What Determines Exchange Rate Regimes?

The Trilemma and its Consequences

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Ben Carliner
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I. Introduction

“The great institutional significance of central banking lay in the fact that monetary policy was thereby drawn into the sphere of politics. The consequences could not be other than far reaching.” – Karl Polanyi

Exchange rate regimes lie at the nexus of several different areas of study. On the one hand, they provide the bridge with which domestic economies can engage with the larger international economy, allowing trade and investment to flow across borders. The political and distributional effects of exchange rate regimes are thus relevant both to area studies scholars with a focus on domestic political factors (wherever they may be focused), and to international relations scholars studying inter-state monetary relations. On the other hand, exchange rate regimes also overlap in the fields of political science and economics. At first glance, the management of exchange rate regimes may seem to hinge on largely technical issues of interest only to economists, like current account balances, interest rates and capital flows. But exchange rate regimes necessarily have large distributional effects that directly influence the interests of powerful economic actors and interest groups. A pegged exchange rate, for example,

1 Polanyi, *The Great Transformation*, p.197-198
might serve the interests of export-oriented domestic industries, while a flexible exchange rate, which allows for greater domestic monetary policy autonomy, might serve the interests of domestically-oriented industries and workers.

So what factors determine the type of exchange rate regime a developed country will operate? As one might expect with a subject that straddles so many scholarly boundaries, the list of potential answers covers a lot of ground. Economists have done much empirical work that illuminates the conditions under which exchange rate regimes operate. But while an economist might be able to tell you where a particular optimum currency area lies or whether a currency crisis is looming, the initial choice of exchange rate regime is a political decision made by national governments. Thus, economic models alone cannot capture the causal factors that determine exchange rate regime choice.

Within political science, a theoretical divide has opened up between those who give relative primacy to international-level explanations of exchange rate regime choice, and those who emphasize domestic-level factors. Realists, for example, tend to look towards relative power within the international system for an explanation. The Bretton Woods international monetary system, for instance, can then be explained in the context of hegemonic stability theory. That is, the US, as the most powerful nation in the world after World War II, determined its own preferences with regard to exchange rates, and then forced other countries to join an international monetary system that served its interests.
Unfortunately, Realists tend to treat national governments as “black boxes,” and their explanations ignore or under-emphasize other potential independent variables that influence regime choice.

Outside of Realism, institutionalists, rational choice scholars and area studies experts have emphasized domestic political factors as the primary determinants of exchange rate regimes. The distributional effects of exchange rate regimes, they argue, cause domestic political actors to lobby the government to support one type of exchange rate regime over others. The specific attributes of domestic political institutions will then determine what types of interests get articulated to policy makers, and path dependency and other institutional features will influence the decision-making process. But, like Realists, their explanations often do not control for all the potential causal variables at work in regime choice. In particular, systemic-level variables that constrain the choices open to governments are given short shrift.

But while economists, realists, rational choice scholars and institutionalists have all produced useful theoretical and empirical contributions to the debate, the whole of their answers seem rather less than the sum of its parts. Here, we will argue that a complete picture of exchange rate regime choice must draw on several different causal factors to come to a plausible explanation.
Exchange rate regimes, this paper will argue, are determined by three main factors: First, policy makers are faced with the structural constraints imposed by the so-called trilemma – the inability to maintain the combination of a fixed exchange rate, free capital mobility, and a monetary policy oriented toward domestic needs. Second, the continuing growth of deep, liquid financial markets and institutions, along with rising international trade and investment, has made international capital flows increasingly hard to regulate. Given the constraints imposed by the trilemma, the difficulties in imposing and maintaining capital controls further limit the range of policy options available to governments. Third, domestic political considerations – primarily interest group pressure to orient monetary policy towards specific domestic goals like full employment, inflation rate targeting, or exchange rate stability – cause policy makers to respond to the constraints imposed by the trilemma in predictable ways. That is, governments, especially democratic governments that can be held accountable through competitive elections, will tend to place a high value on maintaining domestic political support. Large economies like the US, where international trade represents a relatively small proportion of GDP, will value domestic monetary policy autonomy over stable exchange rates. Small, open economies, on the other hand, that are highly dependent upon international trade, will value the price stability that a pegged exchange provides. All this implies that most governments will choose to “move to the corners,” and adopt either
floating exchange rates or hard pegs, like currency boards or even (as in Europe) monetary unions, depending upon the make-up of the national economy and domestic interest groups.

This paper will begin with an analysis of the theoretical implications of the trilemma and free capital mobility, and then move on to examine the role of the trilemma and domestic politics with two case studies. First, we will look at the decision of the Nixon administration to “close the gold window” and break the dollar peg to gold in 1971. This action triggered the collapse of the Bretton Woods international monetary regime and ushered in the modern era of floating exchange rates. Then we will examine the efforts of the European Union to create a European Monetary Union and to expand the Euro to the new group of accession countries in eastern and central Europe.
II. Theoretical Overview

The theoretical foundations of exchange rate regime choice have evolved considerably over the last hundred years or so. Up until World War I, the received wisdom was that “sound money” was the cornerstone of international trade and investment, and as such, a relatively stark contrast existed between those countries that adopted the gold standard and those who issued token or fiat money and chose to float. The gold standard was associated with “tight” fiscal and monetary policies – balanced budgets and stable prices, while “fiat money and floating was considered a radical departure from fiscal and monetary stability and…countries which followed fiat money and permanently floated such as Austria-Hungary and Spain were viewed with disfavor.”

World War I disrupted the international monetary system and the traditional gold standard was never fully restored. During the inter-war period, a series of beggar-thy-neighbor currency devaluations and import tariffs exacerbated the Great Depression and, it was generally supposed, contributed to the rise of fascism and World War II. The Bretton Woods international monetary regime was designed with these lessons largely in mind.

Thereafter, the debates over the relative merits of fixed and floating exchange rate regimes focused on the theoretical implications of the Mundell-

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2 Bordo, “Exchange Rate Regime Choice,” in NBER Working Papers #9654, April, 2003 p.5-6
Fleming model. It stated that, for each specific national economy, the choice of exchange rate regime should be determined by the types of economic shocks the country was likely to encounter. In other words, “in an open economy with capital mobility a floating exchange rate provides insulation against real shocks, such as a change in the demand for exports or in the terms of trade, whereas a fixed exchange rate was desirable in the case of nominal shocks such as a shift in money demand.”

The basic macroeconomic policy predicament that concerns us here follows from the Mundell-Fleming model. Among economists, the combination of a fixed exchange rate, free capital mobility, and independent monetary policy is known as the “trilemma,” or “impossible trinity.” That is, all three pillars of the trinity cannot coexist at the same time in any given country. For example, if a country chooses to dismantle its capital controls and adopt a fixed exchange rate, it will not be able to run a monetary policy dedicated to domestic goals – it must adjust interest rates and money supply to prop up and defend the exchange rate. Conversely, if a country chooses to make price stability or full employment a principal goal of monetary and fiscal policy, then it will not be able to maintain a pegged exchange rate under conditions of capital mobility. The trilemma is thus a systemic-level constraint on policy makers that is due

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3 Ibid. p.7
neither to relative levels of power within the international system nor to
domestic political constraints on governments. It is, rather, a function of
international capital markets and trade flows.

This brings us to the second major constraint facing policy makers: their
inability to adequately control capital flows. The logic of the trilemma allows
that exchange rate stability and monetary policy autonomy should be possible if
only capital flows can be restricted. Under-developed economies, in particular,
seem to be able to maintain some kinds of capital controls, to their advantage.
But the benefits of a pegged exchange rate accrue largely to the encouragement
it offers to international trade. Major exporters and importers do not want to
have to take on large amounts of currency risk in their operations, and are
therefore more likely to engage in trade if they have some assurances that
forward exchange rates will remain constant. Unfortunately, as we shall see,
trade itself undermines the ability of governments to control capital flows.

Maurice Obstfeld asks the question, in regard to increasing capital
mobility even in the face of stronger capital controls under the Bretton Woods
regime of the 1960’s, “how could capital flows continue to undermine
authorities efforts to defend exchange parities even in the face of tightened
capital controls?”5

5 Obstfeld, “The Great Depression as a Watershed: International Capital Mobility Over the Long
Run,” in NBER Working Papers #5960 March, 1997 p.45
His answer has two main components. First, trade invoices can be manipulated to disguise speculative capital flows as trade related transactions. One way to do this is the so-called “leads and lags” trick. For example, if one was expecting a devaluation of, say, Sterling relative to the Dollar, then a British trader could speed up payments in Sterling, while holding up Dollar denominated receipts in expectation of a depreciation. More bluntly, a multinational corporation could simply fudge its internal invoices, paying more or less for its internal imports and exports depending on its perceived currency risks. As trade increases, the number of individuals and firms with both the motives and the means to evade capital controls grows.

A second method of manipulating capital controls was simply the existence (and size) of international currency markets like the Eurodollar market that sprang up in London in response to US capital controls. The Eurodollar markets were necessarily outside of the control of the US Treasury Department simply because they controlled (and traded) large amounts of the US currency outside of the boundaries of the United States.6 Any country that sees it currency traded in high volumes on foreign exchanges will have difficulties controlling capital flows. While this may give some comfort to less-developed nations who would prefer to maintain both currency stability and full employment policies, in the long run, closer integration with the global economy

6 This idea is fleshed out further below on p.23-24
and higher levels of trade and investment will eventually promote capital mobility. For the developed world, the battle is already lost.

The broader point here is that policy makers are confronted with two specific types of constraints when it comes to exchange rate regime choice. First, there is the systemic, or structural, constraint that is imposed by the trilemma. It prevents policy makers, so to speak, from having their cake and eating it too. They must choose between domestic monetary policy autonomy, free capital mobility, and pegged exchange rates. On top of this, financial markets and institutions serve to further constrain the options open to policy makers as they make capital controls increasingly ineffectual and difficult to enforce. In this sense, financial markets deserve to be treated as institutional actors in their own right, and not mere extensions of their national homelands, in the international system. The interests of financial markets do not correspond with particular countries or currencies, or even, for that matter, with the interests of the specific institutions and companies that make up the financial markets. Moreover, the huge amounts of capital swishing around in the markets give them a power and authority that cannot be ignored, even by the largest and richest countries.

Before we move on to our case studies, one final theoretical issue needs to be explored – the role of democratic accountability. During the operation of the classical gold standard, the commitment of most of the governments in the
system to defend the peg was not seriously in doubt, even though adjustments to the current account balance necessarily took the form of tight money policies that raised unemployment levels or cut (from admittedly low levels) social expenditures. This was due largely to the fact that universal suffrage had not yet established itself, the vote being restricted to the property owning classes and the old aristocracies. Governments were thus insulated from domestic pressures to seek full employment or to provide generous and costly social policies. As suffrage began to be extended to the working classes in many countries in the beginning of the 20th century, one of the pillars of the international monetary system began to erode – the primacy of the gold standard over all other economic considerations.

As Eichengreen puts it, “come the twentieth century…it was no longer certain that, when currency stability and full employment clashed, the authorities would opt for the former.”7 The contention here is that the conflict between exchange rate stability and domestic fiscal and monetary policy continues to this day. While universal suffrage is now de rigueur among all the developed countries of the world, this does not mean that electorates will necessarily disdain exchange rate stability. It is the nature and makeup of each particular domestic economy that will determine which policy the voters will prefer. Economies with large domestic markets like the United States that are relatively

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7 Eichengreen *Globalizing Capital: A History of the International Monetary System*, p.4
insulated from the vicissitudes of foreign trade will prefer to maintain domestic policy autonomy. But small, open economies that are highly dependent upon trade – like most of Europe – will continue to value fixed exchange rates precisely because it is in the direct economic interests of their citizens to do so.

The determinants of exchange rate regime choice, then, fall into three different categories. The trilemma looms on the systemic level, and combined with the financial markets on the institutional stage, serves to severely limit the policy options open to governments. The final choice however, is determined on the micro-level, where the economic interests of national constituencies will determine which choice – currency stability or domestic policy autonomy – governments will choose.

Our case studies examine only the US and Europe, in part because we do not believe our thesis applies to the developing world. There, the lack of modern financial and industrial structures renders many of these issues moot. The dynamic Asian economies do, however, offer a particularly promising avenue for further research, and deserve a fuller treatment than they are given here. Asia could also provide insight as to when exactly, in the process of economic development, capital controls become ineffective.
III. The Closing of the Gold Window

The closing of the “gold window” on August 15, 1971 by President Nixon ended the convertibility of the US Dollar into gold and triggered the collapse of the Bretton Woods international monetary regime. While the action itself was undertaken unilaterally by the US, many observers have argued that the decision to abandon Bretton Woods was indicative of declining US power vis a vis resurgent Europeans and Japan. Stephen Krasner, for example, writing in the wake of the collapse of Bretton Woods in 1977, claims that “the fragility of the international monetary system is inherently related to the declining international power of the US.” The inability of the US, he argues, to get its main trading partners to revalue their currencies was a more important factor than domestic issues in determining the outcome of US policy towards Bretton Woods. Thoughtful scholars, of course, are careful to couch their arguments in relative terms. The international balance of power is not supposed to have been the sole determinant of US policy, but rather, domestic political factors and institutional weaknesses were also deemed to have constrained the course of action of US policy makers. Nonetheless, realpolitik interpretations of US foreign policy assign pride of place to the international system of states in determining causal factors.

But such interpretations are, if not altogether false, misleading. First, domestic level factors will be shown to have been the main concern of US policy makers. Second, and perhaps more importantly, proponents of hegemonic stability theory misunderstand the nature of the international forces that constrained US policy. It was neither a state nor a group of states that conspired to limit US power. Instead, it was the growth of deep, liquid financial markets – and their attendant capital flows - that emerged as the main obstacle to US manipulation of the international monetary system, and indeed, of the ability of the US to manage its own domestic economy. Finally, institutional flaws in the design of the Bretton Woods regime contributed to its eventual downfall.

The immediate cause of the 1981 Dollar crisis was, of course, the persistent US balance of payments deficit, which was the result of inflationary US fiscal and monetary policies. As the only reserve currency in the Bretton Woods system, the US was obliged to maintain price stability as the primary goal of its monetary policy. Once it decided to abrogate this responsibility in favor of domestic concerns, the collapse of the Bretton Woods regime was a foregone conclusion. In retrospect, it is surprising that the system lasted as long as it did (the US had been running balance of payments deficits since 1957 and inflationary economic policies since 1965), which is testament to the continued strength of the US and sustained international cooperation.
The predicament faced by US policy makers was, of course, the trilemma. The combination of a pegged exchange rate, free capital mobility and autonomous monetary policy, a reality the US began to face in the 1960’s as capital mobility increased, is not sustainable. Simply put, if a country wishes to fix its exchange rate while maintaining capital mobility, monetary policy autonomy must be sacrificed to defend the peg. Interest rates and money supply cannot target domestic inflation or unemployment. Rather, they must be adjusted to maintain and defend the exchange rate.

As the decade wore on, however, US officials were increasingly unwilling to pursue price stability as they grappled with the problems of financing the Vietnam War and domestic Great Society programs. At first, the response among US policy makers was to try to reinstate capital controls in order to stem the contagion effects of their inflationary domestic policies. But the US was unable (despite repeated attempts) to impose effective capital controls, as the growth of the Eurodollar market bears out. The return of currency convertibility and the dismantling of controls on capital accounts among the major European currencies in 1958 contributed to the growth of foreign exchange markets and increased the potential for capital flight between countries.

This problem was exacerbated by two institutional features of the Bretton Woods system: Dollar convertibility into gold, and pegged but
adjustable exchange rates. Tying the Dollar to gold resulted in persistent liquidity shortfalls as worldwide economic growth required an expansion of the monetary base that outstripped increases in the reserve holdings of gold. This, of course, worsened the reserve to liability ratio. Indeed, by 1971 the amount of US Dollars outstanding dwarfed the gold reserves held by the US. This hurt market confidence in the ability of the US to maintain the gold exchange rate, and threatened to exhaust US gold holdings through a run on the Dollar.

Then there was the problem of adjustable rates. In theory, exchange rate adjustments were allowed for under the Bretton Woods regime to restore equilibrium between surplus and deficit countries. But capital mobility made the costs of parity adjustment so high (if the markets suspected devaluation was in the works, a run on the currency would commence) that governments refrained from this policy option, locking in imbalances in currency values and further undermining market confidence in the stability of the system.

The 1971 Dollar crisis was caused by a persistent balance of payments deficit that put severe pressures on the dollar and required US policy makers to jack up interest rates and/or decrease the money supply in order to restore market confidence in the strength of the Dollar. But the Nixon administration, facing rising unemployment and an upcoming election, chose instead to use monetary policy to address domestic economic problems, thus forcing a devaluation and destroying the Bretton Woods regime.
The point here is that when faced with a decision on whether to support the international monetary system, or pander to domestic economic and political interests, the Nixon administration unilaterally chose the latter. America’s ability to simultaneously pursue both goals was undermined not by intransigent states, but by the strength of international financial markets, buoyed by the increase in capital mobility. The institutional design of the Bretton Woods system contributed to its own downfall by discouraging parity adjustments and failing to provide an enforcement mechanism that could compel the US to pursue price stability.

Moreover, when viewed in hindsight, it is evident that not only did the Bretton Woods regime achieve many of the goals it had been designed to accomplish, but that the fall of the regime did not serve to weaken US power or its international objectives in any fundamental way. Inasmuch as a system of free, floating exchange rates can be seen as a neo-liberal, as opposed to Keynesian, policy, the collapse of Bretton Woods can even be seen as a successful example of the ability of the US to export its preferred economic policies to the rest of the world. Either way, the growth of international trade and investment (one of the main achievements of Bretton Woods) has continued apace and even accelerated in the years since its demise. Given that this was the
main economic objective of the US after World War II\textsuperscript{9}, it is perverse to characterize the success of this goal as an indicator of declining US power.

The theoretical implications of these findings point to the limitations and shortcomings of a realpolitik approach to US exchange rate policy. For not only are domestic considerations slighted, the conception of the nature of the international system is biased in favor of state actors while ignoring the rise of international financial and economic markets as powerful actors in their own rights. While it could be argued that I.R. theories have always acknowledged the existence and power of markets, and hence that to assign them the role of autonomous institutions is a semantic slight of hand that either serves no real purpose or mischaracterizes the role they play, I hazard that no Finance Minister who has ever nervously awaited the arrival of the man from Moody’s or Standard & Poor’s would object. More to the point, financial markets not only have interests of their own, independent of states or even traditional domestic economic sectors, they have both the tools and the means to do something about it. Markets constrain the ability of policy makers to manage their domestic economies. In a world of free capital flows and floating exchange rates, economic mismanagement is dealt with swiftly and harshly – the Asian financial crises of 1997 is a case in point.

\footnote{Ibid. p.636}
Ultimately, then, the collapse of Bretton Woods points to the growing power and influence of markets. And given that the US has long championed neo-liberal economic policies, it is misleading to characterize US abandonment of the regime as a sign of weakness. Not only were domestic political and economic factors deemed more important than the maintenance of the monetary regime by US policy makers, but the long-term results of their actions (increasing international acceptance and adoption of neo-liberal economic strategies) seem to jibe with the basic goals of US policy making as well. The challenge to I.R. theories, then, is to incorporate the growing influence of markets and the role of ideology in determining policy outcomes. That said, there is also a simple answer to the question of when (and why) the US will abandon international regime maintenance and act unilaterally: The US, or more precisely, US Presidents, will act unilaterally when international commitments threaten their domestic political support. Far from being primarily concerned with the preservation and expansion of US international power, Presidents are concerned first and foremost with their own power and chances for reelection. As this is dependent on the will of American voters, Presidents will necessarily choose their own political survival over the maintenance of international commitments or broader US power if the two ever come into conflict. Moreover, the large size of the domestic economy and relative lack of importance of international trade to overall US GDP make it clear that policy
makers will choose to maintain domestic monetary autonomy over a pegged exchange rate.
IV. The Bretton Woods Regime

The outlines of the Bretton Woods international monetary regime were penned in a luxurious resort in the White Mountains of New Hampshire in 1944, primarily by two men – Harry Dexter White, an assistant to US Treasury Secretary Henry Morgenthau, and John Maynard Keynes, the eminent British economist and consultant to the British Treasury. The context of their negotiations, it must be remembered, was that of a world which, except for the US, had been destroyed by the war and whose nations desperately needed aid to get their economies back on their feet. Additionally, the breakdown of the previous international monetary regime (a gold standard) in the 1930’s weighed heavily on the minds of those participating in the negotiations. The “beggar thy neighbor” trade and exchange rate policies that had been pursued during the Great Depression were thought both to have worsened the Depression itself and contributed to the rise of fascism and the war. Stable exchange rates, then, were seen as a prerequisite of a stable and open international economic system\textsuperscript{10} - which was the ultimate goal of the regime.

Bearing in mind these “lessons” from the interwar years, the framers of the Bretton Woods system formulated four major modifications of the pre-war gold standard. First, the system of pegged exchange rates would be adapted to

\textsuperscript{10} See Gowa \textit{Closing the Gold Window: Domestic Politics and the End of Bretton Woods} p.34-37
allow for periodic adjustments. Second, capital controls would be permitted in order to lessen the risks of capital flight and volatility (crucial if the adjustable rate mechanism was to function smoothly). Third, the International Monetary Fund (IMF) was created to oversee the monetary regime and step in with emergency funding for countries faced with balance of payments crises\textsuperscript{11}.

Finally, in an acknowledgment of the postwar dominance of the US, the US Dollar was made the sole reserve currency in the system and the only currency to be pegged to gold. Other currencies set a par value to the dollar, which remained “passive” in the exchange markets and let other currencies determine parity rates. The dollar, in turn, could be exchanged for gold at the fixed rate of $35 per ounce. This last institutional feature would prove to be an important one, for it explicitly took away US policy autonomy in the sphere of setting exchange rates. Other countries could (and did, though not in quite the way which the framers of Bretton Woods imagined – about which more later) change and/or manipulate their exchange rates against the dollar, but the US was unable to effect a devaluation (or a revaluation) of its currency against others. Moreover, not only had the US given up the right to manage its exchange rate, market forces often compelled US policy makers to actively defend the dollar in international currency markets.

\textsuperscript{11} See Eichengreen \textit{Globalizing Capital: A History of the International Monetary System} p.93-102 for a fuller discussion of the differences between Bretton Woods and the inter-war gold standard
Unfortunately, the Bretton Woods regime differed in practice from theory. First, the system of pegged but adjustable exchange rates became a bad joke. While there were a few devaluations in the immediate postwar years, parity changes were rare and the risks of even contemplating devaluation became so intense (because of speculation on the exchange markets) that most countries considered it only as a last resort.

The ability of governments to control and regulate capital controls, meanwhile, steadily declined throughout the post war years, especially after the Europeans restored current account convertibility in 1959. Governments quickly found that was nearly impossible to determine if private currency transactions were truly trade related, or if they were in fact driven by market speculation. By the same token, private companies and financial institutions became more and more adept at masking their speculation with accounting gimmicks that disguised the capital flows as trade related, through over or under invoicing trade accounts.

Still, most governments did not entirely abandon capital controls, though their attempts to use such controls tended to be thwarted or at least undermined as time went on. The growth of the Eurodollar markets can, in fact, be partially explained as the perverse result of US attempts to tighten capital controls and regulate domestic financial institutions. The well-known Regulation Q, for instance, capped the interest payments American banks could make on short
term deposits. But once current account convertibility was restored in Europe, many European, and especially British, banks began to accept dollar denominated deposits at a higher interest rate than their American counterparts, thus drawing away business from their US rivals. That the Eurodollar markets became so large and influential was thus in part a reaction domestic US monetary and regulatory policy. But it was also driven, of course, by the fact that the dollar was the reserve currency, and foreign firms necessarily accumulated dollars through trade and other international activities.

The increase in international capital flows further undermined the ability of national governments to adjust their exchange rates as planned under the Bretton Woods regime, because the increased mobility and liquidity of international capital made exchange rate adjustments extremely volatile and subject to market speculation. In addition, adjustments were politically problematic because they seemed to suggest mistakes or even outright failure on the part of the government in question. As Eichengreen puts it, most governments refrained from adjusting their currencies “in order to avoid provoking capital outflows and exacerbating existing difficulties. To reverse course would be a serious source of embarrassment.”

Despite these problems and shortcomings with the Bretton Woods regime, it did in fact operate remarkably smoothly for most of its life. The

12 Eichengreen p.122
major goals of postwar US foreign economic policy were achieved, no doubt thanks in large part to the Bretton Woods system itself. Europe had rebuilt and its economic recovery was in full swing, Japan was proving astonishingly successful, international trade and investment was growing, and the international monetary regime which underlay all these achievements was relatively stable. If, in the words of Stephen Krasner, “the fundamental objective of [postwar] American decision makers was to create a liberal international economic regime,” they had in fact been largely successful. Indeed, in many ways, it was the success of US policy that proved its undoing. The “tragic flaw” of the system was this: The growth of international financial markets (by any measure a key component of a liberal international economic order), proved to be the main external mechanism that forced the hand of the US in closing the gold window. Granted, institutional flaws in the Bretton Woods regime exacerbated the problems the US faced, and domestic US administrations need not have concluded their domestic political survival depended on inflationary fiscal and monetary policies. But in the final analysis, powerful financial markets, which at least in part derived from the success of the Bretton Woods regime, proved the main constraint on US policy autonomy. Before we jump to conclusions, however, we need to lay out the background of the dollar crisis of 1971.

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13 Krasner p.636
Background to the Monetary Crisis

The primary cause of the US decision to close the gold window was a persistent and worsening balance of payments deficit, which in turn was the result of inflationary US fiscal and monetary policies. However, this underlying structural problem manifested itself in the international financial markets, especially the Eurodollar markets. As long as the US dollar, and only the US dollar, remained pegged to gold, foreign holders of dollars could demand the conversion of their dollars into gold by the US Treasury. As US dollar liabilities began to exceed the supply of US gold holdings (as they did due to rising US government spending), the risk of a “run” on gold increased. The steady decline of capital controls and the increasing liquidity of international financial markets exacerbated this issue because they constrained the ability of US policy makers to “manage the domestic economy, whether by promoting growth or restraining inflation and, at the same time, to avoid sudden explosive increases in its external deficit.”

In 1968, inflation began to pick up in the US, due to the massive government spending programs associated with the Vietnam War and the Great Society social programs. Initially, the response of the Federal Reserve and its new, Nixon-appointed chairman – William Burns, was to try and clamp down on

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14 See Strange: “The Dollar Crisis 1971,” in *International Affairs* Vol. 48 #2 April 1972 p.198-203 for a fuller treatment of the events leading up to the suspension of gold convertibility. The quote is taken from P.198
liquidity in the US banking system. But the existence of the Eurodollar markets allowed big US banks to circumvent the Fed’s restrictions on the money supply by borrowing abroad and increasing their liabilities to their foreign branches. By September 1969, Eurodollar borrowings by US banks had more than doubled from the previous year to $14.3 billion\(^\text{15}\). Open capital flows were preventing US policy makers from controlling the domestic economy, or at least the traditional tools through which monetary policy was conducted were proving ineffective. Eurodollar borrowing also worsened the official US balance of payments deficit and, by extension, its gold liabilities.

In response to the increased borrowing on the Eurodollar markets, the Fed raised reserve requirements on such borrowing, forcing the banks to start bringing dollars back to the US. In addition, the Fed rescinded Regulation Q, which had limited the amount of interests US banks could pay on short term certificates of deposit. While this measure did reflect an abandonment of the policy to restrict domestic monetary liquidity, it also accelerated the return of Eurodollar holdings to the US. Indeed, monetary flows were becoming increasingly volatile and hard to manage, as the fall in Eurodollar borrowings over the course of 1970 attests.

The US also took measures to discourage the conversion of dollars into gold. These measures (many of which predated the Eurodollar flows of 1968-9)
included the establishment of a gold pool among the major central banks (where foreign central banks basically agreed to sell their own gold reserves instead of forcing the US to convert their dollars into gold), swap arrangements (whereby foreign central banks loaned the US Fed their currencies and then launched coordinated interventions on the exchange markets to support the dollar), the so-called Roosa bonds (named after the US Treasury Under-Secretary who conceived them, Roosa bonds carried a guarantee against dollar devaluation), and, of course, the implicit threat to unilaterally end gold conversion, which would destroy the international monetary system. This outcome was foreshadowed in 1968 by the creation of the two-tiered gold market, in which central banks disengaged from the regular gold markets and agreed to buy and sell gold only at the agreed upon price of $35 per ounce while private sales were allowed to diverge from this rate.

The point here is that all the aforementioned policies and measures undertaken to support the dollar were mere window dressing, and did not attack the fundamental cause of the US balance of payments deficit and the convertibility crisis it augured. With brief exceptions, US fiscal and monetary policy remained (and became increasingly so) expansionary over the course of the 1960’s. As the reserve currency, the US simply had to maintain price stability to protect the stability of the international monetary system. Ultimately, it was merely confidence that the US would be able to honor its dollar
commitments that kept the Bretton Woods regime functioning smoothly. As international holdings of dollars began to outstrip US holdings of gold, that confidence began to disappear.

But the day of reckoning was still some way off. A further breathing space was afforded the US by the German decision to revalue the deutschmark by 9.3% on September 29, 1969. This move was taken in response to massive increases in Bundesbank reserve holdings, driven both by its strong macroeconomic performance (low inflation rates and real GDP growth), and by the expansionary fiscal policies of the French (their response to the student riots of 1968), which resulted in significant capital flows from France to Germany and a concomitant French devaluation (against the dollar) of 11.1%16. Large increases in the reserve holdings of European central banks were becoming increasingly hard for them to handle, however, without sparking domestic inflation.

Normally, reserve increases are “sterilized” by central banks – as central banks buy dollars and sell their own currencies on the markets to support their exchange rates, they mop up this increase in the domestic money supply by selling government bonds, thereby converting the cash into debt and forestalling the inflationary effects of an increase in the money supply. But as dollar

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reserves grew, the ability of the domestic capital markets to absorb new debt
issues decreased, to the point that new issues of government securities became
untenable and an increase in the money supply unavoidable (German money
supply growth rose from 6.4% to 12.1% during 1971, the height of the crisis\textsuperscript{17}).
In this way, the combined effects of expansionary US fiscal policies and the
rigidities of the Bretton Woods system forced other countries to “import” US
inflation into their own economies.

But despite the initial success of these all these policies in reducing the
US balance of payments deficit, they were soon overwhelmed by a domestic
political decision on the part of President Nixon. With the 1972 presidential
elections looming, price stability was sacrificed on the altar of unemployment.
As the tight money policies of 1968-9 began to take effect, the economy slid
into recession and unemployment rates began to rise. The Republicans had
suffered some setbacks in the 1970 elections, and domestic approval of
President Nixon’s handling of the economy was slipping\textsuperscript{18}. As such,
inflationary domestic fiscal policies were maintained (these included, of course,
not only domestic social spending but also the rising costs of waging the
controversial war in Vietnam), and interest rates were lowered, boosting

\textsuperscript{17} Ibid. p. 54
\textsuperscript{18} See Odell The US and the Emergence of Flexible Exchange Rates: An Analysis of Foreign
Policy Change in \textit{International Organization} Vol.33 #1 Winter 1979 p. 71
domestic economic growth but also contributing to the reversal of Eurodollar
flows back into Europe and Japan.

The Collapse of Bretton Woods

At this stage, it is worth pointing out that not only was Presidential
attention in the US much more closely focused on domestic political factors than
international monetary policy, but inasmuch as President Nixon focused on
economic issues, he always saw them through the lens of the domestic economy,
rather than the broader stability of the international monetary regime. Put
another way, it is not clear if Nixon really understood the complexities of
monetary economics, or how his management of the domestic economy could
affect the health of the international economic system. To cite perhaps the most
famous example of his approach to economic matters, Nixon once told his
advisors, in response to a briefing on the state of the international monetary
system and particular issues concerning the fate of the Italian lira, “I don’t give a
shit about the lira.” As Joanne Gowa puts it, Nixon “would attend to
international monetary issues on an episodic basis. He very plainly did not want
to be bothered about the balance of payments: he did not want domestic

19 See Gowa p.137 for a brief transcript from the Oval Office tapes

32
economic policy restrained by the payments deficit nor did he want the deficit to impinge on his direction of foreign policy.”

For the most part, international monetary systems were simply not a political issue in the US. To the extent the American politicians could get their hands around international economic issues at all, they largely focused on international trade. Trade issues did become more and more salient over the years as the economies of Europe and Japan recovered from the destruction of World War II and began to compete effectively on the international arena.Fred Bergsten notes that “European and Japanese exports did not significantly threaten American jobs in the 1950’s, but they certainly did so by 1971: and domestic American interest groups reacted accordingly.”

Still, while many American policy makers and economists began to feel that the dollar was overvalued - giving foreigners a competitive edge in their exports to America and threatening job losses - much of the public attention given to trade issues focused on tariff barriers or public subsidies rather than monetary issues. Even so, the institutional design of Bretton Woods left the US with few options for devaluing its currency. The US was a passive player when it came to exchange rates. As the reserve currency, other countries pegged to the dollar and manipulated their exchange rates accordingly due to current

20 Ibid. p.135
account imbalances or other variables. It is true that a rise in the dollar price of gold would have effectively amounted to a devaluation, but politically this possibility never gained much traction. For reasons noted previously, devaluations were politically embarrassing for most governments, and the US was no different. Furthermore the US President, even if he had wished to alter the gold to dollar parity, was unable to act on his own because a change would have required Congressional approval.\textsuperscript{22}

So in fact many of the domestic economic policies implemented by the Nixon administration, even though their inflationary effects would prove the undoing of the Bretton Woods regime, were taken without reference to international monetary issues. This is not to say that Administration officials were unaware of the possible implications of their domestic economic policies, but they were encouraged by Nixon to put domestic considerations first. Moreover, while the US did act unilaterally in closing the gold window, it was a hardly a well planned, pre-emptive act. By the time Nixon reached the decision, in August 1971, to end gold convertibility, it was largely a fait accompli, as market forces and the imminent threat of a run on US gold stocks made it the only plausible policy option.

That US policy was largely a reaction to external market forces is borne out by the example of the policy recommendations of the so-called Volker

\textsuperscript{22} Gowa p.128
Group in June, 1969. Paul Volker was the under-secretary for monetary affairs at the Treasury and had convened a sort of task force in 1969 to present monetary policy options for the President going forward. The group presented three policy options and presented a recommendation to the President: The US could either unilaterally devalue the dollar by raising the price of its conversion into gold; unilaterally suspend convertibility of the dollar into gold; or adopt a “multilateral” approach that would seek to solve the persistent US balance of payments deficit through a combination of negotiated revaluations of certain European currencies and the Yen, the creation of Special Drawing Rights at the IMF to increase international liquidity, and the negotiated reduction of trade barriers harmful to US exports.

The Volker Group recommended, and President Nixon accepted, the latter option, which not only did nothing to address the underlying causes of the US balance of payments deficit, but also was the only viable policy option of the three at that time. The decision amounted, in effect, to doing nothing and waiting for the other shoe to drop. The first two policy options were non-starters, or “straw men,” in Gowa’s words. While the multilateral approach did not address the underlying structural issues that accounted for the balance of payments problem and the imminent conversion crisis – US government...

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23 Gowa. p.129-30
24 Ibid. p.128
spending. Neither President Nixon nor his main economic policy advisors ever seriously considered restraining domestic spending or seeking price stability as a matter of national policy. At the same time, they were not contemplating any preemptive US attack on the Bretton Woods regime, or for that matter any fundamental changes in its structure. Only when the overhang of US dollar liabilities relative to its gold stock threatened a run on the dollar did the Nixon administration act (by May 1971, official dollar holdings stood at $18.5 billion, while US gold reserves had fallen to under $10 billion at the $35 per ounce rate\textsuperscript{25}). In other words, only when international commitments threatened domestic economic policies did the President decide to act unilaterally and close the gold window.

Push finally came to shove in early August 1971 when the British and French began converting some of their dollars into gold at the US Treasury. Some $800 million dollars were exchanged over the course of a couple of days and further conversions seemed inevitable. Confidence in the ability of the US to uphold the convertibility of the dollar into gold had deteriorated to the point of no return. When the British asked the US on August 13 to guarantee their dollar holdings at the prevailing dollar-sterling parity the implication was clear: a run on the dollar was imminent\textsuperscript{26}.

\textsuperscript{25} See Strange p.202
\textsuperscript{26} See Gowa p.148-49
On August 15 President Nixon addressed the nation to explain his “New Economic Policy.” First, and most importantly from the standpoint of this paper, the US Treasury would no longer convert dollars into gold. Additionally, Nixon announced a 90 day freeze on wages and prices, a collection of tax and spending cuts, and a 10% surcharge on merchandise imports into the US\textsuperscript{27}. The immediate effect of the change was to prevent the exhaustion of US gold stocks. But the underlying goal was a massive devaluation of the dollar by forcing foreign holders of dollars to sell their holdings at whatever the market would bear, rather than being able to convert them into gold. While revaluations of the European and Japanese currencies were modest at first (they rose on average by roughly 8% in the first four months after the end of convertibility, due largely to massive central bank intervention buying dollars in the exchange markets). Extended negotiations between the US and the major industrial powers yielded no new agreements on a new international monetary regime, and by early 1973, most major economies had bit the bullet and floated their currencies. The Bretton Woods regime was dead.

Implications for International Relations Theory

This study has argued that economic policy makers are driven primarily by domestic considerations when it comes to setting the goals and guidelines of

\textsuperscript{27} Strange p.204
monetary and fiscal policies. International power relations, which in this case manifest themselves in the relative importance given to maintaining the international monetary regime known as Bretton Woods, were simply not the main priority for US policy makers. In fact, they seemed to resent the obligations that the Bretton Woods regime conferred upon them, and never seriously considered pursuing price stability as the overarching goal of domestic monetary and fiscal policy. But while the interests of US economic allies could be relatively easily dismissed, the reality of market forces could not be ignored forever.

Sooner or later, the “impossible trinity” of pegged exchange rates, free capital mobility, and autonomous monetary policy has to come undone. Financial markets that are not constrained by ironclad restrictions on capital movements will just not tolerate a persistent current account deficit over the long term. Whether US policy makers believed they could maintain inflationary domestic economic policies and the Bretton Woods regime forever is unclear. It seems more likely that they just didn’t care. Domestic considerations came first, and if that meant the collapse of the international monetary order, then so be it. By the same token, the intricacies of international monetary relations broadly and those of the Bretton Woods regime specifically did not arouse the ire of US Presidents or most policy makers in any significant way. As long as Bretton Woods survived, the Americans were mostly content to let it be. Only when the
strength of financial markets had grown serious enough to make the international monetary commitments of the US a threat to its domestic policy autonomy did the US act. This should not be surprising. Given a choice between shoring up domestic political support or maintaining a technical and confusing international monetary regime, President Nixon chose the former.

But whether or not US policy makers underestimated the growing strength and influence of international financial markets is almost beside the point. The real challenge is to integrate financial markets into I.R. theories as powerful, autonomous actors in their own right. Realists may object that financial corporations and markets are merely the progeny of their respective national homelands, but this does not seem to be the case. Financial markets have interests of their own and increasingly the means with which to pursue those interests. Markets constrain the ability of policy makers to manage their domestic economies. It is misleading to bundle the influences of markets on international relations away into a mere error term. They are more important than that, and should be given the theoretical respect they deserve.

Another important explanatory variable that seems to be at work here is the role of ideology. Just as the founders of the Bretton Woods regime were driven in part by the lessons they had learned from the collapse of the interwar gold standard, so too was the Nixon administration more ready to abandon Bretton Woods because of the ideological leanings of its members. Especially
with the benefit of hindsight, an international monetary system of freely floating currencies appears consistent with the overall goals of US policy and its commitments to a liberal international economic order. International trade and investment has not been hurt by the demise of Bretton Woods, and has in fact accelerated in the years since.

Indeed, the closing of the gold window seems to foreshadow the economic “revolutions” carried out by Margaret Thatcher and Ronald Reagan in the early 1980’s (not to mention the revolutions in Eastern Europe and the Soviet Union, or the opening of China). Government regulation has, in most areas, been declining steadily since the 1980’s and the Keynesian economic policies that inspired Bretton Woods have given way to neo-liberal theories that celebrate the efficiency of markets. In a policy area that is so technical and remote from popular attention and partisan conflict, as monetary policy is, ideology must be considered a crucial explanatory variable. Neither interest groups, nor bureaucratic factors, nor balance of power analyses provide plausible or satisfactory causal mechanisms that can explain the actions of policy makers.

To sum up, the closing of the gold window and the collapse of the Bretton Woods international monetary regime can be explained by a combination of factors. First and foremost, the most important single cause of currency crisis facing the Nixon Administration was the basic policy
predicament imposed by the trilemma. The US was running a pegged exchange rate during a time of increasing international capital mobility and deteriorating domestic macroeconomic fundamentals. As efforts to control international capital mobility had failed (as the growth of the Eurodollar market attests), Nixon was thus faced with a choice between defending the peg and sacrificing domestic monetary policy autonomy, or abandoning the peg in order to focus on domestic economic issues. Second, international financial markets and capital flows, and not foreign states, proved to be the main constraining feature that forced the hand of the Nixon administration and forced them to act. International hegemon or not, the interests of international financial markets could not be ignored by the US, as capital flows had become sufficiently large to threaten the stability of the exchange rate regime. The inability of the US to control capital flows made the policy options open to the Administration clear: either defend the peg or abandon it. Third, domestic level political factors were the primary concern of US policy makers. Because of the nature of the domestic US economy, domestic policy autonomy was valued over maintaining the pegged exchange rate.

In this particular case, a couple of other causal factors contributed to the final outcome. These factors are largely case-specific and will not necessarily explain exchange rate regime choice in other settings, but nonetheless are worth mentioning: Flaws in the institutional design of Bretton Woods led to instability
that was intensified and exploited by market forces – highlighting the role this systemic-level variable can play. Next, the policies undertaken by the Nixon administration can best be understood by integrating ideological factors into the analysis. Like international capital flows, ideological considerations serve as a constraint on policy makers and limits the range of acceptable policies that are open to policy makers. Finally, unilateral action on the part of US Presidents will occur when international commitments threaten their domestic political support.
IV. Expanding EMU into Eastern Europe

In May 2004, ten countries from eastern and central Europe officially joined the European Union, ushering in a new era for the EU, and quickening the pace of economic convergence among the nations of the continent. Unfortunately, the process of convergence will bring with it a host of problems for both the accession countries and the current members of the EU. One of the toughest challenges facing the EU is that of extending the Eurozone eastward to encompass the new members of the union.

The adoption of the single currency by the accession countries (and indeed the creation of the Euro in the first place) is motivated by their membership in the common market of the EU. Once they enter the common market, all trade barriers and capital controls will be removed. Their industries will thus be exposed to great competitive pressures from (often more advanced) western companies. At the same time, the accession countries’ currencies will likely be appreciating against the Euro due to the so-called convergence play (more about which later), making their domestic industries even less competitive. Faced with these pressures, two possible domestic political reactions are possible: On the one hand, there could be calls for a competitive devaluation to help restore competitiveness. On the other, calls for the resumption of import protection and trade barriers could arise. Thus, to
safeguard the benefits of membership in the single market, and to avoid a series of competitive devaluations, the accession countries have an interest in joining the Eurozone as soon as possible\textsuperscript{28}.

But the current plan, which calls for gradual adoption of the single currency by the accession countries, is likely to run smack into the wall of the trilemma, thus triggering destructive economic and political crises. Because the requirements for joining the EU explicitly call for the removal of all capital controls (not just for EU member states, but third-party countries as well), and a two year interim stage in the reborn exchange rate mechanism (ERM 2), the accession countries will be attempting to peg their currencies to the Euro without benefit of control over capital flows, and with their monetary policies constrained by the convergence criteria. Something will have to give.

In this case, the choice for the accession countries is clear: Faced with the constraints imposed by the trilemma and free capital mobility, policy makers look to domestic political considerations to make their exchange rate regime choice. In contrast to the US case under the Nixon Administration, domestic monetary policy autonomy is deemed much less important to the accession countries than the benefits of joining the EU and the Eurozone. Not only does international trade account for a larger proportion of GDP in (most of) the

\textsuperscript{28} See Eichengreen, “European Monetary Unification,” in The Journal of Economic Literature Vol. XXXI, September 1993, p 1328-1331 for a more detailed explanation of this argument as it applies to the creation of the single currency.
accession countries compared to the US, but the benefits of joining the single
to market far outweigh the loss of domestic monetary policy autonomy. Thus,
policy makers will either choose to defend the ERM 2 peg at all costs, or, in
extremis, they will choose to unilaterally adopt the Euro without prior ECB
approval.

**Background: Institutions and Policy Guidelines**

While the new EU members will not immediately join the single
currency, all ten are eventually expected to do so, as none of them negotiated
any opt-out of the Euro (as did, for example, Great Britain) prior to accession.
However, due to the differences in the economic and institutional development
of the accession countries, it is also assumed that they will not all join the Euro
at the same time. There are three stages facing the accession countries as they
integrate more closely with the rest of Europe.

The first stage, joining the EU, has been completed. The ten accession
countries have met the Copenhagen criteria for EU membership - which
comprise not just political considerations like democracy, respect for human
rights, and the ability to implement the acquis communautaire (the body of EU
law), but also economic criteria. These include a functioning market economy
and the ability to withstand competition and market forces from the EU. The
pre-accession phase thus involved the liberalization of all prices and trade, the
creation of a legal system that can enforce private property and other rights, the
development of a reasonably strong financial sector with the associated
regulatory institutions, and crucially, the elimination of all capital controls.
Now they have formally joined the EU, Title 7 of the European Treaty requires
the new members to consider their economic policies, including monetary
policies, to be subject to the common concerns and interests of all the EU
member states. Thus, not only must they cease offering cheap credit to their
publicly owned industries, the clause also rules out any competitive devaluations
on the part of the new member states²⁹.

The second stage for the accession countries, now that they have
officially joined the EU, is preparing for the adoption of the Euro. The key facts
concerning the current operation of the single currency and its membership
requirements are as follows: The Maastricht Treaty set the guidelines for the
institutional structures supporting the Euro, including the establishment of the
European Central Bank (ECB) and its main policy guidelines. The governing
council of the ECB is made up of the six executive board members of the ECB
along with the 11 (current) governors of the constituent national central banks.
The primary policy objective of the ECB is to maintain price stability in the
Eurozone, which explicitly involves setting inflation targets. Currently, the

²⁹ Begg, Eichengreen, Halpern, von Hagen & Wyplosz, CEPR Policy Paper # 10 “Sustainable
ECB target is to maintain an annual inflation rate of below 2%, but the specific inflation target is left to the discretion of the ECB, and is not enshrined in any treaty\(^\text{30}\).

Apart from the rules covering the ECB, the Maastricht Treaty also laid out the economic criteria for membership in EMU – these criteria will apply to the new accession countries as well as the current members of the Eurozone, who have already (mostly) fulfilled the criteria. First, sovereign debt rates may not exceed 60% of GDP, and national budget deficits may not exceed 3% of GDP. Second, yields on long-term sovereign debt may not exceed by more than 2% the average long-term interest rates of the three Eurozone members with the lowest inflation rates. Third, annual inflation rates may not exceed by more than 1.5% the average inflation rates of the three best performing countries. Fourth, exchange rates must prove to be stable within a 15% band against the Euro for a two-year period. Finally, candidate countries must enact legislation guaranteeing the independence of their central banks\(^\text{31}\).

Given all this, the second stage facing the accession countries on their way to the single currency is joining the new exchange rate mechanism (ERM 2) for a minimum of two years. Estonia, Lithuania and Slovenia joined ERM 2 in June 2004. Cyprus, Latvia and Malta joined in May 2005, and Slovakia is

\(^{30}\) The Economist “Wobbly Pillars,” 12/19/2002

\(^{31}\) Buiter & Grafe, EBRD, “Anchor, Float or Abandon Ship: Exchange Rate Regimes for the Accession Countries,” 12/01/2002
expected to join shortly. Hungary, Poland and the Czech Republic, the largest economies among the new accession countries, have yet to join, but are expected to do so eventually. ERM 2 entails adopting a “central parity,” through which their currencies are pegged to the Euro (although they will be allowed to fluctuate within a 15% band around the central parity, and revaluations, with the agreement of the ECB, will be permitted if necessary). The parity is set through the joint agreement of the ECB and the relevant country. Joint intervention is a possibility in the event that a currency moves to the extremes of the trading band, but will not occur if the intervention presents a threat to price stability. ERM 2 leaves open a wide range of exchange rate regimes to the accession countries. The ECOFIN Council has explicitly excluded only three types of regime: those without a central parity to the Euro, those with crawling pegs, and those with a peg to a currency other than the Euro. However, it is also believed that unilateral Euroization (which would, in any case, rule out membership in ERM 2) is prohibited under the terms of the accession.32

Prior to joining the EU, the accession countries utilized a wide range of exchange rate regimes. The Czech Republic, Poland, the Slovak Republic, and Slovenia all had floating currencies. Bulgaria, Estonia, and Lithuania all had currency boards with hard pegs. Latvia maintained a fixed peg that was not

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backed by a currency board, while Romania ran a crawling band exchange rate regime. Hungary’s intermediate exchange rate regime consists of horizontal bands. Upon accession, Lithuania changed its exchange rate regime to peg to the Euro rather than the current Dollar peg, while Latvia also changed over to the Euro from its old peg to the SDR (an international reserve asset created by the IMF that is valued on the basis of a basket of currencies – the Dollar, Euro, Yen and Pound Sterling). It is unclear exactly what Hungary and Romania will do - it is likely that they will “move to the corners,” after they join the EU. The other countries are expected to maintain their current regimes but adapt them for use in ERM 2.

Finally, once the Maastricht criteria have been met, and the two-year minimum stay in ERM 2 successfully completed, the new member states will join the Eurozone. Unfortunately, it is widely expected that during the two years the new EU member states must spend in ERM 2 they will be at great risk of speculative attacks on their currencies, which could jeopardize their timely accession to the Eurozone.

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33 Ibid. p.18-19
34 Ibid. p.16-18
Challenge: The Trilemma

Given that the requirements of joining the single market explicitly call for the elimination of capital controls, pegging to the Euro, and maintaining price stability, the accession countries will find themselves in the untenable situation of the impossible trinity during ERM 2. To see how this might play out, consider the likely possibility that the accession countries will be experiencing significant inflows of foreign capital (indeed, many, such as the Czech Republic, already have been) during ERM 2, under the so-called “convergence play.” Capital controls will be non-existent, exchange rate flexibility will be severely limited, and interest rates will still be higher than in the Eurozone. This scenario is very attractive to foreign capital, as investors will be able to arbitrage the interest rate differentials without worrying too much about currency risk or being prevented from removing their capital quickly in the event of a crisis.

But massive capital inflows pose a grave risk to the accession countries. First, they will lead to either exchange rate appreciation (a more than 7.5% rise is ruled out because of the peg to the Euro) or inflationary pressures (which despite being the only alternative, would violate the Maastricht criteria - the possible policy responses - massive budget cuts to bring down inflation, would likely be unacceptable politically, while raising interest rates would reduce economic growth and attract still more foreign capital). Second, foreign
investments must be intermediated through the domestic financial industry. But
the level of development of the financial sector in the accession countries is not
yet up to western standards, and massive inflows could lead to a serious
deterioration in the credit quality of banks’ loan books. This, in turn, could lead
to a “bubble,” where inflated asset prices suddenly collapse, leading to
bankruptcies, panic, a banking crisis, and a swift reversal of capital flows\(^{35}\).

In this scenario, the accession countries would find themselves in a
Catch-22. First, consider that even if the above scenario only occurred in one
country, the risk of financial contagion would be high. Next, consider the
possible policy responses of the affected country. In the face of capital outflows,
their currency will come under pressure to devalue – but being committed to
maintain the peg by the Maastricht criteria, they must defend it through some
combination of central bank intervention in the money markets and by jacking
up interest rates. But intervention would entail fiscal costs that would likely
cause the country to violate Maastricht’s budget deficit criteria, while raising
interest rates would (apart from also violating the convergence criteria) destroy a
domestic economy already reeling from the collapse of the bubble.

Of course, the above is a worst-case scenario that is not pre-destined to
occur. However, it highlights the challenges facing the ECB and the accession

\(^{35}\) Begg, Eichengreen, Halpern, von Hagen & Wyplosz, CEPR Policy Paper # 10 “Sustainable
Regimes of Capital Movements in Accession Countries,” December, 2002 p.25-32
states as they cope with enlargement, and raises the possibility of an alternative path to joining the Eurozone – unilateral Euroization on the part of one or more of the accession countries. As noted above, unilateral Euroization is not considered permissible under the terms of the accession agreements. But, faced with a crisis, Euroization could prove the best way out of the trilemma for the new EU member states.

**The Stability & Growth Pact and Credibility**

Either a major currency crisis afflicting one or more of the new member states or the collapse of the Stability & Growth Pact would be a serious blow to the prestige and credibility of the ECB, and would certainly have serious political consequences across the Eurozone. Flexibility is likely to be a virtue when it comes to confronting the demons of the trilemma. Timely central bank interventions in ERM 2 could prove to be enough to manage volatile capital flows, as could selective fudging of the criteria for membership in the Eurozone – as was successfully done in the run up to the Euro’s introduction.

But the fact that national governments retain autonomy over fiscal policies makes closer coordination and oversight of domestic policies all the more essential for the disciplined management of EU economic policy. The Stability & Growth pact addresses this issue, but recently the continued viability of the pact has come into doubt. Initially, it succeeded in reducing deficits in the
Eurozone and paving the way towards monetary union. But it has come under increasing criticism as many European governments struggle to keep their budget deficits under control, and many analysts have argued that the pact is needlessly strict during times of recession, when deficit spending could be used to stimulate demand and economic recovery.

Still, it is widely agreed that some sort of pact is necessary, and the question has become whether this one errs too much on the side of stability rather than growth. One argument is that the long-term sustainability of the debt load is more important than short-term deficits. Unfortunately, so many EU member states had long term debt loads exceeding 60% of GDP that this requirement was fudged in the run up to monetary union. In March 2005, the EU relaxed the rules governing the pact, but given the increasing likelihood that Germany (the strongest proponent of the pact, initially) will be unable to bring its budget deficit in line, further reform of the pact is likely. But it is unclear what the nature of these reforms will be, and in any event, reducing debt burdens will remain a major policy goal of all the EU states in the future.

Going forward, the ECB must ensure that monetary policy decisions reflect the economic conditions of the Eurozone as a whole, despite the fact that asymmetrical economic shocks could lead to varying monetary policy needs.

36 See Pisani-Ferry, European Commission President’s Group of Economic Analysis, “Fiscal Discipline and Policy Coordination: Assessment and Proposals,” May, 2002
among the eleven current member states. Strains have already become evident as some nations, particularly Germany, struggle through tough economic times while others, like Ireland and Finland, are worrying about inflationary pressures after years of strong economic growth. The lack of labor mobility within the Eurozone accentuates national differences and makes creating a unitary monetary policy all the more difficult. Furthermore, as increasing intra-Europe trade drives further specialization, the risks of asymmetrical shocks increases, making an economic crisis with large political implications all the more likely. How the ECB responds to the first big crisis of this sort will be a big test of its credibility and whether it has become a truly European institution.

The ECB will also need to reform its own governance structure to handle the enlargement. The presence of the governors of the national central banks on the ECB’s governing council could forestall the ECB’s evolution into an autonomous European institution, and will likely prove unwieldy with the inclusion of up to ten new members in the Eurozone. Still, it is unclear at this point exactly what steps will be taken to reform the governance structure of the ECB going forward.

The point here is that the economic forces behind the trilemma will force policy makers to make some distinctly political decisions. If an accession country unilaterally adopts the Euro, should they be given a seat on the governing council of the ECB? Should monetary policy in the accession
countries be devoted solely to defending the peg, or does there come a point when saving the domestic economy is more important? Should the Maastricht criteria be fudged in order to ensure accession to the Eurozone? Should the Stability & Growth Pact be shelved? Could temporary capital controls be allowed in order to preserve the peg and a prudent monetary policy?

Given our contention that the key causal factor behind the adoption of the single currency was to preserve the benefits of the common market by preserving exchange rate stability and avoiding competitive devaluations, the logical answer to the above questions is that policy decisions will focus on safeguarding and defending the common market. Thus, Euroization will be preferred over dropping out of ERM 2 and devaluing (and hence, the offending member will be given a seat at the table). A monetary policy that defends the peg will be preferred to either protecting the domestic economy or conforming to the Maastricht criteria. Fudging the criteria will be allowed if necessary. But capital controls will never, ever be allowed to return.

So despite the fact that European policy makers will come to different conclusions that their counterparts in the Nixon Administration did thirty years ago, the process of exchange rate regime choice is the same. First, they are confronted with the basic policy predicament imposed by the trilemma. Second, free capital mobility among EU members further limits the options open to policy makers who are already operating under the conditions imposed by the
trilemma. Finally, as exchange rate regime choice is ultimately a political
decision to be made by national governments, the choice to peg or “abandon
ship” and float is made on the basis of domestic political considerations. In the
accession countries, due to the importance of international trade and
membership in the EU, policy makers will choose a hard peg (or monetary
union) over domestic monetary policy autonomy.
V. Conclusion

In closing, the process of exchange rate regime choice is determined by three main factors: First, policy makers are faced with the structural constraints imposed by the so-called trilemma – the inability to maintain the combination of a fixed exchange rate, free capital mobility, and a monetary policy oriented toward domestic needs. Second, the continuing growth of deep, liquid financial markets and institutions, along with rising international trade and investment, has made international capital flows increasingly hard to regulate. Given the constraints imposed by the trilemma, the difficulties in imposing and maintaining capital controls further limit the range of policy options available to governments. Third, domestic political considerations – primarily interest group pressure to orient monetary policy towards specific domestic goals like full employment, inflation rate targeting, or exchange rate stability – cause policy makers to respond to the constraints imposed by the trilemma in predictable ways. In our case studies, we have shown why the US and Europe have chosen to respond the constraints imposed by the trilemma differently – their respective electorates have distinct economic interests, and their choice of exchange rate regimes reflects those interests.
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Vita

Ben Carliner is the Director of Research at the Economic Strategy Institute. Prior to joining ESI, Mr. Carliner worked as a financial journalist in New York for Project Finance International. Mr. Carliner was previously the founder and Editorial Director of a new media company, DigitalUpside, Inc., a major music portal and application service provider on the Internet. Mr. Carliner has also worked for Barron's Business and Financial Weekly and WBAI Radio in New York.

Mr. Carliner holds a B.A. from the University of Wisconsin-Madison and an M.A. in International Political Economy and Public Policy from the University of Texas-Austin.