. The money flows effect changes in the geographic distribution of real resources. And that is how a truly international monetary system would work.[1]

There were periods of sustained deflation in the 19th century. They were associated, however, with technological progress and associated productivity growth. In both the United Kingdom and the United States, economic growth occurred along with falling prices. Between 1873 and 1913, Britain experienced growth in real income

[1]White (1998) outlines a system of "monetary internationalism" in which there is not only an international base money (gold) but also transnational fiduciary money (bank notes and deposits) with global branch banking.

of 65 percent while prices fell 20 percent on average. In the United States, the income gain was 110 percent while prices fell 32 percent (Steil and Hinds 2009: 167–68).

In the 1870s, Friedman (1992: 113) notes, "Prices came down as rapidly as they did only because output was rising so much faster than the quantity of money was." Friedman and Schwartz (1963: 15) observed that the historical record "casts serious doubts on the validity of the now widely held view that secular price deflation and rapid economic growth are incompatible." They also found there were periods of decelerations in the rate of economic growth (from approximately 1892 to 1896), followed by sharp accelerations (1896–1901). But there was growth over the entire period 1879–1914. Friedman and Schwartz (1963: 93) conclude "that the forces making for economic growth over the course of several business cycles are largely independent of the secular trend in prices."

In the United Kingdom for the period from resumption after the Napoleonic Wars to the eve of WWI, the price level was roughly unchanged. True long-run price stability is a major economic benefit of the gold standard. The deflationary episodes in the 19th century reflected the conflux of two events: extremely rapid economic growth and the international spread of the gold standard. As countries adopted gold, the monetary demand for it increased. Technological advances in gold production and new discoveries of gold eventually enabled the supply of gold to catch up to the new global demand for gold for monetary use (Friedman 1992: 112–13).

I am making a distinction between what has been called "good" and "bad" deflation by Selgin (1997) and Horwitz (2010). Good deflation is a consequence of strong productivity growth. Goods become cheaper over time. Real wages rise because of the productivity gains. And the real value of money balances increases. Bad deflation is a consequence of monetary shocks. The causes of the two deflations are different and so, too, are the consequences. Monetary history simply does not support the view that deflation is always bad.

The idea that "deflation is bad (always)" comes from the consequences of the breakdown of the gold standard, not its operation. The major breakdown was caused by WWI, from which the system never fully recovered. The monetary shocks and unanticipated inflation of WWI were followed by what amounted to a deflationary monetary shock of returning to convertibility at prewar parities. These were not the growth-induced secular declines in prices of the 19th century.

And then there was the experience of the Great Depression. Friedman and Schwartz (1963) argued that the Fed permitted the money supply to collapse. It is an explanation now broadly accepted. The return to the gold standard at the wrong parities and policy errors of central banks were to blame. As I have noted, central banks could and did exercise discretion under the gold-exchange standard.

Fiat money and flexible exchange rates are supposed to insulate countries from the transmission of financial shocks. They obviously have not done so. It is instructive to understand why. Hayek (1937:56) diagnosed why they would not work as promised. The "variability of exchange rates introduces a new and powerful reason for short-term capital movements." The fear of depreciation in an exchange rate drives capital out of that currency, while the expectation of an appreciation in a currency attracts capital into assets denominated in that currency. Such movements can be self-reinforcing, leading to large swings in exchange rates. It is a scenario that has been repeated many times since Hayek predicted them.

It is worth dwelling on the issue. First, and contrary to popular mythology, capital flows in the 19th and early 20th centuries were proportionately *higher* than today. According to Steil and Hinds (2009: 93), "Mean current account surpluses and deficits as a percentage of GDP in 1880 were roughly twice as high as they are today. British foreign net investment reached 7.7 percent of GDP in 1872, and a high of 8.7 percent in 1911—nearly twice Japan and Germany peaks in the late 1980s."

What separates the gold standard from monetary nationalism is that short-term capital movements were stabilizing in the classical gold standard while, as Hayek predicted, they can be destabilizing with fiat currencies. For the gold standard, Steil and Hinds (2009:95) explain the mechanism: "Trade deficits not offset by an inflow of long-term capital could be reliably financed by short-term inflows stimulated by a modest rise in short-term interest rates. The cross-border flow of gold itself was peripheral to the adjustment mechanism."

Bretton Woods

The 1930s witnessed a collapse of global trade and capital flows. Currency blocks formed within which trade occurred behind protective tariffs (Friedman and Schwartz 1963: 315, 315n). Monetary

nationalism, including competitive currency depreciations, was associated with the decline in global trade and investment. The allies, particularly the United States and Great Britain, were determined that post-WWII international institutions would avoid the beggar-thy-neighbor policies of the 1930s. The Bretton Woods system of international organizations and its monetary arrangements was the outcome. Meltzer (2003: 612–27) and Eichengreen (2011: 45–51) provide historical accounts.

The Bretton Woods monetary system envisioned fixed exchange rates with a gold linkage. All other member countries linked to the U.S. dollar with the dollar linked to gold. The gold linkage was even more tenuous than with the post-WWI gold exchange standard. The economizing on gold reserves was even greater. It was truly a dollar standard with the ghost of gold.

It worked as long as it did because, at the end of World War II, there was a dollar shortage among trading partners. Countries needed dollars, which constituted international reserves, to grow and rebuild their economies. They accumulated dollars through trade and by attracting long-term investment. By the end of the 1950s, however, the global dollar shortage had ended. As Eichengreen (2011:49) wryly observes, "This was not an entirely happy development." The inner contradictions of Bretton Woods were now revealed.

Bretton Woods depended on the United States running chronic balance of payments deficits in order to provide global liquidity. When the dollar shortage ended, however, the United States continued to flood the world with dollars. The link to gold was fixed at $35 per ounce. The supply of dollars was elastic and the supply of gold was inelastic. To continue to function, foreign holders of dollars had to be persuaded not to demand gold for their dollars (Eichengreen 2011: 49–50; Steil and Hinds 2009: 223–26). Such a system was bound to collapse, as had the gold-exchange standard. President Nixon's decision to close the gold window in August 1971 (i.e., permanently end the convertibility of dollars into gold) was in response to a growing international run on the dollar for gold amid rising U.S. inflation.[2]

[2]Meltzer (2009: 763–69) and Ferrell (2010: 50–54) provide an account of the Camp David meeting at which the decision was made (along with imposition of price and wage controls and other policies).

Monetary nationalism had not won by the persuasiveness of its intellectual arguments, but by default and political tactics of a president worried about his reelection. There was no finely tuned economic calculus behind the Camp David decision. The world once again returned to fiat currencies and floating exchange rates. It was a system historically associated with wars and the temporary expedients that war begets. What followed immediately was the first peacetime high-inflation episode in the United States.

Longer-term, the pure fiat money system exposed the rest of the world to what Steil and Hinds (2009: 200) term a monetary conflict of interest within the Fed: "The money it creates is both a domestic currency and international one, and the objectives of each of the aspects of the dual role can and frequently do clash." The legacy today is a Fed policy that is increasingly viewed as a beggar-thy-neighbor policy to gain competitive advantage for its exporters. It is a return to the 1930s.

The Way Forward

Steil and Hinds (2009) emphasize that the gold standard was the monetary system compatible with the classical liberal order—namely, with free trade and free capital movements. That order worked because governments were much smaller than today (about 10 percent of GDP). This realization led Steil and Hinds (2009: 239–39) to shy away from the logic of their own argument, which is a return to the gold standard. In much the same fashion, Hayek (1937) deferred to what he thought was politically possible and did not follow his own logic.

I don't know what is politically possible, nor do most economists. There is nothing in the training of economists that provides that expertise. I do know that economic freedom and political freedom are systematically related. To maintain the classical liberal order requires the monetary arrangements congruent with that order (O'Driscoll 2012). That system is the classical gold standard.[3]

There are many moving parts in monetary reform. Ultimately, as many thinkers in the 1930s realized, monetary reform requires

[3]In principle, another commodity could substitute for gold.

reform of the banking and financial system (Hayek 1937: 76–84). My argument is that monetary reform comes first.[4] The classical gold standard has worked with a variety of different banking systems. Vera Smith (1936) provides a historical perspective from an advocate of free banking. Free banking systems, which showed considerable institutional variation, have no central bank.

In Britain, the gold standard operated with a central bank. The Bank of England was founded in 1694 and the gold standard adopted only much later. The Bank of England dominated the system. There were many commercial banks in both England and Scotland. Lawrence H. White (1984) provides historical background and an argument for the superiority of the Scottish system of free banking over the English system with central banking.

The United States adopted gold in the 1870s, but had no central bank until 1913. The banking system was highly fragmented with numerous small institutions. Branching was highly constrained if not forbidden. Banks with a national charter issued notes.

In Canada, there emerged a system of a small number of nationally branched banks with some other financial institutions (such as trust companies). The banks issued the currency and there was no central bank until 1935 (Rich 1988). The Canadian banking system survived the Great Depression without a major failure and without a central bank to act as lender of last resort.[5]

The structure of the banking system matters. But adoption of the gold standard is a key for restoring monetary discipline and a free monetary order. A gold standard accomplishes two goals (1) it constrains a central bank from offsetting good, productivity-driven deflation, and (2) it makes bad deflation less possible. Yet, a gold standard doesn't solve all problems. Restoring a commodity standard is a necessary, but not a sufficient condition for monetary reform.

The argument for gold is not that it is a perfect monetary system. There is no such thing. The most basic argument for a commodity standard is a Public Choice one: it constrains the ability of the fiscal authority to spend. If there is a central bank, a commodity standard prevents the kind of wholesale monetization of government debt that is now occurring in developed countries.

[4]On reform of the banking system, see Selgin, Lastrapes, and White (2010).

[5]The Reserve Bank of New Zealand was founded in 1934.

A few intellectual efforts have been made toward restoration of the gold standard, such as by Todd (2004) and White (2012). It is unlikely to come about through international agreement, but it did not do so in the 19th century either (Steil and Hinds 2009: 84). Britain's adoption was a strong impetus to its gradual adoption by other countries that saw it in their self-interest to do so. It emerged as a global monetary system in an unplanned fashion.

My argument is simply that restoration of the gold (or other) commodity standard must be on the agenda for those wanting to restore a classical liberal order. Doing so undoubtedly requires greatly downsizing government. Downsizing government is its own imperative. A gold standard, by constraining central banks, would help limit the growth of government. It would also render possible a serious debate over the rationale for central banking.

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