

**Hegemony Without Motivation:  
Domestic Policy Priorities and the  
Management of Exchange Rate Stabilization**

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## Introduction

There have been a number of experiments with systems of international exchange-rate stabilization over the past century, and these have met with varying degrees of success. One of the primary structural explanations for the success of international economic cooperation, and by extension international monetary cooperation, is hegemonic stability theory. Yet this does not succeed fully in explaining why some systems of exchange-rate stabilization succeed better than others. This paper argues that in order to explain the degree of success of systems of international monetary cooperation, one must look not only at the capabilities of the dominant power in the system, but at its motivations as well. Only if it is motivated primarily by financially internationalist interests will it undertake to provide the active management of the system necessary for its long-term success.

Different sorts of national economies generate different national economic interests. Structural approaches to determining foreign economic policies tend to be somewhat blunt in that they often do not distinguish amongst differing national economic interests. Hegemonic stability theories, for example, often distinguish among states purely on the basis of capabilities.<sup>1</sup> States undertake to act as international leaders if they are big enough, and do not if they are not. This assumes that all states

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<sup>1</sup> See, for example, David Lake, "Leadership, Hegemony, and the International Economy: Naked Emperor or Tattered Monarch with Potential?" pp. 459-60. In this review of hegemonic stability theory, he clearly identifies the seminal independent variable as political power.

have a similar interest in providing leadership; that all states stand to benefit from it proportionally.<sup>2</sup> Some approaches to hegemonic stability theory are in fact somewhat more nuanced. They take into account such developmental factors as degree of industrial advancement or relative productivity.<sup>3</sup> They still, though, do not allow that different national economies of the same size and general productivity level can have very different national economic interests, depending on how they interact with the international economy.

There are a number of ways in which a national economy can profit from interaction with the international economy. A country can export goods to other countries, it can service international commerce, or it can invest abroad. Each of these activities can provide for a different type of national economic interest in generating foreign economic policy. Structural theoretical approaches, and particularly hegemonic stability theory, have tended to focus on trade as the more important interaction with the international economy.<sup>4</sup> It will be argued here that in fact, in predicting the extent to which a country will be willing to act as a leader in managing exchange rate stabilization, foreign investment is the key variable. More specifically, given the appropriate capabilities, the degree to which income from investments in the international economy contribute to total

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<sup>2</sup> An example of this logic can be found in Duncan Snidal, "The Limits of Hegemonic Stability Theory," pp. 5948-603. He assumes that the costs of leadership are perfectly proportional across states, and that the benefits to each state of leadership are identical.

<sup>3</sup> Stephen Krasner, "State Power and the Structure of International Trade," pp. 321-22, and David Lake, *Power, Protection, and Free Trade*, pp. 40-44, respectively.

<sup>4</sup> Ibid.

national income will determine whether or not a country will be motivated to manage international exchange rate stabilization.

This article will first develop the concept of financial motivations, presenting first the relevant variables and then the logic suggesting why they should be linked. Then it will look at monetary policy behaviour in four international monetary systems; the gold standard at the beginning of this century, the gold exchange standard of the interwar period, the Bretton Woods system in the 1960s, and the European Exchange Rate Mechanism of the past decade. In each case, the behaviour of the core state in the monetary system will be examined, except in the interwar system, for which both British and American policy will be addressed, as both countries were crucial to the system. This set of cases represents the universe of major functioning market-driven exchange rate systems this century. The case studies will trace the relationship between financial motivation and monetary policy in these core countries. Finally, the conclusion will suggest some implications of these findings for the construction of new systems for exchange rate stabilization.

### **Foreign Investment and Monetary Leadership**

Hegemonic stability theory has always been first and foremost about capabilities; the biggest state will either lead or enforce.<sup>5</sup>

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<sup>5</sup> There is often considerable overlap in the literature in the use of the two words "hegemony" and "leadership." For the purposes of this article, hegemony will refer to the extent to which a state has the capabilities needed in order for it to be able to successfully manage a system, while leadership will refer to the extent to which it actually chooses to undertake such leadership.

Capabilities, though, only dictate what a state can do, not what it will be motivated to do. Structural theories predicated on state capabilities can reasonably claim to predict motivations such as a desire for survival, and thus for national security. In the realm of foreign economic policy, though, where each policy area can serve a number of ends, such simple assumptions of motivations cannot predict specific types of policy choices. States may indeed have the capabilities to act as international economic leaders, but it only makes sense to expect them to do so if they are motivated by some expectation of gain from acting as a leader. In other words, it is only reasonable to expect a country to act as a leader if it is in its national interest to do so. Structural theories of international leadership tend to focus primarily on the capabilities aspect; they often do not allow for different national interests, and as an extension motivations to adopt different types of foreign economic policies. It will be argued here both that determining the motivation for leadership is both as important as determining capabilities, and that it is equally feasible to do so in a systemic way.

This article assumes that states have a national interest, and are capable of devising policies that will enable them to act in support of that interest.<sup>6</sup> It further assumes that the national interest in economic issues will generally focus on maximizing national welfare, and that a central element of the national

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<sup>6</sup> For a discussion of the concept of a national interest, see Stephen Krasner, *Defending the National Interest: Raw Materials Investment and U.S. Foreign Policy*. For a good working definition of a deductive national economic interest, see David Lake, *Power, Protection, and Free Trade*, pp. 60-61.

welfare is national wealth. Thus, states are assumed to act rationally in the interest of maximizing their wealth.

The policy area being discussed here, monetary policy, can be used towards a number of proximate ends. The national currency can be devalued to help promote exports, or maintained at a high level to promote its use as a currency for international exchange.<sup>7</sup> Interest rates can be manipulated with a focus primarily on the domestic economy, with such goals as controlling inflation and encouraging employment, or with a focus primarily on the international economy, used to affect currency exchange rates. The question thus becomes, when will a country be motivated to use these policy options for one set of goals, and when for another?

Simply put, a country should adopt a set of foreign economic policies when the benefits of adopting those policies outweigh the costs, these being primarily the opportunity costs of foregoing other uses of those policy areas. For example, the cost of using interest rates to stabilize a currency's exchange rate is the loss of the ability to use it to either fight inflation or stimulate demand. The benefits of this kind of use of interest rate policy include reducing the transaction costs of international commerce and trade using the currency.<sup>8</sup> A country should then use the mechanism of interest rate policy to stabilize its currency's

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<sup>7</sup> This applies both in fixed exchange rate systems, where governments can alter rates largely by fiat, and floating exchange rate systems, where governments have a number of tools, from market intervention in the short term to interest rate manipulation in the medium term, to affect their currency's exchange rate.

<sup>8</sup> Although there is considerable uncertainty as to the specific costs and gains to commerce of exchange rate stabilization. See Paul Krugman, "What do we Need to Know About the International Monetary System?" *Princeton Essays in International Finance*, No. 190 (Princeton: Department of Economics, Princeton University, 1993).

exchange rate when there is a net benefit to the economy of such a policy. In other words, when the national welfare is increased more by a currency that is made more attractive as a currency for international exchange than by the extra inflation control or demand stimulation that might have resulted from setting interest rates differently. The same logic applies to all of the other policy tradeoffs suggested above.

The extent to which the benefits of focusing a country's foreign economic policy on international monetary leadership outweigh the costs depends on the extent to which that country earns its income from financial involvement in the international economy. The logic showing that leadership policies maximize returns on investment in the international economy will be developed in the next section of this article. If this involvement does not generate a large proportion of the national income, then the benefits of leadership policies will be less than the forgone benefits of using foreign economic policies to promote exports, or focusing economic policies on purely domestic priorities. It is only when the demands of financial involvement internationally are a central and core element of the economy that the benefits of acting as a leader, the increased rate of return on investment in the international economy, outweigh the costs, the loss of ability to use economic policy tools to promote exports or purely domestic economic priorities such as price stability or demand stimulation.

The precise point at which returns to investment in the international economy reach the critical mass at which the

benefits of adopting the policies of international economic leadership outweigh the costs is difficult to specify precisely. These returns will always constitute a relatively small proportion of a national economy, yet given that they are likely to be comprised substantially of economic rents, and given their direct impact on the balance of payments, they can have a disproportionate effect on the health of the national economy. Research elsewhere<sup>9</sup> suggests that the point at which this occurs is when income earned abroad constitutes from 8-10% of the total national income.

Thus, in short, countries will be motivated to act as international monetary leaders when their income earned from investment in the international economy exceeds 8-10% of the national product. If income earned abroad is less than that, states will be motivated by other factors in the creation of their foreign economic policy, such as promoting exports or maximizing domestic consumption in the short term. It must be stressed again here that this assumes a relatively secure state; states will be ~~motivated by national security concern when faced by a perceived~~ immediate and overriding military threat. This does not necessarily mean that countries that do not have these international financial motivations will never fulfill any of the functions of international monetary leadership; they may for reason of other motivations, but these other motivations are unlikely to suggest leadership policies over the long term. Only

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<sup>9</sup> J. Samuel Barkin, *Financial Dominance and International Economic Leadership* (Ph.D. Dissertation, Columbia University, 1994)



countries that have international financial motivations will act consistently as international economic leaders over a long term.

Of course, motivations themselves are also insufficient; in order to act reliably as leaders, states must have both the motivations and capabilities. This article will not, however, address the question of what constitutes sufficient capabilities. Rather, the case studies will simply look at the predominant financial powers in the respective monetary systems.<sup>10</sup> In the interwar system, where no single power was predominant financially, the two largest financial powers in the system, Britain and the United States, will both be studied. While a much more precise approach to capabilities would of course be required in developing a comprehensive theory of international economic and monetary leadership, the argument here requires simply that the motivations vary. Therefore, for the purposes of this article the issue of capabilities need not be specified.

International monetary leadership, the dependent variable in this article, entails the management of an international monetary system. David Lake refers to this leadership function as the provision of the infrastructural good of an international medium of exchange.<sup>11</sup> It incorporates two of Charles Kindleberger's five functions of international leadership, the management of a system of stable exchange rates and the coordination of macroeconomic

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<sup>10</sup> While there is certainly room for debate on the question of capabilities, one paper can scarcely do justice to the question of motivations alone. Therefore the conventional wisdom on the subject of capabilities will be accepted here to allow for a focus on motivations.

<sup>11</sup> David Lake, "Hegemony, Leadership, and the International Economy: Naked Emperor or Tattered Monarch with Potential?" p. 462.

policies.<sup>12</sup> This article will look not so much at states' efforts to coordinate the macroeconomic policies of others as at their own adherence to the macroeconomic policies required to maintain the international monetary system.

### **The Logic of Financial Motivation**

There are two kinds of investment in the international economy that can motivate states to act as international monetary leaders, investment in international commerce and foreign investment.<sup>13</sup> They work through somewhat different logics to motivate leadership, but their effect is quite similar. In order to promote the profitability of these investments in either case, the leader must maintain the same primary set of conditions in the international economy. Both types of investment therefore motivate a country for which this investment is a fundamental element of the national economy to ensure that this set of conditions is met.

In order to maintain the profitability of investment in international commerce over the long term, a country must ensure its ability to service substantial amounts of profitable commerce over the long term. This refers to all commerce, not simply the export of goods, as it is the processes of financing and trading

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<sup>12</sup> Charles Kindleberger, *The World in Depression, 1929-1939*, p. 289.

<sup>13</sup> Foreign investment here refers to long-term capital investment, whether direct or portfolio. Investment in international commerce refers to investment in such activities as shipping, the underwriting and financing of trade, international trade services, etc. While the funds from these investments may not necessarily go abroad, they are committed to the international economy, and thus have a similar motivational effect to foreign investment.

themselves, not production of any sort, that is the source of wealth for the financial interests in question. Profit may be made in a number of ways, including direct financing, that is, buying goods at a low price and selling them higher, the provision of financial services for trade and commerce, such as insurance or debt financing, or investment in trading services, such as shipping or warehousing. The leader need not be the primary exporter or importer in this trade; it need only service it.<sup>14</sup>

A basic condition required to promote international trade, and thus the profitability of investment in such trade is the maintenance of international financial stability, and the focus of that stability on the leader. In other words, international traders and financiers must have confidence in the currency and financial stability of the leader. This stability, by reducing uncertainties, will promote commerce, and the focus of the stability on the leader will encourage traders and financiers to use its services. This is necessary to attract traders to the trade services of the leader, at the expense of other potential services.

Foreign investment requires similar conditions in order to ensure the value of investments abroad and the liquidity of profits. The maintenance of the value of the currency in which the investments are made and denominated, and the convertibility

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<sup>14</sup> Foreign investment and international commerce may reinforce each other, as was the case with Great Britain in the 19th century. If this is the case, then leadership policies will likely be oriented to promoting both. They may also, however, be competitors, in the sense that foreign direct investment in manufacturing, for example, can displace trade in manufactures. This is to an extent true of American investment since World War II. In this case, leadership policies will likely focus on promoting one more than the other, in particular the one that is the greater source of motivations.

of local currencies is crucial to ensuring the profitability of such investment. Without this condition the perceived values of the investments will fluctuate unpredictably and profits will be difficult to repatriate.

These sets of conditions, while they stem from slightly different concerns, have very similar practical implications. As a result, the leadership roles played by all financially dominant countries tend to be similar, whether the dominance is a result of investment in commerce, foreign investment, or a combination of both. This set of conditions, the maintenance of financial stability for investors in trade and the maintenance of currency-of-investment values and convertibility for foreign investors, can be addressed by the dependent variable defined above, the provision of a medium of exchange to the international economy and the coordination of macroeconomic policies. This requires that the leader establish its currency as the primary international currency of exchange, and establish a banking structure capable of stabilizing the currency and maintaining international confidence in it. This course of action is further recommended by the benefits of seignorage, the profit that accrues to a sovereign from the issuance of a currency.<sup>15</sup> Because the use of a leader's currency as a standard for international exchange expands its circulation, it should expand the profitability of seignorage as well. It also requires that the leader manage its own macroeconomic policies primarily in the interest of maintaining

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<sup>15</sup> See Charles Kindleberger, "Dominance and Leadership in the International Economy: Exploitation, Public Goods, and Free Rides," in *International Studies Quarterly*, vol. 25 (1981), p. 248.

its currency as the centre of the international monetary system, and thus foregoing the possible benefits of using these policies for other ends.

It is this last requirement that will provide the basis for the empirical discussion that comprises the bulk of this article. The case studies will look at countries that were generally seen as being at the centre of their international monetary systems. They will first establish the levels of motivation for these countries to act as reliable leaders of these systems. They will then look at each state's respective macroeconomic policies when the demands of international monetary leadership on these policies were identifiably different from the demands of some domestic economic priority such as inflation management or demand stimulation. To the extent that motivational levels correlate with propensity to sacrifice other macroeconomic policy priorities to the needs of international monetary leadership, the argument made above will have been supported.

### **Britain and the Gold Standard**

#### *Motivations*

Great Britain is generally recognized as having been at the centre of the international economy during the classical gold standard era, and as having self-consciously played the role of international economic leader. The story usually told is one of predominance in industry and trade; Britain was the world's leading manufacturer and exporter, and therefore had the greatest

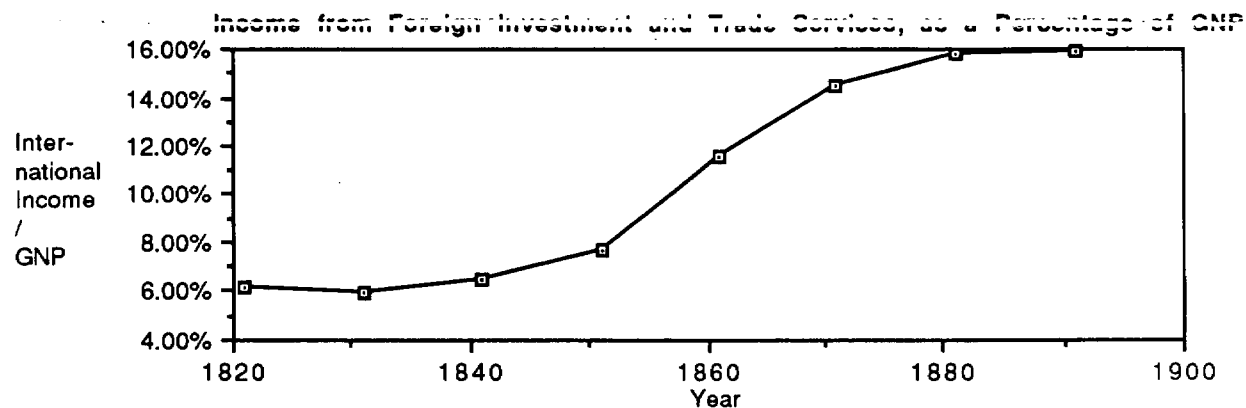
interest in a well managed international economy.<sup>16</sup> Yet British industrial predominance peaked early in the 19th century, before British leadership began in earnest, and by the end of the century had disappeared almost altogether.<sup>17</sup>

Great Britain did, though, have returns from investment in the international economy that were remarkably high by historical standards. Furthermore, these levels peaked around the turn of the century, coinciding with the most active and self-conscious period of British international economic and monetary leadership. Income from investment in the international economy passed the 8-10% level of GNP needed to motivate a country to act as an international monetary leader right at the middle of the 19th century, coinciding with the original adoption by the British of their role as international economic leaders.<sup>18</sup> It peaked near the

<sup>16</sup> See, for example, Robert Gilpin, *U.S. Power and the Multinational Corporation: The Political Economy of Foreign Direct Investment*, ch. 3, and Krasner, "State Power," pp. 335-7.

<sup>17</sup> See, for example, Aaron Friedberg, *The Weary Titan: Britain and the Experience of Relative Decline, 1895-1905* (Princeton: Princeton University Press, 1988), ch. 2.

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Sources: Albert Imlah, *Economic Elements in the Pax Britannica: Studies in British Foreign Trade in the Nineteenth Century* (Cambridge, MA: Harvard University Press, 1958), pp. 72-4, and Phyllis Deane and W.A. Cole, *British Economic Growth, 1688-1959*, 2nd ed. (Cambridge: Cambridge University Press, 1967), p. 166.

turn of the century at about 16% of total gross national product, reflecting a stock of investment abroad equal to twice the value of GNP. Given that a state becomes motivated to act as an international monetary leader when this income passes the 8-10% range of GNP, Britain should have been more than motivated to fulfill this role in the early years of this century.

### *The Gold Standard*

The classical gold standard was in theory a monetary system that in theory was purely market-operated. Currencies were fully tradable for each other, and fully convertible into gold at a fixed parity. Temporary imbalances of payments were dealt with through transferences of gold, and pressures on the currency's parity, felt as increases or decreases in a country's gold reserves, could be addressed by adjusting interest rates.<sup>19</sup> In practice, the City of London's financial clout and influence as the central clearing house for the system meant that the Bank of England could have a major impact on liquidity throughout the system by adjusting its own interest rates.<sup>20</sup> This gave the Bank a central role in managing the system and ensuring monetary stability throughout.<sup>21</sup> It also meant that any attempts by the Bank to use monetary policy to pursue goals tied to such things as

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<sup>19</sup> For a discussion of the general workings of the classical gold standard, see Michael Bordo and Anna Schwartz, eds., *A Perspective on the Classical Gold Standard* (Chicago: The University of Chicago Press, 1984).

<sup>20</sup> That is, when the Bank of England raised rates liquidity was withdrawn from the system as a whole, and when it lowered rates liquidity was injected into the system as a whole.

<sup>21</sup> By 1890 it was an "absolute certainty" that the City of London was the financial center of the world. Youssef Cassis, *Les Banquiers de la City à l'Epoque Edouardienne, 1890-1914* (Geneva: Librairie Droz, 1984), p. 169.

export promotion or goals of a purely domestic nature would have a systemic impact. Thus when the demands of systemic stability and the demands of other economic priorities conflicted, Britain was confronted by a very clear choice between the two.

### *Policy Choices*

This choice was, more often than not, not even debated; the imperative for the bank to act according to systemic priorities was so strong that alternatives were often not even considered.<sup>22</sup> This does not mean, though, that the potential domestic effects of these policies were unknown; those who created policy at the Bank of England were fully aware of the deflationary or inflationary effects of the bank rate on the economy. They felt, though, that the goal of confidence in Sterling was more important.<sup>23</sup> The consistency with which this policy was applied, though, does create a problem of a dog that did not bark, which makes it more difficult to find a smoking gun example of the choice being debated and going one way rather than the other.

Two examples of the variation in the Bank of England's discount rate, though, do illustrate its separation from the state of the domestic economy. The first is a general observation, that the rate tended to go up and down far more frequently than might be expected if it were being used to moderate the business cycle. In fact, the rate went through 72

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<sup>22</sup> Charles Kindleberger, *A Financial History of Western Europe*, 2nd ed. (New York: Oxford University Press, 1993), p. 92. Control of the domestic money supply was addressed through rules on the reserves required against the issuance of banknotes, rather than through the discount rate.

<sup>23</sup> R.G. Hawtrey, *A Century of the Bank Rate* (London: Longmans, Green and Co., 1938), ch. 1.



cycles between 1855 and 1914, while there were only ten business cycles.<sup>24</sup> The second illustration is the behaviour of the Bank in response to the crisis of 1873. At that time, a major Continental financial crisis coincided with the beginning of a decrease in economic output. The Bank responded, at the peak of the crisis, by increasing the rate to 9%, its highest point in the last third of the century.<sup>25</sup>

### The United States and the Gold Exchange Standard

#### *Motivations*

The First World War ended Great Britain's clear international financial predominance and made the United States into a major financial power.<sup>26</sup> Charles Kindleberger, in his review of the origins of the Great Depression, remarked that one of the more intriguing questions of this period is that of why Great Britain, which no longer had the capabilities to act as an international economic leader, tried to do so anyway, whereas the United States, which did have the capabilities, did not try.<sup>27</sup> This article will argue that the answer lies in their respective levels of motivation, as measured by returns on investment in the international economy as a percentage of gross domestic product.

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<sup>24</sup> Ibid., Appendix 1, and Mitchell and Deane, *Abstract of British Historical Statistics*, pp. 3647-68. A cycle in the Bank Rate is used here to mean a process of increase, peak, and subsequent decrease.

<sup>25</sup> Ibid., and Kindleberger, *A Financial History of Western Europe*, p. 92.

<sup>26</sup> See, for example, Fernand Braudel, *Afterthoughts on Material Life and Capitalism* (Baltimore: Johns Hopkins University Press, 1977), pp. 80-86.

<sup>27</sup> Kindleberger, *The World in Depression*, pp. 288-90.

This section will discuss the United States in the 1920s, and the next will look at Great Britain in the 1930s.

Although the United States in the interwar period had by far the world's biggest and most productive economy, it was not the greatest participant in the international economy, certainly not in financial terms. The First World War boosted the United States from a position of net debtor to the international economy to one of net creditor, but by the early 1920s total American foreign investment was barely half of the British total.<sup>28</sup> By the eve of the Great Depression this ratio had risen only to two-thirds.<sup>29</sup> The American economy, though, was by that time roughly three times the size of the British,<sup>30</sup> suggesting that returns on foreign investment as a proportion of the economy would have been less than one-quarter as great, in other words returns on this investment accounted for less than 2% of the total economy, far below the level required for a country to be motivated to lead the international economy. Nor did income from services to the international economy contribute much to this motivation; the United States in this period was a consistent and substantial net importer of services.<sup>31</sup> Thus the United States should not have been motivated to act as an international economic leader in this period.

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<sup>28</sup> Harvey Fisk, *The Inter-Ally Debts: An Analysis of War and Post-War Public Finances, 1914-23*, pp. 275, 284-8, 310, 314-16, 348-49, and the League of Nations, *International Trade and Balances of Payments, 1912-26*, pp. 183-86.

<sup>29</sup> *Ibid.*, and League of Nations, *Balances of Payments, 1930*, p. 30.

<sup>30</sup> Fisk, *The Inter-Allies Debts*, p. 265.

<sup>31</sup> Of an average of about half a billion dollars a year over this period. League of Nations, *Balance of Payments 1931 and 1932, Including an Analysis of Capital Movements up to September 1933*, p. 9.

One final aspect of American international financial penetration worth noting is the concentration and location of American foreign investment. Almost two-thirds of this investment was concentrated in two specific countries, Canada and Germany.<sup>32</sup> Canada remained relatively stable during the period in question here, but Germany was at the centre of many of the world's greatest financial disputes in this period.<sup>33</sup> If it is indeed financial returns that motivate a country to act as an international monetary leader, would could expect the United States to take a particular interest in Germany in these disputes, even perhaps to be more concerned about German than about international financial stability. As such, both American behaviour with respect to the system as a whole and American behaviour with respect to German crises specifically will be addressed.

#### *The Gold Exchange Standard*

At the end of the First World War it was recognized that a return to the prewar gold standard would be problematic because the world gold supply was simply insufficient for the task; new sources of international liquidity were needed.<sup>34</sup> Thus the gold exchange standard was implemented, which was similar in most respects to the gold standard, except that national monetary

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<sup>32</sup> Calculated from the figures in Fisk, *The Inter-Allied Debts*, p. 310, and The League of Nations, *Memorandum on International Trade and Balance of Payments, 1927-29* (Geneva: League of Nations, 1930), p. 30.

<sup>33</sup> For a discussion of American financial involvement in Germany during this period, see William McNiell, *American Money and the Weimar Republic: Economics and Politics on the Eve of the Great Depression* (New York: Columbia University Press, 1986).

<sup>34</sup> Kindleberger, *A Financial History of Western Europe*, pp. 322-26.

reserves were held in gold-backed currency as well as gold itself, primarily Sterling. This eased the demand for gold and thus aided international liquidity. It also in the short run made life easier for the Bank of England, which could now deal with some of its international liabilities in Sterling, rather than just gold. In the longer term, though, it made the system less transparent. The gold standard had forced countries to deal with balance of payments disequilibria in a fairly prompt fashion, as gold supplies were limited and thus major changes in levels of holdings by one country would be felt internationally fairly quickly. With the Gold Exchange standard, disequilibria could be masked longer as Sterling could be used to replace gold. This could put off adjustments in the short term, but at the expense of increasing the Bank of England's potential liabilities precipitously in the longer term.<sup>35</sup>

The largest international financial issue in the 1920s aside from the reconstitution of an international monetary system was the question of German war reparations. These had originally been assessed at 132 billion marks, a figure similar to the total global amount of foreign investment at the time.<sup>36</sup> It came to be accepted by the international community that Germany could not pay

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<sup>35</sup> In the gold-exchange standard, small countries were expected to hold their reserves in Sterling instead of in gold. However, their currencies could still be convertible to gold. In case of pressure on the currency, then, the country would have to demand gold from the Bank of England in exchange for Sterling. This source of liability did not exist under a pure gold standard. If a significant number of smaller countries tried to draw on the Bank of England's gold in exchange for Sterling at the same time, it would seriously threaten Sterling's convertibility. This is what in effect happened in the crisis of 1931, when Sterling's convertibility was suspended.

<sup>36</sup> Fisk, *The Inter-Ally Debts*, pp. 284-88. This figure is equal to just over \$30 billion, or just under £7 billion.

these reparations in full and maintain financial stability. This put the interests of those countries that were the primary recipients of reparations, particularly France, at odds with countries more interested in longer-term German financial stability.

#### *Policy Choices*

As would be predicted by the examination of its motivations, the United States in the 1920s seemed much more concerned with maintaining German financial stability than with maintaining the stability of the system as a whole. American policy clearly subordinated the needs of the international monetary system, particularly the need for liquidity, to the domestic political priority of keeping economic growth in check and avoiding an inflationary reflation. At the same time, though, the American government put significant diplomatic effort into finding solutions for Germany's reparations dilemma that clearly favoured German financial and fiscal stability over France's desire to see as much of the reparations owed them as possible.

The United States came out of the First World War with a strong tendency to balance of payments surpluses, and there was therefore a strong international demand for dollars that tended to put upward pressure on the currency's par value. These tendencies continued throughout the 1920s. The traditional remedy for this imbalance in the classical gold standard would have been for the United States to lower interest rates, thus stimulating the economy and increasing the demand for imports while at the same

time encouraging the export of capital. This would increase the supply of dollars abroad, which in turn would ameliorate the upward pressure on the value of the dollar. The American economy, though, was growing quite healthily at the time, and the government feared that lowering interest rates would be inflationary rather than.<sup>37</sup> The consistent policy choice throughout the 1920s was to focus monetary policy on the stabilization of the domestic economy, keeping interest rates relatively high and avoiding the risk of inflation.<sup>38</sup> The upward pressure on the dollar was ameliorated by sterilizing gold, which in turn decreased the available global supply and thus removed considerable liquidity from the international monetary system.<sup>39</sup> In the gold exchange standard, this liquidity squeeze was masked for a time by the availability of Sterling as a reserve currency, but in the end this only added to the pressure on the Bank of

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<sup>37</sup> Cheaper money tends to result in nominal economic growth. If the economy is below its full employment level this growth tends to come as real growth, or deflation. If the economy is near or at its full-employment level the growth tends to come as growth in prices rather than in output, or in other words inflation. The current trend among economists is to refer to the non-accelerating-inflation rate of unemployment rather than the full-employment level, but the gist of the relationship remains the same either way.

<sup>38</sup> See, for example, Carl Moore, *The Federal Reserve System: A History of the First 75 Years*. It is illustrative to note that in his chapter dealing with the 1920s, there is not a single mention of international monetary or financial issues.

<sup>39</sup> Sterilization refers to policies designed to shield the domestic economy from the effects of international exchange rate pressures by essentially removing gold from international circulation rather than inflating the economy to ease further gold inflows. See Raymond Mikesell, *United States Economic Policy and International Relations* (New York: McGraw-Hill, 1953), pp. 22-23, and Fred Block, *The Origins of International Economic Disorder: A Study of United States International Monetary Policy from World War II to the Present* (Berkeley: University of California Press, 1977), pp. 21-22.

England and was therefore a factor in the collapse of Sterling, and with it the international monetary system, in 1931.<sup>40</sup>

The one area of international economic leadership in which the United States did take an active role was in the negotiation of the Dawes Plan of 1924 and the Young Plan of 1930. Both plans dealt with the issue of German war reparations. Both were attempts to reach compromises that would allow for German postwar economic recovery without triggering an active negative response from the expected recipients of reparations. That this was the major form of American participation in international economic management in the 1920s is entirely in keeping with the notion that it was the concentration of American foreign investment in Germany that motivated such participation as it had in international economic leadership at the time.

### **Britain and the Gold Exchange Standard**

#### *Motivations*

The First World War significantly eroded Great Britain's international financial position, as Britain ended up bearing the brunt of financing the Allied war effort. This resulted in Britain liquidating roughly a quarter of its foreign investments, and a marked slowdown in 1920s on the rate of new foreign investments, compared to the decades immediately prior to the

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<sup>40</sup> For a discussion of the decision to suspend convertibility in 1931, see Stephen Clarke, *Central Bank Cooperation, 1924-31* (New York: Federal Reserve Bank of New York, 1967), ch. 8.

war.<sup>41</sup> With the growth of the United States' role in international finance in this period, this meant that Britain was no longer the clear centre of the financial world. International finance also declined substantially as an element of the British economy, from a peak of 16% at the turn of the century to the 10-12% range in the latter half of the 1920s, once the international monetary system had been fully reconstituted. The Great Depression depressed this ratio to the 7-8% range for most of the 1930s.<sup>42</sup>

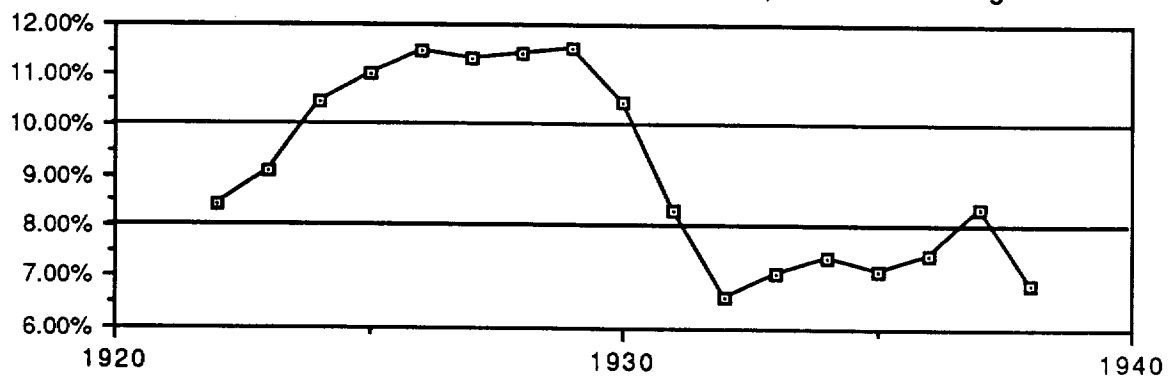
Although these levels were significantly lower than their peak levels, they were still quite high by international standards, and an order of magnitude higher than comparable American levels. In the 1920s they were still clearly high enough to motivate Britain to act as international monetary leaders. In the 1930s they were on the margin of the threshold at which financial motivation begins. It is also worth noting here that while British foreign investment was less concentrated than

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<sup>41</sup> Fisk, *The Inter-Allied Debts*, pp. 275 and 348-49, B.R. Mitchell and Phyllis Deane, *Abstract of British Historical Statistics* (Cambridge: Cambridge University Press, 1962), pp. 334-35, and Charles Kindleberger, *The World in Depression, 1929-1939*, revised edition (Berkeley: University of California Press, 1986), p. 40

<sup>42</sup>

**Income From Foreign Investments and Trade Services, as a Percentage of GNP**



Data from Mitchell and Deane, *Abstract of British Historical Statistics*, pp. 355 & 368.



American, it still followed a fairly constricted pattern that did correlate strongly with their monetary policy behaviour. Roughly two-thirds of it was in the Empire or the "informal empire", while less than a tenth of it was in Europe.<sup>43</sup>

### *Policy Choices*

There came a point in 1931 when the British could no longer maintain the convertibility of Sterling; the combination of the liquidity squeeze resulting in part from the American sterilization of gold and declining British capabilities resulted in a run on Sterling that the Bank of England could not have stopped.<sup>44</sup> It is interesting to note that in the crisis that precipitated this run, the Bank of England tried to bail out the Austrian central bank, facing its own crisis, when no one else would.<sup>45</sup> In that sense, then, it was Britain's monetary leadership behaviour that got it into trouble in the first place. The response to the crisis, though, displays an interesting compromise between a motivation to monetary leadership on the one hand and a recognition of markedly diminished capabilities on the other.

When it became clear that the convertibility of Sterling to gold could not be maintained, Britain floated its currency cleanly. At the same time, though, it encouraged those countries with which it had close economic relations to remain on a Sterling

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<sup>43</sup> Peter Mathias, *The First Industrial Nation: An Economic History of Britain, 1700-1914*, 2nd ed. (London: Methuen, 1983), pp. 300 and 436-37. The "informal empire" consisted of countries such as Argentina and Egypt where British financial penetration was sufficient to give London a *de facto* veto power over local fiscal and monetary policy.

<sup>44</sup> Cf. fn. 39.

<sup>45</sup> See Kindleberger, *The World in Depression*, pp. 144-58.

standard. Most did, and thus the Sterling bloc was created, in which the participating countries pegged their currencies to Sterling (in effect maintaining convertibility to Sterling), except of course Britain, which allowed Sterling to float. The countries participating in the Sterling bloc were those in which Britain had the highest level of financial commitment.<sup>46</sup> They were therefore the countries for which Britain was most motivated to act as an international economic leader. Britain did undertake this role consciously with this smaller group of countries,<sup>47</sup> once it had become clear that it could not do so for the broader international community.

### **The United States and the Bretton Woods System**

The Second World War had, among other things, the effect of gutting Great Britain's international financial position, leaving the United States in the immediate postwar era as the world's only predominant international financial power. American international financial predominance occurred, though, not through an expansion of American investment in the international economy, but through the contraction in the positions of other countries.<sup>48</sup> In effect,

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<sup>46</sup> There were 25 of them, including all of the Empire except for South Africa and, partially, Canada, the Scandinavian countries, much of Eastern Europe, and some of Britain's traditional raw materials suppliers, such as Argentina, Portugal, and Egypt. Kindleberger, *The World in Depression*, p. 159. These countries accounted for over two-thirds of British foreign investment. Mathias, *The First Industrial Nation*, pp. 436-37.

<sup>47</sup> See Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939* (Oxford: Oxford University Press, 1992), p. 338.

<sup>48</sup> Although American investment abroad only increased from \$11.5 billion to \$13 billion from the beginning to the end of the war, contraction in or the elimination of the investments of other countries meant that the U.S. went from being the second largest investor, measured by income returned, to being

the international economy had shrunk in the Depression and the war. Thus in the postwar era, the United States had become much more important to the international economy, but the international economy had not become proportionally more important to the United States.

In the immediate postwar era, American income earned abroad hovered between 1.5 and 2% of GNP.<sup>49</sup> It has never ranged upward beyond 3%. Income from services to the international economy in the immediate postwar period accounted for a fraction of one percent of the economy, and has never ranged upward much beyond 2%.<sup>50</sup> In short, then, international finance is not that important to the American economy, and should not, at any point since the Second World War, have motivated the United States to act as international monetary leader. Its capabilities allowed the United States to a large extent to dictate the postwar monetary order, which they did in a manner that suited their economic position at the time.<sup>51</sup> The question, though, is whether once the demands of monetary leadership conflicted with other American policy priorities, the United States chose the one or the other.

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a larger foreign investor than all other countries combined. International Monetary Fund, *Balance of Payments Yearbook, 1947* (Washington: International Monetary Fund, 1948), p. 362, and IMF, *Balance of Payments Yearbook, 1948* (Washington, IMF, 1949).

<sup>49</sup> IMF, *Balance of Payments Yearbook, 1950* (Washington: IMF, 1951), p. 402-3, and United States Department of Commerce, *Survey of Current Business*, Feb. 1953, statistical summary.

<sup>50</sup> United States Department of Commerce, *Statistical Abstract of the United States: 1992 (112th Edition)* (Washington: U.S. Bureau of the Census, 1992).

<sup>51</sup> For a discussion of the creation of the postwar monetary order, see Richard Gardner, *Sterling-Dollar Diplomacy in Current Perspective: The Origins and the Prospects of an International Economic Order* (New York: Columbia University Press, 1980).

### *The Bretton Woods System*

The international monetary system set up at Bretton Woods differed from the gold exchange standard in three notable ways. The first was that it was not a true gold standard; only the dollar was primarily convertible into gold, while most other currencies were convertible only into dollars. This put the dollar in the centre of the system in a very formal, structural way.<sup>52</sup> The second was that an international institution, the international monetary fund, was set up to manage the exchange system. The third was that the system was far less open than either the gold or gold exchange standards; there was much less freedom of capital movement.<sup>53</sup> This last difference was reinforced in the 1960s by American controls on and limitations of convertibility of the dollar to gold, and on the ability of private citizens to trade internationally in monetary gold.<sup>54</sup> These three differences meant that in the short term states could insulate domestic politics from the demands of the international monetary system much more than had been the case in the past.<sup>55</sup> This was particularly true of the United States, due to the

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<sup>52</sup> Sterling played an intermediate role in this system, as a buffer between the dollar and most other currencies. It served as a secondary reserve currency in the period when there were not sufficient dollars in international circulation to adequately fulfil the role.

<sup>53</sup> For a more thorough discussion of the mechanics of the Bretton Woods system, see Armand van Dormael, *Bretton Woods: Birth of a Monetary System* (New York: Holmes and Meier, 1978).

<sup>54</sup> See Gowa, *Closing the Gold Window*, p. 53.

<sup>55</sup> John Ruggie refers to the underlying compromise reflected by this new ability to insulate the domestic from the international economy as 'embedded liberalism.' Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," in Stephen Krasner, ed., *International Regimes* (Ithaca: Cornell University Press, 1983), pp. 195-231.

structurally central role of the dollar in the Bretton Woods system.<sup>56</sup>

### *Policy Choices*

In the immediate postwar period there was no particular conflict between the demands on American policy of international monetary leadership and the demands of other policy priorities, whether macroeconomic or geopolitical. The reflationary pressures that had posed such a conflict in the 1920s were not present because conscious action was taken to avoid them. American policy-makers recognized that the United States would be unwilling to bear the brunt of adjustment to a new international monetary system, and thus designed the system so that they would not have to. A positive and significant American balance of payments did not cause the same sort of liquidity problems that it had in the interwar period because the United States government injected liquidity into the system directly, both through such bilateral mechanisms as the British Loan and the Marshall Plan, and multilaterally through the IMF and World Bank.<sup>57</sup> The primary motivations for this largesse are debated, but it seems unlikely

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<sup>56</sup> Most countries when faced with a balance of payments deficit would have to sell reserves of gold or foreign currency, or raise interest rates, to support their currency. Because the dollar was the world's primary reserve currency, it had to do neither; it could simply export dollars, of which it had a potentially unlimited supply, and up to a point other countries would be forced to hold them. This meant that the United States was spared many of the rigours associated with maintaining parity in a fixed exchange rate system.

<sup>57</sup> For a detailed discussion of the processes through which these liquidity-generating institutions were created, see Gardner, *Sterling-Dollar Diplomacy*.

that it was motivated primarily by a concern for international monetary stability.<sup>58</sup>

A major conflict between the demands of international monetary leadership and other policy demands did not develop until the 1960s. By that time America's chronic balance of payments surplus had turned into a chronic deficit. This resulted both from changes in the balance of trade, and from large unrequited security expenditures abroad.<sup>59</sup> The monetary system, though, was still one designed to prevent creditor countries from having to adjust. Since the United States was at the centre of the Bretton Woods system, American debtorship was bound to have systemic effects.

The United States had a number of policy options that would have considerably ameliorated its balance of payments problems, including deflationary macroeconomic policies or a curtailing of its security commitments abroad. It was willing to undertake none of these options, and instead used the dollar's position as the structural centre of the international monetary system to avoid the problem of adjustment by continually exporting dollars that

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<sup>58</sup> The traditional view is that security concerns were the predominant motivator of American foreign policy, that the Cold War drove American foreign economic policy in this period. The revisionist view is that the Cold War was to a certain extent a cover for American economic imperialism, a way of ensuring American export markets. Either way, financial motivations, those underlying international economic leadership, were secondary at best. For a contemporary review of this debate, see Howard Jones and Randall Woods, "Origins of the Cold War in Europe and the Near East: Recent Historiography and the National Security Imperative," in *Diplomatic History*, vol 18 (1993), pp. 251-76.

<sup>59</sup> These hovered around \$3 billion annually from 1955 to 1965, and had reached nearly \$5 billion by the late 1960s. Department of Commerce, *Survey of Current Business*, Oct. 1972. See also Fred Block, *The Origins of International Economic Disorder: A Study of United States International Monetary Policy from World War II to the Present* (Berkeley: University of California Press, 1977), ch. 6.

other countries had little choice but to accept.<sup>60</sup> This had the result of causing significant inflationary pressures throughout the system.<sup>61</sup> It also resorted to a number of stopgap measures intended to ease pressures on the dollar, such as controls on capital flows and on the convertibility of gold.<sup>62</sup> When these measures could no longer relieve the pressure, and when the other countries in the system were no longer willing to continue accepting inflationary dollars, the United States simply pulled out of the system altogether. It never showed any willingness to make significant concessions on other policy fronts in the interest of international monetary leadership.<sup>63</sup>

Finally, it should be noted that this argument should not be taken to mean that the United States failed to act in a leadership capacity more generally in the postwar era. Clearly it acted as a leader in many ways; this argument refers only to a very specific type of international monetary leadership. The United States lack of sufficient financially internationalist motivation meant that when confronted with a range of possible leadership roles, the

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<sup>60</sup> Some proponents of an American leadership role argued that unloading dollars abroad was a legitimate mechanism for encouraging international liquidity, but by the mid-1960s few of the recipients of these dollars agreed. See, for example, Charles Kindleberger, *Balance of Payments Deficits and the International Market for Liquidity* (Princeton: Princeton Essay in International Finance, 1965).

<sup>61</sup> See, for example, Benjamin Cohen, *Organizing the World's Money: The Political Economy of International Monetary Relations* (New York: Basic Books, 1977), pp. 103-4.

<sup>62</sup> To the point where some analysts consider the dollar to have been *de facto* inconvertible by 1968. See David Calleo and Benjamin Rowlands, *America and the World Political Economy: Atlantic Dreams and National Realities* (Bloomington: Indiana University Press, 1973), p. 284.

<sup>63</sup> For this argument in reference to the specific policy decision to end convertibility of the dollar in 1971, see Joanne Gowa, *Closing the Gold Window: Domestic Politics and the End of Bretton Woods* (Ithaca: Cornell University Press, 1983).

United States did not choose that of international monetary leader. This particular case also points to a crucial difference between capabilities and motivations, between what a state can do and what a state will want to do. The United States had sufficient capabilities in the immediate postwar era to give it considerable leeway in shaping the new international monetary order. This did not necessarily mean, though, that it had the financial motivation, and thus the commitment, to maintain it in the long term. Capabilities and motivations need not necessarily covary.

#### **Germany and the ERM**

The final and most recent case is that of Germany<sup>64</sup> in the European Exchange Rate Mechanism. The Deutchmark has long been considered Europe's strongest currency. While there has been a debate over whether or not Germany was hegemonic within the ERM,<sup>65</sup> the Deutchmark has been almost universally recognized as the anchor currency of the system. In a way, debate over whether Germany is financially hegemonic in the European financial and monetary system misses the point, as it does not adequately distinguish among the three separate categories of what German capabilities would allow it to do if it chose, what formal role

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<sup>64</sup> Germany as used here refers to the Federal Republic before unification and Germany since.

<sup>65</sup> On this debate, see Matthias Kaelberer, "Money and Power in Europe: The Political Economy of European Monetary Cooperation," Paper presented at the American Political Science Association annual meeting, Washington DC, September 1993, and Richard Pomfret, "What is the Secret of the EMS's Longevity?" *Journal of Common Market Studies*, December 1991, pp. 623-633.



Germany and the Bundesbank have in the ERM as the system was constituted and managed, and finally what Germany would likely choose to do within the system, what its financial motivations are. Hegemonic stability theory usually focuses on the first of these questions, institutional analysis on the second. The focus here will be on the last.

The late 1980s saw substantial increases in German investment abroad, and as a result substantial increases in income from these investments as a proportion of the German economy. Although this proportion has increased from just under 3% in 1988 to 4.65% in 1992, though, it is still far below the equivalent ratios in Britain during either the gold or gold exchange standards, or for that matter the equivalent ration in such EU countries as Britain, Holland, or France today. The increase of the 1980s seems, furthermore, to have peaked; the ratio actually shrank from 1991 to 1992.<sup>66</sup> The persistence of German current accounts deficits suggest that the growth in income earned abroad in the late 1980s will not resume. Thus we should expect that German monetary policy should not be particularly strongly financially motivated to act as an international leader; rather, that it should be focused on the needs of domestic macroeconomic management.

#### *The European Exchange Rate Mechanism*

The ERM differs from all of the monetary systems discussed above in that its currencies are not in any way convertible to

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<sup>66</sup> These figures are all from the International Monetary Fund, *International Financial Statistics Yearbook 1993* (Washington: International Monetary Fund, 1993).

specie. The mechanism is essentially a commitment by the governments of European Community countries to maintain their currencies within a band of 4.5% of par.<sup>67</sup> The par in the ERM is set by the European Currency Unit, a basket of the participating currencies. Thus in essence the ERM was a commitment by participating states not to allow their currencies to fluctuate outside of a narrow band from the European mean. The ERM was set up, though, at a time when most European countries wanted to emulate German macroeconomic policy,<sup>68</sup> while Germany did not want to risk allowing other European governments and central banks to dictate its own monetary and macroeconomic policies.<sup>69</sup> Reflecting both of these conditions, the ERM was set up to give the Deutchmark a central role in the system.<sup>70</sup> Instead of making the ECU a simple basket of the participating currencies, it is calculated as the sum of a set of bilateral relationships among all participating currencies. Whereas the Deutchmark would make up a relatively small proportion of a simple basket of currencies, it can predominate in any strictly bilateral weighting.<sup>71</sup> Thus the

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<sup>67</sup> The 4.5% band was the requirement for most countries before the recent ERM crises. Some weaker currency countries, such as Italy, were always allowed a wider band, and after the crises the basic band was expanded to 30%.

<sup>68</sup> Kathleen McNamara, *Consensus and Constraint: The Politics of Monetary Cooperation in Europe* (Ph.D. Dissertation, Columbia University, 1994), ch.6.

<sup>69</sup> In fact, the Bundesbank specifically stated that it would continue to give domestic price stability priority over its EMS commitment if the two came into conflict. Peter Ludlow, *The Making of the European Monetary System*, p. 240.

<sup>70</sup> Although the EMS was originally designed to balance the responsibilities of both strong and weak currency countries, it functioned from the start as a Deutchmark-led regime. See Alberto Giovannini, "How Do Exchange-Rate Regimes Work? The Gold Standard, Bretton Woods, and the EMS," in Miller, Eichengreen, and Portes, eds., *Blueprints for Exchange Rate Management*.

ECU, and thus the ERM, was consciously set up to give Germany as central a role as possible, by forcing others to adjust their currencies to the Deutchmark rather than having the Deutchmark adjust to a European average.

### *Policy Choices*

As long as the major economies in the European Community faced similar macroeconomic conditions, and they all shared similar macroeconomic and monetary policy goals, the ERM worked quite well. There was no divergence between the demands on German policy of acting as the leader of the European monetary system and other macroeconomic policy priorities, particularly in this case a strong German bias towards price stability.<sup>72</sup> The first real test of Germany's propensity to act as Europe's monetary leader came when German macroeconomic conditions were suddenly thrown on a divergent course by the absorption of East Germany into the Federal Republic. Aside from the pressures that the East put on the German budget and balance of payments, the exchange of East Germany's nonconvertible currency for West Germany's convertible currency at par injected inflationary pressure into the German economy that would take years to wear off.<sup>73</sup>

The combination of this inflationary pressure and the recession of the early 1990s led to a crisis in the ERM that

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<sup>71</sup> For a complete description of the mechanics of the system, see Daniel Gros and Niels Thygesen, *European Monetary Integration* (London: Longman, 1992).

<sup>72</sup> McNamara, *Consensus and Constraint*, chs. 6 and 7.

<sup>73</sup> See, for example, Dale Cameron, "British Exit, German Voice, French Loyalty: Defection, Domination, and Cooperation in the 1992-3 ERM Crisis," (Mimeograph, 1994), esp. p. 13.

lasted from August 1992 until August of 1993, and resulted in two countries leaving the ERM, three countries devaluing, and the fluctuation bands for remaining currencies being widened from 4.5% to 30%. In short, the crisis gutted the ERM. The development of the crisis has been discussed elsewhere,<sup>74</sup> and need not be reviewed here. Three particular observations of the crisis are relevant to this discussion, though. The first is that the proximate cause of the crisis was a disjuncture in macroeconomic condition amongst the major economies participating in the ERM, as Germany inflated its economy to deal with unification while the rest of Europe faced the deflationary effects of recession. In dealing with unification in an inflationary way, the German government knew that it would be generating strong inflationary pressures, but decided that the benefits of a generous unification strategy outweighed the inflationary costs.

The second observation is that the Bundesbank set its interest rate policy throughout the crisis almost exclusively to deal with the inflationary pressures, and this forced the other central banks to keep their rates far higher than was macroeconomically reasonable in order to maintain the strength of their currencies against the Deutchmark. Again, it was common knowledge that high German rates were significantly hindering the ability of other European central banks to help generate economic recoveries from the recession. The third is that when confronted directly with a clear choice between maintaining their high rates to fight inflation or keeping the ERM intact, German policy-makers

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<sup>74</sup> Cameron, *ibid.*, provides a thorough survey of this development.

twice decided to give the domestic goal priority over the international. Thus both in the choices made by the German government on how to deal with unification and in the choices made by the Bundesbank on how to cope with the effects of those choices, there was a clear and strong tendency to use monetary policy for purposes of domestic macroeconomic stabilization, rather than international exchange-rate stabilization.

### **Conclusions**

These five cases do not prove the relationship between financial motivations measured as the proportion of national product generated by income earned abroad and foreign economic policy behaviour; plausible alternative explanations exist for all of the cases, and there are not enough of them for the results to be anything beyond suggestive. They do suggest the relationship fairly strongly, though. The cases represent all of the major market-driven fixed-rate international monetary systems of this century, and are thus fairly comprehensive as a sample. And the relationship holds for countries facing both reflationary and deflationary pressures, so that the relationship can plausibly be argued to hold for both kinds of pressures.

The scope of the particular hypothesis suggested here is quite narrow; it explains only the behaviour of countries with the capabilities to manage international monetary systems, and only that aspect of their behaviour that relates to such management. Furthermore, it is only relevant when the demands on macroeconomic

policy of international monetary leadership differ from the demands of other aspects of the national interest. Even this narrow an argument can have significant empirical and policy implications, which will be addressed below. On a theoretical level it suggests that the national interest can be addressed theoretically in more than a generic way. More precisely, if a relationship can be established between international financial motivations as discussed above and specific aspects of foreign economic policy behaviour, perhaps other relationships can be found between specific elements of a national economic or political structure and other specific foreign policy motivations. If a set of these generalizable relationships can be found, then foreign policy can be predicted more precisely than through the use of simple abstract assumptions about states' national interests. In short, national motivations are worth studying, and deductive and generalizable models of sources and effects of particular types of motivations are worth developing.

### **Implications**

The relationship between international financial penetration and propensity to act as a responsible international monetary leader also had real empirical and policy implications. While there is significant debate amongst economists about whether currency stabilization is a good thing in theory, it remains a prominent policy goal for many governments, particularly those of

the European Union.<sup>75</sup> It is in fact a stated goal of the Union both to maintain high degrees of stabilization currently through the remnants of the Exchange Rate Mechanism, and to move towards full monetary union in the future. In creating monetary systems an important design factor is system reliability, which in turn is to an extent predicated on the reliability of the most monetarily powerful countries within the system. To the extent that the most powerful cannot be expected to lead the system when the demands of such leadership come into conflict with other demands on macroeconomic policy, the system cannot be expected to be reliable in the long term. In fact, it cannot be expected to be reliable beyond the point in time when macroeconomic conditions prevailing at the time when the system was created begin to change.

Germany is clearly the monetary powerhouse of Europe, and thus its willingness to lead would be central to the long-term efficacy of the system. The ERM crises of 1992 and 1993 showed convincingly that this willingness cannot be taken for granted. The hypothesis of this paper suggests that Germany should not be expected to display a new or increased willingness in the near future. Returns on international financial penetration are not a sufficiently large proportion of the economy, and therefore the appropriate motivations are simply not there. Furthermore, Germany's recent trend towards current accounts deficits and the East's continuing need for massive infrastructural investment suggest that Germany's level of international financial

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<sup>75</sup> For an extensive discussion of the politics of European currency stabilization since the Second World War, see McNamara, *Consensus and Constraint*.

penetration will not expand rapidly in the medium term.<sup>76</sup> This suggests that Germany is not likely to become motivated to act as a European monetary leader through the medium term.<sup>77</sup>

This is not to suggest that the European Union's future is necessarily one of monetary chaos. There are two distinct paths talked about as potential routes to greater monetary integration, a gradualist, incremental route and a more sudden, all-at-once approach. This way of looking at foreign economic policy motivations would suggest that the second of these two routes, in which broad powers over monetary policy are devolved to a pan-European, Union-level authority all at once, is the more likely to be successful.<sup>78</sup> The incrementalist route would be prone to setbacks whenever monetary crises occurred, because the centre of the system, Germany, cannot be counted on and should not be counted upon in the future, to act appropriately in mitigating monetary crises. Therefore, any approach that removes decision-making authority from German institutions and vests it authoritatively in broader European institutions will be much more likely to weather such crises as do occur.

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<sup>76</sup> Germany in fact had a net debit in international income in 1993 for the first time since 1974, suggesting that it is becoming less rather than more motivated for leadership. International Monetary Fund, *International Financial Statistics Yearbook 1994*, pp. 374-75. Between 1989 and 1992 Germany's current account fell from a credit of \$58 billion to a debit of \$26 billion. In the same period the German government's foreign borrowing increased sixfold. International Monetary Fund, *Balance of Payments Yearbook*, 1993, pp. 268 and 274.

<sup>77</sup> This argument is compatible with the suggestion that macroeconomic shocks that affect different countries asymmetrically pose the greatest danger for European monetary stabilization and integration. See Eric Jones, "The European Monetary Trade-off: Economic Adjustment in Small Countries."

<sup>78</sup> This conclusion has been reached by others as well, for different reasons. See Alberto Giovannini, *The Transition to European Monetary Union* (Princeton: Princeton Essays in International Finance, 1990).