Last month we talked about how the evolution of the gold standard led to global growth. This month we will discuss how the conflicts of the 20th century altered the world's monetary systems and look at what may come next.

Global monetary systems: then and now

BY ANN BERG

World War I — the war to end all wars — changed the map of humankind forever. Battle and famine claimed 15 million lives. Empires and dynasties imploded into multiple states throughout eastern and central Europe. A pact between France and Britain carved up the last unclaimed dominion of the crumbled Ottoman Empire, creating the mandates of Syria, Lebanon, Iraq and Palestine.

But the peace that ensued after the Treaty of Versailles in 1919 could not mend the world's monetary system — the gold standard. Evolving organically through three centuries, by 1890 it shouldered the whole of European and American commerce. When European nations suspended gold convertibility at war's outbreak to finance their massive military campaigns, it collapsed.

At war's end, Great Britain, previously the world's largest overseas investor, was one of its biggest debtors with interest payments devouring 40% of all government spending. Tsarist Russia, formerly a magnet for foreign investment, experienced a flight of capital as the Bolsheviks seized control of industry, agriculture, banking and foreign trade. France and Belgium, devastated from the German land invasion, became hoarders of bullion. Forced to pay reparations, Germany saw its coffers drained of gold and its land emptied of coal and steel. Hyperinflation, unknown on the continent in the preceding century, ravaged the economies of Russia, Austria, Hungary, Poland, Bulgaria and Germany.

Against this backdrop, the restoration of the gold standard and the fixed-rate currency system was a tenet common to political and social doctrines of the new Europe. Lenin's communist Russia was the first country to stabilize to gold in 1923. Mussolini waged a nationalistic battle — Quota Novanta — vowing to restore the weakened Italian lira to the prewar level of 90 against the British pound, which was itself fixed to gold in 1924. In an opposite move, France devalued its currency by 80% to gain an export advantage. Reasserting its supremacy, Britain fixed the pound at the pre-war level and quickly saw a 12% surge in unemployment, which had held steady at 3% for 70 years.

Previously considered a purely economic institution, an unstable world discovered that a single money standard was also a social mechanism, underpinning the welfare of swaths of agriculturalists and workers.

Once currencies were refixed to gold, they came under speculative attacks and government intervention. Also common were bank panics: a bank failure in Austria in 1931 ignited a wave of bank runs across the financial world in which depositors demanded gold. That same year, Britain left gold and devalued the pound, creating a de facto sterling currency zone for nearly half the world. Eight years earlier the British economist John Maynard Keynes had damned the gold standard for its stringency.

In a review of the interwar period, Fed Chairman Ben Bernanke describes the impossibility of reconciling the two opposing trends that eventually tore the gold standard apart: "central banks could do little in the face of combined banking and exchange-rate crises, as the former seemed to demand easy money policies while the latter required monetary tightening."

In the late 1920s, when the U.S. Federal Reserve countered inflation with monetary contraction, it triggered a worldwide depression. Concurrently, surging nationalism and protectionism strangled trade and prevented a coherent monetary system from revitalizing, leaving each country to defend its currency on a managed or "dirty float" scheme. Much to American and European consternation, Germany conducted trade through bi-lateral barter arrangements with the nearby Balkan states and across the Atlantic with Brazil and Argentina, noted Murray Rothbard in, *The History of Money and Banking in the United States*. The opaque transactions bypassed the banking system altogether and effectively blocked American goods from reaching Germany and its trading partners.

U.S. BECOMES DOMINANT POWER

The Second World War shifted the balance of power between continents. War debt forced Britain to cede its India, Middle East, and eventually African, South Asian and American possessions, bringing the 350 year old Empire to a close. Europe and East Asia were in shambles. By contrast, in 1945 the United States held 80% of the world's gold and boasted a booming capital market. It produced half the world's coal, two-thirds of its oil, and more than half the electricity. With only 6% of the world's population, the U.S. generated 40% of global industrial output.

However, war's end brought the U.S. a problem: it needed markets. It couldn't abide a return to the interwar currency chaos and also viewed the Keynesian plan of a central clearing house using a universal currency, called the bancor, as a non-starter. The conference of Bretton Woods would give the nation the opportunity to cinch its control on the world's financial system by creating American controlled monetary institutions and stamping the dollar with reserve currency status.

A plan combining a pegged currency system, a stabilization fund and a dollar-centric monetary standard gave the United States world command. Currency parities were "pegged" rather than fixed to the dollar, giving the system flexibility. The dollar was then fixed to gold at $35 per ounce creating a quasi-gold standard. The arrangement solved the pesky problem of bank runs, because the public could not redeem foreign currency in gold equivalents; in the U.S., Roosevelt had outlawed gold coin ownership in 1933. The International Monetary Fund (IMF) would administer the stabilization fund by making short term loans (in dollars) to any country suffering a balance of payments problem.

Sixty years hence, it is hard to imagine that the original problem with the system was a world wide dollar shortage. In 1953, U.S. gold reserves exceeded foreign liabilities by threefold. But dollarization of the world economy proceeded apace and the liability/gold ratio became equal by 1964 as the United States inflated its money supply and exported dollars overseas. In 1958, the Suez Canal crisis caused the British to slap capital controls on sterling to prevent its use in third country financing. Surplus dollars substituted for sterling loans, thus giving birth to the Eurodollar market, the largest credit market today. By the time President Nixon took office in 1969, debt attributed to the Vietnam war effort reversed the monetary position of the United States. By 1970, foreign liabilities were five times greater than gold reserves.

When Charles de Gaulle of France demanded gold in redemption of dollars, Nixon responded by halting the dollar's $35 dollar per ounce convertibility in 1971. Unmoored from its golden anchor, the dollar sunk, inflation surged and the Bretton Woods currency system collapsed. Currencies were left to float, giving birth to the first financial futures, currency futures, at the Chicago Mercantile Exchange, and to the largest traded market ever — forex.

CAN THE CURRENT SYSTEM LAST?

Most traders today probably consider the current monetary system as a natural and permanent phenomenon. Given the depth and liquidity of the American markets and the dollar-based gargantuan derivatives market now topping a quadrillion dollars in notional volume, who could imagine otherwise?

But several cracks appear in the floating rate system. For one thing, world economists note that capital "runs uphill," from poor to rich countries, upending standard theory. For another, a floating dollar doesn't float with all countries and has failed to correct America's trade deficit.

Some monetary anomalies could be ascribed to an overshoot of the hegemonic dollar policy, which has turned the dollar into the proverbial elephant in the bathtub. The Fed has increased the broadest aggregate of the money supply (M3) twelve-fold since abandoning gold in 1971 by monetizing Treasury debt, which will reach $9 trillion soon.

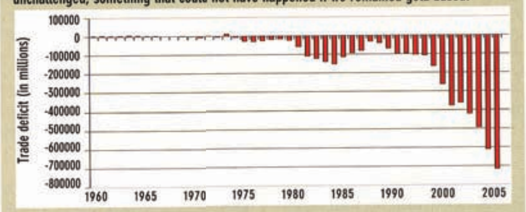
During this M3 growth phase, credit expansion and asset appreciation have caused the trade deficit to balloon (see "Off the rails," page 64) by discouraging savings (now negative) and producing a "wealth effect" in the minds of Americans. The asynchronous capital markets development between poor and rich countries has created a dollar-recycling industry between them and explains the uphill capital flows baffling economists. Without the broad money supply expansion, neither anomaly would exist. Today they work in tandem.

Noble prize winner Robert Mundell, a Canadian economist and advocate of fixed rate systems, compares the floating rate system with the gold standard: "The present international monetary system neither manages the interdependence of currencies nor stabilizes prices. Instead of relying on the equilibrium produced by [gold's] automaticity, the superpower has to resort to bashing its trading partners."

The most significant change to the world's monetary system since the end of Bretton Woods occurred in 1999, when the euro replaced most European currencies, was a partial reversal of the floating rate system. Milton Friedman, a renowned proponent of monetary floats, described the event as "without precedent," noting that European nations, while retaining sovereign fiscal policies,

OFF THE RAILS

The ability of the Federal Reserve to create money allows our trade deficit to grow unchallenged, something that could not have happened if we remained gold based.



Source: U.S. Census Bureau

ceded monetary policy to the European Central Bank. Such a system, he argued, would eventually break down. However, the level of success and stability enjoyed by the euro to date could impact the fate of the dollar.

Around the eve the euro launch, Mundell describes the dilemma of the dollar's reserve currency status: "The United States can't fix its dollar! To what would it fix?" In a similar vein, in its currency battle with China, the U.S. can't unilaterally devalue the dollar against the yuan, relying instead on protectionist threats to compel China to raise the yuan. Due to trade and budget deficits, some economists advocate a return to a gold-backed money system or alternatively a gold "signal" system in which the money supply rises and falls in accordance with the gold price. Given the inherent fiscal discipline of a gold based system, less than a handful of legislators even flirt with such a notion. However, if the dollar were to suffer a sustained devaluation in the world's currency markets, some consideration of a euro fix, given the economic size and future enlargement of the Euro zone, could begin to loom in the minds of nervous politicians.

Monetary systems have tended to collapse because of war and war debt, although the engineering of the euro was a peacetime phenomenon.

Today's world is undergoing change at a pace that has no historical precedent. Russia, suffering an economic meltdown in 1998 is now a trade surplus nation and the world's largest energy producer. China recently has become the largest consumer of steel, copper and tin and is now the second largest economy on a purchasing parity basis. In the Mid East, oil wealth and global struggles about political, religious and cultural issues have helped forge Muslim identity, spurring the development of Islamic finance as an alternative to the Western model (see "Want to buy a Sukuk? September 2006). Meanwhile a triple alliance of Russia, China and Iran is emerging as a counterweight to U.S. global dominance. Finally, as witnessed by the collapse of the Doha Round, protectionism is rising in response to the immense increase in emerging market productivity, which in turn is deflating wages and fanning the growth of welfarism in the industrial world.

The current floating rate system, pivoting on the dollar as the reserve currency, follows a succession of systems including gold, sterling, dirty floats and Bretton Woods. It has lasted 35 years, longer than any system since the gold standard and is therefore a proven success. Can it continue? A century of transformation, the changing aspirations of cultures and shifting alignments within the world economic and political order would suggest not. FM

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