Introduction

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The long-run history of the international financial system in the course of the twentieth century can be described in terms of the current debate about globalization and its limits. At the beginning of the new century, there existed a substantially integrated world economy, tied together through more or less unconstrained flows of capital, goods, and labor. During the next decades that "one world" economy disintegrated, in part as a response to World War I, in part as a result of growing political expectations about how the state might limit the shocks emanating from the global economy. The years after 1945 saw the creation of an institutional infrastructure – in particular the Bretton Woods institutions – that altered the calculations about appropriate state policy and permitted the recreation of a world in which trade expanded more quickly than production, capital flows increased (especially after the 1970s), and labor also began to move.

The course of the twentieth century can be described from this perspective as a U-shape. First integration collapsed, and then the pendulum swung back. Can there be another dip in the U? If so, what does history tell us about "backlashes" against globalization (to use the expression of Kevin O'Rourke and Jeffrey Williamson)?[1] What exactly is a "backlash" – an attempt to reverse the previous course of globalization, or an attempt to secure that course by directing it along more stable tracks?

In the nineteenth century, international markets existed without international institutions. A response to the problems of capital flows came in the form of attempts to regulate national capital markets (for instance through the establishment of central banks). In the interwar years, there were (largely unsuccessful) attempts at designing a genuine international

1 Kevin H. O'Rourke and Jeffrey G. Williamson, *Globalization and History: The Evolution of a Nineteenth Century Atlantic Economy* (Cambridge, Mass., 1999).

Cambridge University Press
0521819954 - International Financial History in the Twentieth Century: System and Anarchy
Edited by Marc Flandreau, Carl-Ludwig Holtfrerich and Harold James
Excerpt
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trade and monetary system; and at the same time (coincidentally) the system collapsed. In the post-1945 era, the intended design effort was infinitely more successful. At first, it was designed to regulate and indeed control financial markets. The development of large international capital markets since the 1960s, however, increasingly frustrated attempts at international control. The emphasis has shifted in consequence to debates about increasing the transparency and effectiveness of markets.

Much of the tragedy of the interwar period, when globalization went into reverse, can be attributed to the collapse of world trade and, in policy terms, to the position of the United States. Whereas in the globalized nineteenth century, Britain as a hegemonic power had followed a liberal trade policy, in and after the First World War and above all after 1932 Britain moved decisively to trade protection. U.S. commercial policy, in particular the Hawley-Smoot tariff of 1930, had even wider repercussions and was a decisive element in the upward ratcheting of protective tariffs, quotas, and other types of trade discrimination. After the Second World War, by contrast, the United States was in a position of unchallenged hegemony and was able to set a worldwide liberal trade agenda, which reached an initial peak of success with the Kennedy round of GATT negotiations in the 1960s. Liberalized trade markets came out of the bottom part of the U-curve more quickly than did capital markets. But financial flows may be needed to help in cases in which trade adjustment is sticky, in other words to finance current account imbalances. In the 1960s, as global commerce expanded, countries began to worry about balance of payments adjustment and about the relative role of markets and international institutions in making this adjustment.

There has thus been a long-running debate that from the beginning accompanied the evolution of the global economy – a debate about the appropriate institutional design of the international financial system. "Peel's wisdom, Bismarck's precision, Descartes' logic, and Franklin's common sense, should meet to draft a new monetary order: then the world monetary peace would be signed." These words were not the product of a speechwriter in the U.S. Treasury. The reference to a new "monetary order" – a nineteenth-century equivalent to the recent concept of a "new architecture" – was really made more than a century ago by the political economist, philanthropist, and leading bimetallist Henri Cernuschi in his *Diplomatie Monétaire*, published in 1878.[2] This parallel should remind us that the quest for an appropriate – if not ideal – monetary and financial architecture did not begin in the midst of the recent East Asian crisis. Rather, modern advocates of monetary reform

2 *La Diplomatie Monétaire en 1878* (Paris, 1878).

are just the latest offspring of a long and venerable tradition dating back to the nineteenth century. We may find it wholly discouraging and suggest, with Paul Krugman, that calls for comprehensive monetary reform are a bit like calls for global brotherhood: good for your self-esteem, but not quite practical. Yet even pessimists may find a short detour through history useful. The past has lessons that are relatively cheap to learn, and, as we shall see, they are telling and compelling.

Put simply, these lessons are: (1) attempts at international coordination or control rarely work; (2) such attempts are most unstable when they are politicized as a result of unstable international politics; (3) the markets are themselves possible only on the basis of powerful institutional, political, and social forces.

These issues provided the major themes of a conference that was organized by the German Historical Institute and held in Princeton, New Jersey, in April 1998. The participants were mostly economic historians, but the discussions were attended by the two retired heads of the world's most powerful and respected central banks, the Deutsche Bundesbank and the U.S. Federal Reserve System. There was something of an atmosphere of latent crisis, with fears that the Asian financial crisis, which had emerged originally in Thailand in the summer of 1997, might present a global contagion. In the middle of the conference, one of the central bankers, Helmut Schlesinger, was called away to Indonesia to advise on the reform of its central bank. Meanwhile, Paul Volcker delivered an insightful but gloomy address on the likelihood of a mass popular rejection of globalization and financial and trade liberalism (the so-called Washington consensus).

Like the conference, this book examines the three phases of the modern globalized economy – the creation of the global world in the nineteenth century, interwar disintegration, and postwar restoration – in a very broad context, looking at the economic history but also at the institutional and political and security debates that provided a context for the financial developments.

THE CLASSICAL GOLD STANDARD

In regard to the first era – the gold standard years of an integrated global economy – three questions arise. The first is the question of how the financial markets processed and evaluated information. Particularly, what institutions handled flows of information in that era? How did global capital movements respond to opportunities? Was there any or much political intervention – as has often been claimed in the case of British, French, and German lending in the era of imperialism? How did the private sector manage uncertainty and crises in a world without international institutions?

Marc Flandreau's essay (Chapter 1) examines the Credit Lyonnais's economic intelligence department, and he establishes that a quite sophisticated (and remarkably de-politicized) credit rating system was already in operation before World War I. Its existence gave the bank a competitive advantage through superior access to information.

A second question relates to the nature of the capital movements that occurred during this period. Capital flows not only in the form of short-term credits, bond issues, and the issue of securities. The existence of a substantial amount of industrial investment, in which transnational corporations sought foreign activities and investment, is part of the remarkable story told by Mira Wilkins (Chapter 2). Her essay raises the question of the linkage of such very stable and long-term flows to the more volatile securities markets. The investments of companies depended on a great deal of knowledge about local markets. Here was another channel through which information was disseminated. Did such information spill over into other markets and affect the securities and credit markets?

Third, what sort of institutional setting was required? How far was the gold standard managed? There are some paradoxes, as Eric Helleiner demonstrates (Chapter 9). The gold standard of the last quarter of the nineteenth century was perhaps the first truly global system; but at the same time it might be said that the gold standard was a profoundly nationalistic construct. In the previous period, there had long been a plurality of international currencies, with gold and silver coins circulating widely across national frontiers. The second half of the nineteenth century was an age of nationalization, in which powerful nation-states emerged (in part at least, it might be argued, as a defensive response in the face of globalization). They imposed national moneys. Yet at the same time, this is the age that we think of in retrospect as the era of a truly golden internationalism.

The origins of the gold standard are indeed deeply interwoven with the acceleration of international exchanges that took place after 1850. This era was accompanied by an expansion of free trade, at least in Europe. Globalization in commerce seemed to call for a corresponding globalization in money, and the supporters of lower tariffs were often as well the advocates of a "universal" currency system. Each period has challenges of its own: At that time, reforming the world monetary architecture involved replacing heterogeneous national standards (gold, silver, and bimetallism) by a uniform one. There was widespread agreement, notably among European elites, that such a reform was needed. But when it came to deciding what the basis of a universal currency should be, policymakers disagreed. The costs of monetary reforms would be unevenly spread between countries, depending on the mismatch between their current regime and the one that would be eventually selected – and this created considerable tensions. From a purely logical point of view, the standard that should be adopted eventually appeared straightforward. Gold was a natural choice in the 1860s because of the network externalities generated by England's leading position in international trade and finance, and by its early choice of that standard. In addition, the gold discoveries of the 1840s and 1850s had created a situation of flux that reinforced this rationale: The proportion of gold in bimetallic countries had dramatically increased, and a few former silver countries had taken advantage of the gold glut to switch to what appeared then as a soft money standard.

Yet putting this economic logic into action required political actions: Such was the origin of the making of monetary diplomacy in the second half of the 1860s. The concerted move of bimetallic countries on the Continent that resulted in the drafting of the Latin Monetary Union in 1865 and its ratification in 1866 was a first step toward the recognition of the need for coordination. A new architecture required a new consensus. An international conference was gathered in Paris during the International Exhibition of 1867 to discuss the practical transition to gold. The exhibition's motto was: "L'Empire c'est la Paix," by which it was meant that civilized nations would no longer fight on battlefields but only through industry and trade. This was, if one excuses the comparison, the nineteenth-century version of Francis Fukuyama's "End of History" thesis. The agenda of liberalism was, as it is, comprehensive, and it thought it had in monetary reform – in a new monetary architecture – the ultimate step of economic globalization. Nonetheless, in the absence of any compensation scheme to buy silver countries into gold, the 1867 conference parted under a somewhat vague agreement to organize the international monetary system around a 25 French franc gold coin, but to leave each country time to adjust to the new regime. Each nation would have to find its own way to switch to gold, adjusting to the global standard in a fashion that would suit it best. French diplomacy kept preparing the ground, lobbying foreign governments in Europe and elsewhere. The whole scheme came close to succeeding. Recent research by Luca Einaudi has shown that in early 1870 even England came to recognize that it could be useful to debase its sovereign (worth 25.22 francs) to bring it in line with the new global currency.

But the one considerable obstacle in this projected transition to gold, some policymakers realized, was that one would have to dispose of the by then useless silver monies. This problem was nowhere bigger than in silver standard Germany, which would have to implement its monetary reform from scratch and convert huge amounts of silver into gold. A number of economists, on the other hand, warned that the resulting shrinkage in the supply of high-powered money would cause worldwide deflation. Thus, the "rational" system of the gold standard stumbled on considerable "irrationalities" with political implications: The heavy difficulties in moving to gold in turn acted as a powerful stabilizer of monetary architecture. The laissez-faire approach to gold globalization that had been adopted during the 1867 conference was really recognition of the incapacity of policymakers to actually agree on a global stance. Nation-states remained sovereign, and the question of architecture would have to be solved on-site through the actual strategies of the various countries involved. A new architecture, if it was to emerge, would be obtained "ex post" as the product of individual strategies, not "ex ante" from a grand design.

This became obvious in 1873, which marked the beginning of the decline in the role of silver. This date, perhaps not accidentally, does coincide with Karl Polanyi's chosen turning point when nineteenth-century liberalism took on a more nationalistic tone. At that date, Germany decided to switch to gold using the proceeds of the indemnity it had collected from France after the war of 1870–1. France had technically the capacity to exchange Germany's silver against gold. But it nonetheless decided not to facilitate Germany's reform. It took retaliatory action and first limited, then suspended silver coinage to block Germany's attempt to use French mints to dispose of its silver surplus. The collapse in the price of silver that ensued led to a worldwide flight away from silver. Such was the trigger that caused the emergence of the international gold standard.[3] Thus, the making of the gold standard was more an exercise in collapse than one in construction: The spread of the gold standard, as an international monetary regime, really reflected its nationalistic dimension. In the language of game theory, it resulted from a coordination failure between France and Germany. Problems of coordination were again evident when the bimetallic crusade developed after 1873. As silver depreciated, and as it became clear that those who had forecast a decline in price levels were correct, policymakers sought to rebuild a monetary architecture that, ironically, implied a partial reversal to a measure of bimetallism. This is where Cernuschi and the supporters of "international bimetallism" entered into the picture with a new agenda toward silver: The

3 On the transition from bimetallism to the gold standard, see Marc Flandreau, "The French Crime of 1873? An Essay on the Emergence of the International Gold Standard, 1870–1880," *Journal of Economic History* (1996): 862–97.

pendulum had swung again. In the views of bimetallists, a new monetary architecture was needed to avert deflation. The cooperation of at least four powers (Britain, Germany, the United States, and France) was needed to implement a concerted resumption of silver coinage. A better architecture, they claimed, required a larger role for silver, for this was the only way to escape the deflationary implications that the spread of the gold standard was bringing about. Conferences were held in 1878, 1881, and 1892 without achieving much. Each time it seemed that the critical mass required to reach an agreement was lacking. Moreover, here again, the gains and losses from such an action were unevenly spread. Europeans looked suspiciously at the Americans, for they – on top of monetary stability – would get a better price for their silver output. Domestic politics in Germany seemed to preclude any return to silver, and France would not move if Germany did not. Yet, again, as deflation developed, it appeared that bimetallists would finally have their way. This was in the 1890s, when in the United States the presidential campaign of 1896 focused precisely on the issue of bimetallism, and when in Britain, confronted with exchange instability within the Empire (India had remained on silver), even the Old Lady of Threadneedle Street appeared for a while to hesitate.

But with the gold discoveries of the late 1890s and the return to inflation, the silver question lost momentum, paving the way for the golden years of the gold standard. Some saw in the resulting system, by then no longer a subject for criticism, a kind of ideal of universalism. This illusion still affects many contemporary writers and policymakers. Yet the fundamentally national nature of the international gold standard after 1896 is not only evident from the point of view of its genesis, but also from its actual record. It is revealing, for instance, that after 1900 adopting the gold standard became a nationalistic slogan in semi-sovereign nations as different as India and Hungary. This was because the gold standard – as opposed to a London-operated gold-exchange standard for India or mandatory participation to a Habsburg-dominated currency zone in Hungary – required the establishment of a domestic central bank. And the corollary of having a national central bank was a measure of control in the shape and direction of domestic credit.

The gold standard required an institutional framework, though no international institutions. In a pure gold standard, no central banks are needed. The classic mechanism through which specie flow responded to price differentials and price changes, and produced a self-balancing order, as described by David Hume in the eighteenth century, needed no mechanism whereby a central bank influenced or controlled interest rates. It might be possible to interpret the introduction of central banks, late in the day in some countries, as a response to crises in which the international economy had an undesirable impact. Thus, the German Reichsbank of 1875 was in part a response to the dramatic stock market crash (the *Gründerkrise*) of 1873, whereas the debates that led to the creation of the U.S. Federal Reserve System were reactions to the abrupt crisis of 1907.

The way each nation adhered to the gold standard reflected a menu of choices (within political possibilities) that suited national preferences. For decades, scholars have puzzled over the question of the "rules of the game" that either explained or failed to explain the success of the gold standard but which in the end never existed. These somewhat irrelevant discussions (very much a product of the interwar years) are swept away if one recognizes that each country's record as a member of the gold club must be assessed not from the point of view of alleged rules that never existed but from the point of view of each country's needs, constraints, and potentials: England, with its global banking system, did stick to a rigid gold convertibility; Italy, a debtor country with a large public debt, gave itself much more flexibility; France, with a somewhat inflexible money market, stood in between. The greater homogeneity that characterized the years between 1900 and 1913, when more countries than ever before were found on gold or "close to gold," really reflected the positive effects that gold inflation had on national indebtedness: By inflating away public debt burdens, the South African developments and Klondike discoveries of the 1890s gave national governments enhanced maneuvering space, thus limiting the conflict between domestic objectives and exchange stability. This in turn permitted a steadier maintenance of gold standards on a national basis. Inasmuch as the gold standard had an architecture of its own, it was the product of history.[4]

THE INTERWAR CATASTROPHE

It is striking how much greater the state's role in domestic and international economic affairs became during the interwar years as globalization collapsed. That was in large part a result of popular political pressures and expectations. Again, national preferences and priorities played a decisive role, but this time the effect was highly destructive.

There was now a greater consensus about the undesirable political and social costs of unemployment that limited central bank actions and weakened

4 On this view, see Marc Flandreau, Jacques Le Cacheux, and Frederic Zumer, "Stability without a Pact? Lessons from the European Gold Standard," *Economic Policy* 26 (1998): 117–62.

credibility (the markets might believe that some policies were unsustainable and might thus launch speculative attacks). There was a greater mobilization of political forces demanding tariff and quota protection (while business interests in favor of trade protection were largely unaware of the bad consequences of such action for the functioning of capital markets). There were demands on the public sector for public spending in response to the consequences of the war that were fundamentally at odds with the equally powerful expectations of taxpayers and voters about the need for a quick return to fiscal stability and orthodoxy. These tensions generated inconsistent policy and further undermined credibility. The result was a vulnerability to crisis, not simply on the periphery (as had been the case in the pre-1914 system), but in the financial and economic centers.

What seems unique about the interwar situation is how completely and devastatingly the political process failed. It may be, as one of the editors of this book has argued in relation to the intense debate about whether there was political room for maneuver in Germany in the Depression era, that there was a willful failure of the political imagination.[5] It may be that policymakers were already subject to impossible constraints at this time.[6] But no one will doubt that one of the blights of the age was the politicization of the process – a politicization very eloquently described in Steven Schuker's essay (Chapter 3). In this account, everything was paralyzed by the sheer volume of political ill-will generated by the war debts and reparations issue. Even the most apparently idealistic institutions were affected by this blight of politics. The League of Nations, which at times offered what appeared to be apolitical, technocratic, and expert advice on stabilization politics, was in fact nothing more than an attempt by Britain to maintain its severely weakened international power.

The protective mechanisms that had already been established in the framework of the nation-state in the prewar era clearly failed. Trade policy became explicitly protectionist in every major country and helped to cause a dramatic and unprecedented contraction on world trade. Migration policy, too, became progressively more restrictive. In the international financial system, there was at first, in the 1920s, an uneasy tension between, on the one hand, attempts to restore a global system and to get back to the gold standard (the aim of the experts assembled in 1922 at an international monetary

5 Carl-Ludwig Holtfrerich, "Alternativen zu Brünings Wirtschaftspolitik in der Weltwirtschaftskrise," *Historische Zeitschrift* 235 (1982): 605–31.
6 See Knut Borchardt, "Constraints and Room for Manoeuvre in the Great Depression of the Early Thirties: Towards a Revision of the Received Historical Picture," in Knut Borchardt, *Perspectives on Modern German Economic History an Policy* (Cambridge, 1991), 143–60.

conference in Genoa) and, on the other, demands for monetary nationalism. Internationalism expanded on the basis of a fragile sense of international central bank cooperation, but this prompted controversy about the role of the central banks in domestic economic management. It produced legends and myths about the baleful influence of the "bankers' ramp" (in the United Kingdom) or the "*deux cent familles*" (in France). Then came the financial panics and crises of the early 1930s.

Central banks and international central bank cooperation, which had for a time been seen as the solution to problems of the international monetary system, were both terribly discredited by the Great Depression. The Federal Reserve System, torn between different regional interests, allowed the U.S. money supply to collapse. The German Reichsbank, which had previously exhibited a quite generous (maybe even overgenerous) commitment to lender of last resort operations, was obliged to stand by in 1931 while the German banking system failed. Perhaps the Bank of England was more flexible (indeed, it is easier for central banks of creditor countries to be flexible than it is for those of debtor states), and the end of the British gold standard in September 1931 was a policy triumph. The critical issue, however, was the adjustment process in the surplus countries of the later 1920s, the United States and France. The Banque de France, examined here in Kenneth Mouré's essay (Chapter 4), maintained orthodoxy long after the crisis of the early 1930s and helped to make the French depression longer than it would otherwise have been.

THE POSTWAR BOOM

What accounts for the upward arm of the U after 1945? The traditional story, most fully set out in the work of Charles Kindleberger, is that it was the enthusiastic and generous U.S. embrace of internationalism that put the world back to rights.[7] The most well-known embodiment of that benign internationalism was the Marshall Plan (European Recovery Program), first adumbrated by the new Secretary of State George Marshall in a speech in February 1947 to Princeton University alumni (the speech formed the basis of a later, and better-known, speech at the Harvard commencement in June). Marshall explained:

> We have had a cessation of hostilities, but we have no genuine peace. Here at home we are in a state of transition between a war and peace economy. In Europe and Asia fear and famine still prevail. Power relationships are in a state of flux. Order has

7 Charles P. Kindleberger, *The World in Depression* (Berkeley, Calif., 1986).