International Political Economy
In Historical Perspective

LECTURE NOTES

Massimo M. Beber

DRAFT VERSION (December 2011): comments welcome, not for quotation

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1 Introduction

1.1 Course aim and objectives
This course introduces its participants to the debate on the economic roles of the state in the global age. Over the course of our twelve contact hours, the argument is developed in four successive stages:

- a non-technical introduction to “public economics” – the study of the economic roles of the state in a society where markets play a major role in co-ordinating production, and more generally in delivering the material welfare of that society;
- a historical overview of the political economy of the 1950-1973 “Golden Age” of fast economic growth and full employment, whose institutions still dominate, for good or ill, the economic landscape of the advanced capitalist countries of Europe and North America;
- a analysis of the collapse of the post-war consensus, focussing specifically on the relative importance of domestic and external factors;
- a case study, reviewing the policy responses to financial globalisation. This is an especially interesting area of public policy which is both central to the workings of a market economy, and which has experienced a particularly fast process of internationalisation: since late 2007, of course, it has also been the highly contested topic of an intellectual battle between eulogists and critics of free enterprise and light-touch public regulation in financial markets.

1.2 Course materials and examination format
The choice of course materials and of examination format must balance a number of different priorities; this is always the case, but the trade-offs are especially important in a case of a graduate course such as the M.St.: its multidisciplinary audience brings to the discussion a wealth of relevant perspectives and experiences, but also in many cases limited familiarity with the economists’ specialist language of algebra and numbers; and distance learning puts a special emphasis on the availability of study materials on-line, and on a clear structure of the course so that individual readings can be placed in the correct context without the assistance of supervisions. Additionally, it is important to avoid information overload in a very intensive course run to a very
compressed timetable; at the same time, it is also crucial to fulfil a fundamental educational requirement of a graduate course, namely to develop your skills in handling vast amounts of information, and assessing the value of contradictory pieces of evidence and lines of argument. To ease these trade-offs,

- All readings necessary for this module will be made available on-line; where this is not possible (e.g. because doing so would not be permissible under copyright rules) the relevant argument will be summarized in these Notes.
- Powerpoint presentations (mostly charts and graphs) will be made available on the module homepage: their essential use will be to make available data (charts, tables, diagrams) which can be cross-referenced both to the Lecture Notes, and to the original sources.
- Additionally, a final list of essay questions for the final examination paper for this course has been distributed, so as to allow you to focus your readings and preparation.
- While these arrangements should minimize exam anxiety, I shall nevertheless offer additional reading suggestions both in these Notes and in the lectures. I hope that many of you will want to consult these additional “non-examinable” sources, at least for those aspects of the course in which they have a special interest.

1.3 Markets, public policy, and globalisation: an overview

What creates the “wealth of nations”? This has been the central issue of economic discourse, ever since Adam Smith demolished the Mercantilistic misconception that national wealth consisted of the gold accumulated through trade and conquest, and re-defined it as the output of the national economy. Indeed, the development of economics as a scholarly discipline has been interpreted as intellectual progress towards a logically rigorous demonstration of Adam Smith’s "invisible hand" - the claim, first made by the Scottish philosopher and founder of political economy, that spontaneous co-ordination of individual economic efforts through a system of markets would result in the most socially desirable outcome.
To argue that market co-ordination is indispensable to the wealth of nations does not, however, imply that markets are a sufficient and self-sustaining technology for the co-ordination of economic interactions. From the outset, it was recognized that markets may fail, resulting in suboptimal outcomes, or in outright break down (missing markets): this provided a rationale for non-market co-ordination. In principle, a number of institutions could and do fulfil this role - from clubs, to social capital, to many other dimensions of "civil society"; for that matter, the large scale enterprise, which is the central organisational form of contemporary capitalism, achieves internal co-ordination by the “visible hand” of management and by hierarchical structures. Markets, therefore, are “instituted processes”, and the nation state has been, since industrialisation, a major player in the creation of the institutional “embedding structures” of market activity. Over the last three decades, however, the economic role of the state has been the subject of extensive critical re-examinations. Some strands in the debate – such as public choice theory, or the limits to government action in an environment characterised by “rational expectations” in the private sector – concern the proper role of government in society, regardless of the degree of openness of that society towards the outside world. Many of the core themes of this critique were incubated during the 1950s and 1960s in the work of libertarian think tanks such as the Mount Pelerin Society, originally inspired by the ideas of Schumpeter, Hayek, and Mises: in the 1980s, this critique of the economic role of the state was translated into neo-liberal political strategies, focussed on “rolling back the frontiers of the state”: To the (limited) extent that liberalisation of cross-border activities played a role in this discourse, it was typically as a wilful national choice, which may facilitate the break-up of entrenched domestic interests (e.g. monopolies by domestic producers).

There is little doubt, however, that globalisation has played a major causal role in many analyses of the decline of national economic management. This view is exemplified by the New Democrats behind the US administration of Bill Clinton in the 1990s, by Britain’s New Labour project, and by successive policy recommendations of bodies such as the OECD and the EU: the common theme is that there is no alternative to a number of awkward reforms of institutions and policies, which globalisation has rendered both obsolete and unsustainable.

Historically, a major role in framing and in modifying market processes has been played by the nation state, which had broadly established itself as the dominant form of social organisation in Europe when the 18th century "market revolution" began: indeed, the market revolution spread from cities to entire societies in the aftermath of the consolidation of a system of nation states. “Public” action in the economic field came to be synonymous with “government policy”. The study of the economic roles of the nation states became known as "public economics"; in this course, the term is extended to include the realm of macroeconomic policy, which has been a major area of governmental responsibility since the late 1930's.
In the aftermath of the second world war, the political economy of the Golden Age (1950-1973) consisted of a very specific settlement between major organized interests in the rich countries: mass economic security was underwritten by public action (the welfare state; the commitment to macroeconomic management for full employment) and financed by the resources made available throughout the system by progressive trade liberalisation and by convergence of European (and Japanese) living standards towards the American level. At least in the minds of the policy-makers, markets were tools used within a framework of social consensus – they did not constrain that consensus, which indeed included a number of severe limitations to market freedom (not least in the regulation of financial institutions).

The Golden Age was built upon a foundation of international public policy, of course: quite apart from the system of the United Nations, whose institutions lie outside the scope of these lectures, it included the International Monetary Fund, the General Agreement on Tariffs and Trade, and the International Bank for Reconstruction and Development (World Bank). These were the three original International Financial Institutions (IFI’s) envisaged at the 1944 Bretton Woods Conference as the policy-making bodies for exchange rates, trade, and capital movements respectively. The resulting international political economy was defined by the strong economic ambitions by national governments (full employment, fast growth, a high degree of economic equality and social security), pursued within a relatively co-operative international context.

This “national management of the international economy” was a temporarily successful, but ultimately fragile equilibrium, which began coming under increasing strain as differential productivity growth rates, and growing inflationary pressures, made it difficult to reconcile internal balance (full employment and reasonable price stability) and external balance (current account equilibrium, which was essential in a situation of very limited capital mobility). Two successive oil shocks in the 1970’s, as well as changes in American monetary policy and in global productivity trends, resulted in a much more loosely organized international financial architecture, which appeared so counter-intuitive and undesirable to many observers to be dubbed the post-Bretton Woods “non-system”.

If the crisis of the 1970’s had largely been one of the rich Western economies, with commodity producers playing the role of detonators, since the 1980’s the international context of public policy has been further transformed by “globalisation” – an increase
in cross-border economic activities (trade, production, lending, investment, and increasingly migration) involving distances, numbers of actors, and differences in costs and efficiency levels, on a massive scale.

How does globalisation affect the practice and the theory of public policy? Specifically, have external economic pressures really been more fundamental in the redefinition of the economic role of the state than the “shifting involvements” of affluent societies away from the collective insurance mechanisms of the welfare state, and towards greater individual choice? By examining the pressures on selected national economic policies, these lectures will clarify the relative importance of different factors in the emergence of several distinct political economies, from neoliberalism to the “Third Way”.

As noted above, the "national management of the international economy" had clearly been eroded by the growth in international economic integration, well before the large developing countries of the world (above all the “BRICS” – Brazil, Russia, India, and China) began playing a significant role. The initial symptoms of a crisis in the Bretton Woods settlement had included everybody’s dissatisfaction with the role of the US dollar as the anchor currency; the recurrent balance of payments difficulties of countries with slower-than-average productivity growth, notably the United Kingdom; pressures on social consensus in countries with militant labour movements, such as France and Italy; and a growing feeling that somebody, somewhere, was “overtaking” us – the defi Americaine, and later Japan’s rise as a major exporter.

After an initial phase of inertia (epitomised by the "Eurosclerosis" of the late 1970’s), the perceived failures of traditional policy instruments have elicited three broad intellectual responses. The first response, neo-liberalism, did not depend fundamentally on the openness of the economy: its main argument was about the danger posed by big government to individual freedom, and its analytical foundations had been developed by scholars such as Hayek, Schumpeter, von Mises, and later Milton Friedman, in response to the much expanded economic ambitions of national governments in the aftermath of the Great Depression. At the same time, a later generation of neo-liberals welcomed the restraint imposed by globalisation on the controlling ambitions of national governments: in their view, competition between national jurisdictions would empower economic agents - whether firms, workers, or consumers - by giving them choices: firms could locate in jurisdictions offering a more business-friendly package of laws and regulatory regime, tax-payers would to an
increasing extent be able to protect their savings from “predatory” taxation, and so on. In its export version, promoted throughout the late 1980’s and 1990’s, the neo-liberal vision of the economic role of the State became known as the “Washington Consensus”.

A second policy strategy - the "Third Way" - promoted policy innovation as a way to pursue fundamentally unchanged - broadly social-democratic - objectives in a changed socio-economic environment. Here, globalisation does constrain how social objectives are pursued through policy: yet the choice of these objectives remains, at least in principle, relatively free. Thus, for example, “security for all” is still a defining dimension of the public interest, which government must pursue: but the policy instruments to achieve it can no longer include trade protection or the public ownership of selected industries to guarantee “employment”: these have been superseded by active labour market policies and “employability”. The Third Way thus retains an emphasis on the national level of policy-making.

Finally, regionalism – especially in its intensely institutionalised European version – has stressed the need to assign policy competencies to super-national institutions, when this was required by reasons of "scale and external effects" (the subsidiarity principle). It is significant, in this regard, that Gordon Brown, the dominant figure from the outset in the economic policy-making of New Labour, will be much more robustly Euro-sceptic than Tony Blair; and that he has chosen traditional economic diplomacy mechanisms to tackle global poverty. As later chapters will show, the relationship between Third Way and European regionalism in particular is a complex one: while the Commission would stress the reasons of “scale and effect” justifying a major and growing role for the Union’s institutions, the welfare systems of Europe are still fundamentally systems of national welfare, suggesting that there may be relatively narrow scope for joint policy-making in a number of key areas.

These three perspectives frame the current debate on "global governance". In analysing this debate, the course aims to equip participants with a critical understanding of the following issues:

- "market efficiency" and "market failure", with reference to fundamental categories of "individual choice" and "social co-ordination", "production" and "scarcity";
• the "market as an instituted process", with particular reference to the economic roles of the nation state;
• the political economy of the 1945-1973 "Golden Age", including both the objectives of policy in the economic sphere, and the public economic institutions and instruments used to pursue those objectives;
• the reasons for the crisis of the social and economic model of the Golden Age, with specific consideration for the relative importance of changes in the economic environment (de-industrialisation and globalisation), and political economic changes ("shifting involvements") in the public and private sphere;
• policy responses to the crisis of the "national government of the international economy", with particular reference to financial regulation and supervision, a crucial dimension of public governance in which the "optimal policy area" increasingly exceeds the jurisdiction of the nation state.

The final part of this course attempts to cast light on this debate by examining public policy-making in a crucial area – the regulation and supervision of financial activity. The analysis of international financial regulation, which constitutes the empirical core of this course, suggests the importance – as well as the several difficulties – of transferring the competence for policy-making to public institutions whose jurisdiction coincides with the integrated market. European regionalism may only provide a special and imperfect case of such multi-level governance; yet it offers greater promise for the successful management of globalisation, than either neoliberal laissez-faire, or Third Way policy-unilateralism.
2 The Invisible Hand: Scarcity, Production, and Co-ordination

Our discussion of the role of “public” intervention in the economic field must begin with a review, however brief, of the basic principles and concepts used in the analysis of economic activity.

| Pivotal Ideas and Methodological Outlooks in Economics: a Classification |
|-----------------|-----------------|
| **Scarcity**    | **Production**  |
| **Choice**      | Homoeconomicus; | General Equilibrium |
|                 | Robinson Crusoe or the | Theory; |
|                 | “representative agent” | Welfare Economics |
| **Co-ordination** | Game Theory; | Political Economy |
|                 | Public Economics | |

In the table above, two pairs of fundamental concepts are used to offer a classification of different economic discourses.

2.1 Choice and Co-ordination

The fundamental claim of economics concerns the value of a system of property rights and markets as a way to organize the innumerable individual efforts by society’s members to ensure the material necessities and luxuries of material well-being. Adam Smith established this claim, while comparing the relatively free and relatively wealthy society in which he lived with the more dirigiste and rather less successful approach to commerce and industry prevalent in other countries, such as France. How did English freedom, and its citizens’ ability to pursue their perceived self-interest, he asked, resulted in wealth rather than anarchy? His answer was given in one of the most famous quotations in the history of economic thought:

*It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.*
Much later, the Cambridge economist Dennis Robertson pointed out that efficient markets did not prevent individuals from being altruistic and caring – but they did reduce the demand for such selflessness by giving every member of society a fair chance to look after themselves and their families: markets “economized on love”.

The rational choice perspective does not require economics to be a *social* study: Lionel Robbins’ canonical definition of economics as “the study of the optimal allocation of scarce resources with alternative possible uses” typifies an understanding of the subject, which puts individual rationality, rather than social interaction, at the centre of the economist’s attention. Robinson Crusoe on his desert island, and - less poetically - the “representative agent” of many contemporary economic models, faced a series of problems of optimal allocation of resources. He must determine how much of the day to devote to work and leisure respectively, which combination of goods to consume today, and how much of today’s income to save for the future; each of these decisions must take into account the “state of the world” (exogenous shocks) which may alter the payoffs available from different activities (there isn’t much point in a fishing trip during a sea storm, for example). One problem, which Crusoe does not have to deal with, is how to co-ordinate his economic efforts with those of other individuals: there is nobody else on the island. In the more rigorous if less memorable case of the “representative agent” of modern economic theory, all necessary information about the rest of society is incorporated in the set of equilibrium prices, at which the representative agent can buy and sell. These “signals” of relative scarcity are said to guide our choices from investment (graduate salaries are up - ASERI master or a straight graduate job?) to consumption (petrol price is up - bicycle or car?): crucially, as long as information about all products and services traded in the market is complete and equally available to all (“symmetric”), the price system cuts out all need for costly bi-lateral interactions, for expensive long legal contracts, etc.

This is clearly an over-simplification, and we pointed out in the lectures that a major criticism of this impersonal market co-ordination approach has focussed on the fact that information is often incomplete, difficult to process, and differentially available to buyer and seller: you would not buy the cheapest second-hand car available without a lot of additional information, and an employer will not hire the cheapest person for the job: indeed, Joseph Stiglitz’s Nobel Prize in economics was awarded precisely for his work on the “causes and consequences of the dependence of quality upon price”,
which undermines the very notion of prices as sufficient signals for efficient economic transactions.

A different criticism of the “rational choice” approach was voiced by one of the students during the lecture, pointing out that some purchases are “emotional” rather than rational. There was some discussion whether tee-shirts or cars were a better example of an emotional purchase; and we also pointed out that “behavioural finance” is a whole field of research devoted to investigating the hypothesis that activity in financial markets may in fact be explained to a significant extent by complex psychological mechanisms including the pursuit of risk for its own sake and herd behaviour, rather than purely profit-seeking, motives. This latter point, incidentally, has important implications for public policy towards the financial sector, and for financial regulation in particular, and will be discussed in more detail in the final part of the course.

It is important to note that many scholars, who stressed the desirable characteristics of market co-ordination, also developed a “liberal” political argument in favour of minimal government intervention. There was an element of this already in Adam Smith, who envisaged the gradual spread of market activity as a progressive trend leading society towards a final “state of perfect liberty”, in which the agenda of the political ruler had shrunk to little more that the protection of property, the enforcement of law and order, and the amelioration of limited instances of market failure. It was in the works of 20th century economists such as Friedrich from Hayek (The Road to Serfdom), Joseph Schumpeter (Capitalism, Socialism and Democracy) and Milton Friedman (Free to Choose), that the rejection of big government was articulated most forcefully – unsurprisingly maybe, given that some of the tyrannies which these scholars had escaped or their families experienced (from Nazi Germany to Stalinist Russia) had in part justified themselves as public solutions to economic ills. More recently (1986), James Buchanan’s work on “public choice” added stronger analytical foundations to the scepticism of Hayek and others towards public policy: public choice theory stresses that market failure does not automatically justify public policy, because “government failure” is at least as possible – and potentially, at least as damaging – as market failure: politicians are neither saints nor criminals, just individuals trying to make the best for themselves, reacting to incentives like anybody else – except maybe for the very high value the place on the exercise of power: they are, in the jargon, “office-seekers” and will do what’s best for society as a whole only
to the extent that they face incentives compatible with that objective (e.g. a central banker’s “contract”).

2.2 Scarcity and Producibility

The interplay between two distinct lines of research, based on “scarcity” and “production” respectively, runs through the history of economic analysis. The scarcity discourse has focussed on the finite nature of the sources of economic well being: its essential outlook is well summarised by the Physiocrats’ perception that agriculture alone could provide a surplus or net product. Today’s cry of “zero emissions”, as a way to respect a strictly finite environmental safety threshold, can also be interpreted as a manifestation of the “scarcity” perspective.

In contrast, the production perspective has highlighted the role of technical change in releasing previously binding constraints on economic activity. This was clearly the case both in agriculture and in manufacturing, and today it lies at the heart of the environmental strategy of those who, while recognising the impact of economic activity on climate change, argue against Kyoto-style binding emission limits.

Combining the scarcity-production and choice-co-ordination perspectives generates the four-cell table above, and allows us to locate the approach taken here within a context of different varieties of economic discourse.

While the table identifies “general equilibrium theory” as combining an interest in production with the emphasis on individual choice, there is significant doubt that the choice outlook can deliver this.

An interest in co-ordination, coupled with the emphasis on the scarcity of resources, leads to game theory and to the traditional field of welfare and public economics. In the table above, I have chosen to place welfare economics at the junction of the choice and production perspectives, emphasizing its close connection with general equilibrium theory: welfare economics, after all, aims to explore the optimal properties of complex economic systems based on production, as well as exchange. Public economics, in contrast, studies the impact – for good or ill – of the public, non-market institutions of the state, therefore has a more specific focus on the variety of co-ordination mechanisms, by which society operates, and takes the outcomes of private exchange as its starting point.

2.3 “Embedded markets” and the role of social capital

The last cell in the table above identifies “political economy” as the approach combining an emphasis on production, with a methodology which allows for both market- and non-market co-
ordination linkages between individuals and economic organisations. Ever since Adam Smith’s “pin factory” we have known that economic progress (the “wealth of nations”) is ultimately driven by division of labour and technical progress; and ever since Alfred Chandler’s “visible hand” and Oliver Williamson’s emphasis on the interplay of “market and hierarchies”, we have known that the wilful co-ordination of economic effort within firms is as important as the “invisible hand” of atomistic, anonymous market co-ordination. Note that Adam Smith, whose name outside the economic profession is almost exclusively associated with the apotheosis of atomistic, competitive market behaviour (“the invisible hand”) was in fact deeply and increasingly conscious of the embedding role played by other institutions and norms, from those explored in the *Theory of Human Sentiments* to the importance of the law, which was to be the subject of a third, never completed treatise. Just as crucial for our purposes is to note that the intellectual background of classical political economy included the concept of an *international* civil society, as a set of linkages which allowed and facilitated economic activity and social intercourse across national borders. The approach taken in this course is broadly consistent with this international political economy: the focus is on how public intervention plays an integral role in the social sustainability of a system of market co-ordination, and in the interaction of growing cross-border market activity and public policy-making.
There are two good reasons for introducing our discussion of public policy, and international public policy, with a historical overview of the political economy of classical liberalism. The first reason is a pedagogical one – anchoring concepts in historical experience is a very good way to make complex ideas understandable and memorable. The second reason is analytical: the neo-liberalism of the last three decades – the age of “rolling back the frontiers of the state” or, as Paul Krugman put it, “the age of diminished expectations” – found its inspiration and many of its core ideas in the political economy of pre-1914 liberalism.

On the eve of the first World War, classical economic liberalism still provided the basic framework for interpreting and assessing the economic role of the State. Strictly defined, the “Gold Standard” consists only of the international monetary arrangements of that age: in practice – and therefore here too - it is often used as shorthand for the overall architecture of public policy and for the social contract of the “European century” from Napoleon’s defeat at Waterloo (1815) to the outbreak of the Great War in 1914.

Defending the State’s citizens against external aggression and internal lawlessness was a basic pre-requisite of normal social interaction; supplying the appropriate quantity of security, law and order, and those other (few) non-excludable goods and services which were subject to “market failure” provided an accepted justification for the state’s economic presence through taxation and public spending. Measured in terms of either tax or expenditure, the “size” of the typical European State rarely exceeded 10% of national output. Indeed, classical political economists from Adam Smith to John Stuart Mill had implied not just a limited role for the State, but also a shrinking one over time: the State’s agenda would gradually dwindle, as a progressively more sophisticated society took over the co-ordination of wider spheres of activity through its natural, horizontal linkages (sponte acta). In the practice of governments, significant divergences from the picture just presented existed: in most countries, commercial policy had gradually become more protectionist since the 1860s apogee of free trade, whether as part of a strategy of promotion of domestic infant industries, or in response to the agricultural depression since the 1880s. The economic role of the state was gradually emerging in a number of further areas: in
education and in science policies, with the increasing involvement of government in
the funding and provision of primary schooling and university research; in the
introduction of the early elements of a welfare state, again first in Germany under
Bismarck in the last quarter of the nineteenth century. At the theoretical level,
criticism of the liberal position had emerged in the heterodox economic thinking
particularly of Friedrich List and of the German Historical School; yet the economic
role of the state remained limited, and demands for a more central economic role for
government remained, at least outside the Marxist school, limited. In the remainder
of this chapter, each of these key aspects of the political economy of classical
liberalism is examined in some more depth.

3.1 Security and Property Rights, and the State as “Night Watchman”
Market interaction requires a clear allocation of property rights, a reliable framework
of commercial law defining the characteristics of contracts, and a legal and penal
system providing enforcement. Classical economic liberalism recognised this as the
“night watchman” role of the state, which would ensure security and property even as
its citizens slept.
While the protection of property and the legal structure of contracts may appear
obvious, the experience of development (especially since the end of the Cold War)
has provided several pieces of often tragic evidence of the fact that the “night
watchman” role is far from an easy one to fulfil. We only need to remember how
disappointing the early performance of transition economies was, however, to realise
that this public pre-requisite of a market economy is far from trivial: in a number of
post-Soviet countries, as well as in many developing contexts elsewhere, the lack of
the night watchman is a defining characteristic of the “failed state”.
Moreover, it is no longer even possible to think of “failed states” as a finite set of
problem cases which would in due course be resolved, with the appropriate help from
the international community, or maybe from the USA as re-instated hegemon of a
mono-polar order. This may have been the vision which led to unilateral
interventionism from Somalia to Kosovo to Afghanistan, and to the emergence of
“neo-protectorates” as a form of governance. Yet it is far from clear that once the
“age of empire” has ended, the fate of failed states can be rescued by outsiders: rather,
a “strategic gap” of ideas and resources increasingly characterizes surviving attempts to build up civil society and governmental institutions. Finally, it should be noted at this point that classical liberalism did not deal with an issue which has since become much more significant – the essentially political – but economically relevant choice of the assignment of property rights to previously free (i.e. not scarce) goods. Property rights were indeed assigned - from the enclosure of the Scottish commons, to the registration of farming lands in the during the expansion of colonists into the American Far West; but the economic implications of these actions (whether for the efficiency, or for the distributional fairness of the system) were typically not discussed. We shall notice later in the course the importance of this role both domestically (e.g. the auction for 3G mobile telephony bandwidth in the 1990’s, heavily influenced by the British economist Ken Binmore) and even more so internationally, where the ownership of global commons involves major international re-distribution of resources: for example, should carbon permits be allocated internationally according to existing use, or to population (equivalently, should China pay the US or vice-versa in a market-based framework to control climate change)? Does Brazil “own” its rain forests, or the world (and if we believe Brazil does, how can the rest of the world pay Brazil to continue its contribution to bio-diversity as well as to providing a major carbon-sink?)

3.2 Market Failure and the Regulatory State

When prices do not fully reflect the social benefit and cost of a particular economic activity, market will either break down completely (“missing markets”) or result in the “wrong” output and price for the product of the economic activity in question. The lack of property rights is a first obvious case of market failure. In this case, defining ownership clearly is the first task of government: farming and mining concessions in the Far West, and auctions for radio frequencies and 3G bandwidth, and the whole system of patents, are examples of governments allocating property rights.

3.2.1 Public Goods

Public goods are characterised by non-excludability and non-rivalry in consumption: street lighting, parks, defence and security are all characterised by the difficulty to
charge for them, or to exclude those who chose not to pay for their provision from enjoying the benefits. This is another case of market failure, which has historically justified state provision: at the same time, we should note that in specific circumstances and given the appropriate technology, what used to be thought as “public goods” can in effect be privatised, as in the case of the “gated communities” in the United States, where a vast range of amenities and services are rendered excludable, and residents pay for them.

3.2.2 Monopoly
The regulation of monopolies, and more general “competition policy”, refers to the need of forcing producers facing no or limited competition to behave in a way, which approximates the outcome of a market in perfect competition (productive and allocative efficiency). Both these roles of government in the economic sphere had been clearly understood by Adam Smith, and were widely accepted as proper functions of the state throughout the liberal age of the nineteenth century: There were, admittedly, significant different in the emphasis and in the size of government intervention in different areas, reflecting different national characteristics and priorities: for example, the United States – the first economy to witness significant concentration in industry, as the likes of DuPont, Vanderbilt etc. built dominant market positions in industries from chemicals, to steel, to railways, was the first to develop a competition or “anti-trust” policy; Germany, under Bismarck, funded public education and research, effectively recognizing the public good dimension of both general education and science and research Indeed, even the equity or Robin Hood role of the state, discussed in the next paragraph, was recognizable in the early institutions of a welfare state, again to be found in imperial Germany.

3.2.3 Incomplete and asymmetric information
A third category of market failure, which has received increasing attention in the literature following pioneering work by Joseph Stiglitz since the 1960’s, is the consequence of incomplete and asymmetric information. It would be fair to say that this line of enquiry (and its policy implications) really only took off in the aftermath of the rigorous demonstration of the welfare properties of a competitive general equilibrium: a project which had indeed yielded early fruit towards the end of the
classical liberal age in the work of Walras and Pareto, but without significantly affecting the policy debate. The final construction of competitive general equilibrium was due to Frank Hahn and Kenneth Arrow, and became known as “General Equilibrium Theory” – *pace* the strictures of Neo-Keynesian economists such as Edmund Malinvaud. Neither author meant the model to be used as the basis for policy, incidentally: Arrow advocated a public, universal health care system because of the likely failures of private provision given the asymmetric information (and power) between user and provider; and Frank Hahn repeatedly justified his research programme to often sceptical Cambridge colleagues as an prelude – Keynesian in spirit, though rigorous beyond the master’s patience and skills – to a class “micro-founded” model incorporating less general (and therefore more policy-relevant) assumptions. National insurance, which as we shall see was one of the defining institutions of the post-war settlement, provides a good example of a public policy addressing a possible market failure caused by asymmetric information. It is very difficult indeed to purchase private insurance against loss of earnings, whether through illness, accident, or redundancy.

Typically, the buyer of such insurance would know a lot more about his risk in each of these areas, than the insurer. A first negative consequence arises when at the price, which the insurer would charge on the basis of a profit calculation based on the actuarial risk calculations for the population as a whole, only risky applicants would buy the insurance (“adverse selection”). Moreover, the mere fact of having insurance may change the behaviour of the individual, who might for example try less hard to remain in employment, or avoid sporting injuries which may keep them off work (“moral hazard”). By organising a compulsory, universal scheme of insurance for these fundamental individual uncertainties, by “socialising the risk” of illness, accident, redundancy, and old age, national insurance systems were seen by their advocates as ways to improve the efficiency of the economy, rather than charity at the taxpayer’s expense.xiii

We note in passing that the “public choice” critique of market failure, pioneered by the Chicago school of social theory (from George Stigler, to James Buchanan) has been sceptical from the outset about the potential for good of public policy intervention: they typically argue that market failure is not in itself a justification for public policy, given the possibility – likelihood, in their view – of even costlier “public” or bureaucratic failure. If public economics is the study of what
governments could do to rectify market failure, public choice is the analysis of what they typically end up doing, whether through regulatory capture, rent-seeking, etc.

3.3 Fairness: the State as Robin Hood

Finally, the nation state acted to limit the disparities in living standards among its citizens. As Amartya Sen observed, a perfectly competitive economy may be perfectly efficient, but also at the same time “perfectly disgusting”: if the distribution of property rights is extremely unequal, even after markets allow each member of society to “make the best of what they have got” we may still find the outcome, in terms of contrasts of wealth and squalor, morally unacceptable. In fact, the economic theory of classical liberalism provided a powerful argument for major income redistribution: if the aim of public policy is indeed, as utilitarian philosophers such as Jeremy Bentham had argued, “the greatest happiness of the greatest number”; if one person’s happiness is as important as another’s; and if an extra euro of income matters more to the poor than to the millionaire (“diminishing marginal utility of income”), then policy should redistribute income subject only to retaining enough economic incentives for efficient market activity. In practice, liberal political economy kept this aspect of its own doctrine rather quiet; and what redistribution took place was often justified on altogether different grounds – the need to provide sufficient nutritional standards and amenities for physical exercise in childhood to provide fit cohorts of military recruits, for example; or the need to create a literate workforce for the increasingly complex tasks of industrialized production.

In limiting disparities in living standards, the liberal state acted through a combination of progressive taxation (taking a larger percentage of higher incomes, and/or taxing wealth), free-at-point of use provision of a number of basic services (notably health, education, and national insurance), and often subsidised provision of certain utility services (water, electricity, telecommunications). While welfare expenditure was very limited by later standards, it become an established part of public policy especially as revolutionary socialism began to take hold as a working class ideology: German social policy under Chancellor Bismarck has been interpreted as a conscious attempt to defuse the social tensions of industrialisation, binding the growing working class to the State rather than driving away into revolutionary opposition to it.
3.4 “Sound Finance” and the business cycle

Nineteenth century economic liberalism had been founded on the powerful notion that the decentralised co-ordination of economic activity through a system of markets resulted in the most desirable use of society’s material resources and skills over time. Short term departures from optimality were recognised, and provided the basis of trade or business cycle theory; equally, it was understood that changes in circumstances could result in temporary underemployment of resources and/or in some sectors of the economy experiencing recession, while in other demand outstripped capacity. The most fundamental characteristic of a market economy, however, had been encapsulated already in the eighteenth century by Say’s Law, according to which “supply creates its own demand”.

In Say’s Law, and therefore in the liberal understanding of the operation of a market economy, because each good taken to market was intended by its owner to be exchanged for some other good, there could never be a situation in which the market supply as a whole exceeded total demand as a whole. Microeconomic imbalances could of course happen, with some goods being in excess demand and others in excess supply at their current prices: but such sectoral disequilibria would be resolved by a combination of relative price changes and transfers of labour and capital from depressed to booming industries. Macroeconomic imbalances (“too much money chasing too few goods”) would also resolve themselves by variations in the average price level.

In other words, a market system was characterised by powerful natural forces which would tend to reconcile the aggregate supply (income, production) with the aggregate demand (expenditure) at the level which would ensure the full utilisation of available resources (capital, land, labour): persistent situations of generalised over-supply (or equivalently, of insufficient aggregate expenditure) were not possible.

Against this background, the role of public policy consisted in avoiding disruptions to the operation of Say’s Law. The classic form of this disruption was the “debasement of the currency” through the creation of “fiat money” – banknotes not backed by gold reserves, so that the king’s agent “promise to pay the bearer on demand” a particular sum was in fact a lie. In fact, kings had cheated even before the invention of the banknote gave them an easy technology to create money by “running the printing
presses”: in the “age of clipping and filing”, gold and silver coins had been lightened below their legal weight (or indeed, coined in cheaper alloys).

By creating *fiat* money, the king would effectively tax his subjects: their purchasing power was reduced by rising prices, and the king appropriated resources without having to resort to taxation – always unpopular, and in those times also often difficult to administer.

Typically, governments had resorted to inflation either in the emergency of wartime, or as a result of an accumulation of public debt which eventually proved “unsustainable”: once the king ran out of merchants and bankers willing to lend him new money, and even interest on existing loans proved difficult to pay, the temptation to “monetize the debt” increased. This provided the rationale for the fundamental principles of “sound finance”: gold convertibility and balanced budgets.

3.4.1 Gold Convertibility as an “external anchor”

The fundamental guarantee of a predictable balance between output and expenditure was found in using a particular commodity as money; once public monetary institutions such as a Royal Mint and a bank of issue were created, the same guarantee was sought by anchoring *fiat* money to commodity base, so that effectively base metal coins and bank-of-issue banknotes served as convenient certificates of gold ownership. The 1844 Bank Act, which separated an “issue department” from a “banking department” within the Bank of England, is the best known historical example of legislation aimed at achieving monetary predictability by providing credible constraints on the creation of paper money: the Issue Department could only issue banknotes up to a set ratio to its reserves of gold and consolidated government debt; the Lending Department would conduct “normal” banking business with its clients – the commercial banks and the Treasury – without being able to create money, whatever pressures those clients tried to put upon it.

It was on the foundation of this public policy that sterling became the first world currency or “reserve currency” during the 19th century, a period of major international trade and investment expansion.
3.4.2 Balanced budgets
Governments should “live within their means”, by running balanced budgets in peacetime, or even moderate surpluses which would allow it to repay over time the debts accumulated, unavoidably, in wartime: for example, the British crown had accumulated debt equal to over 200% of national income during the Napoleonic wars: that ratio was very gradually reduced over the following century, through a combination of service and repayments of the war debt out of peace-time surpluses and, of course, economic growth.

3.5 International Trade, Finance, and Payments: a “Manchester consensus”
A crucial characteristic of the political economy of classical liberalism was that its prescriptions for the pursuit of national economic interest were also understood to provide a framework for international economic relations. This was in stark contrast to Mercantilism: by identifying the wealth of the state with its reserves of precious metals, and therefore the successful pursuit of wealth with a balance of payments surplus, Mercantilism depicted international relations as a zero-sum game, in which one country’s gain (the external surplus, the accumulation of gold) was another’s loss. Adam Smith identified the “wealth of nations” in the economy’s net product; he also saw that division of labour is at the heart of productivity, and that division of labour is limited by the size of the market. Clearly, if national borders act as a limit to economic activity (and therefore as an obstacle to the international division of labour) they are a limit to the wealth of nations: in this sense, the intuition that free trade across state borders must be good for all involved was already implicit in Smith’s original vision.\textsuperscript{\textit{xiv}} In later analytical developments, this intuition was made more precise in the two concepts of comparative advantage and of the automatic payments adjustment mechanism, each of which carried a clear policy implication: comparative advantage demanded free trade, and the automatic payments adjustment depended upon generalized gold convertibility.

3.5.1 Comparative advantage and free trade.
The basic intuition behind comparative advantage is both powerful and simple. In the international economy, just like inside a household, or in a sports team, it does not make sense for the most capable member to take on all the tasks which he or she can
perform better: rather, each member should contribute what they are “even better” (or “not as worse”) at: a wife who is twice as good as her husband at cooking, but four times as smart at managing the family’s bank accounts, should leave the husband to potter in the kitchen and get on-line to make sure the bills are paid. Assuming that both partners have a set amount of time available for household activities (the “resources” of this particular social economy), the division of labour just described will maximise the joint output which they can enjoy (this may of course include some leisure). In translating this intuition to a context of states trading with one another, the idea that combined or “world” output would be maximised by successful international division of labour is relatively convincing: the political delicacy of free trade arises from three issues, namely

- The transitional disturbances which may be involved in re-structuring the domestic economy: how long are the workers in a country’s internationally uncompetitive (and therefore shrinking) industries going to be unemployed for, before being drawn into the expanding ones? Is permanent damage going to be done to the nation’s skills and social cohesion during the restructuring? Do “infant industries” justify limits to trade liberalisation?
- The need for self-sufficiency even above efficiency in strategic resources which are vital to the defence of the country – armaments, but maybe also food, or energy;
- The distribution of the gains from free trade. Is it really enough to say that if no nations are made worse off by free trade, then all should be in favour of it? One can think of both Realpolitik airiness arguments against it; and the distribution of the gains from trade among countries, industries, classes of workers etc. is extremely complex.

The era of free trade began with the repeal of the Corn Laws (1820??): introduced some two decades earlier, the Corn Laws had provided protection to English agriculture during the period of the Napoleonic wars, when the threat of a successful naval blockade forcing England to capitulate or starve had provided a strong political justification for it. Successive generations of British scholars (from David Ricardo, to the Manchester School of Richard Cobden and others) advocated the removal of obstacles to trade by argument, and successive generations of British statesmen
promoted it in foreign policy, by negotiation or by force. Free trade (with its complement of a convertible gold currency, discussed in the next section) provided the essence of a “development strategy” strongly promoted by the hegemon of the time: during a visit to the newly unified Kingdom of Italy, Richard Cobden lectured Massimo d’Azeglio that “Italy’s coal is her sunshine” – leave manufacturing to us, your comparative advantage is in wine, oranges, and ancient ruins for tourists... The Anglo-French free trade agreement of 1865, known as the Cobden-Chevalier treaty, was the high tide of free trade; yet by the 1880’s two major exceptions to the free trade philosophy had emerged in the commercial policy of Germany and of the United States: in the last three decades of classical liberalism, international trade and investment continued to expand not because of increasing trade liberalisation, but rather in spite of progressively more frequent and more pronounced divergences from it in the practice of many countries: Britain’s unilateral free trade stance became the exception, rather than the norm or the aspiration.

3.5.2 The **automatic** price-specie flow adjustment process and the Gold Standard.

Of the three issues above, only the first one had a clear and unambiguous answer within the international political economy of classical liberalism. This answer is known as the “monetary approach to the balance of payments”, and it provides an open-economy version of the connection between demand (money, expenditure) and supply (production, income). Specifically, the automatic adjustment process would achieve two fundamental results:

- It would “adjust” the balance of payments, so that any deficit would be temporary – a mean to redistribute the world’s supply of money between countries, and therefore to adjust their real exchange rates until balanced trade between them was restored;
- At the same time, it would create the price incentives to achieve structural change, transferring resources from the uncompetitive to the competitive sectors in each country.

To understand the working of the automatic adjustment mechanism, it is helpful to remember the analysis of the quantity theory of money in the closed economy: “too much money” (excess demand) would lead to higher prices, until once again the total
expenditure matched production available. Here, the result merely showed the “neutrality of money” or “classical dichotomy”: money and total expenditure (the nominal variables) had no impact on production and income (the real variables).

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**Monetary Adjustment**

- **CLOSED ECONOMY**
  - $M \rightarrow MV \rightarrow P$ (domestic inflation)

- **OPEN (GOLD STANDARD) ECONOMY**
  - $M \rightarrow MV \rightarrow P$ (domestic inflation)
  - $P \rightarrow Pe/Pw$ (loss of price competitiveness as prices rise above purchasing power parity)
  - $Pe/Pw \rightarrow B \rightarrow R=M$ (trade deficit and “gold drain”)
  - $M \rightarrow MV \rightarrow P$ (domestic deflation back to purchasing power parity)

The first step of the quantity theory remained true in the international economy: a nation could have “too much money” - for example, because its government had plundered central American gold and silver, carried it back home in the holds of a fleet of galleons. Initially – and in spite of the best efforts of Francis Drake and assorted privateers to re-distribute Spanish plunder towards English shores – the bulk of new silver and gold would end up in the treasure of the king of Spain, who would begin to spend it within the country. Spanish prices would rise; note that (on a number of simplifying assumptions) even at this stage Spanish inflation would be mirrored by a fall in prices in the plundered country, so that the world price level – the ratio of world money to world production – would remain unchanged. However, free trade between countries introduces a strong linkage between the prices charged for the same good in different countries: in the absence of tariff and other trade policy actions, and on the assumption that transport and marketing costs are negligible, the “law of one price” suggests that any significant differences in the
prices of traded goods should attract arbitrage: for example, you may find a lot of coffee and Ibuprofen tablets in the return suitcase of your Cambridge-resident lecturers). As a result of arbitrage, the same good should trade at the same price regardless of the country in which it is traded. In our example, Spanish prices would become uncompetitive relative to those of production elsewhere. The next logical step in the adjustment mechanism stresses that as expenditure is diverted away from Spanish production, money leaves the country in payment for imports. Note that in a system where only gold and silver are used for payments ("commodity money"), all money can be used internationally, and "money" and "foreign exchange reserves" are identical; in later systems of gold convertibility, it becomes important that the bank of issue should respect the "rules of the game" – just as the already mentioned Issue Department of the Bank of England, a bank of issue should not try and prevent changes in the country’s reserve from determining changes in the total supply of money: there must be, in today’s term, no "sterilisation" of reserve flows. As money “drains away” from the country which has “too much” of it (and whose prices are therefore “too high”), expenditure falls and prices also decline – immediately, if there is no rigidity or inertia; eventually, in any case; and if the deficit country is sufficiently large relative to the rest of the international economy, it may lose money in a sufficient volume to determine an equal but opposite process (i.e. inflation) elsewhere. This process will continue until purchasing power parity is re-established, and trade returns to balance – each country earns by exports more or less what it spends in imports.


3.5.3 International factor mobility, colonialism, and the sustainability of the Gold Standard.

The policy minimalism of classical liberalism – its message that while governments need to attend to specific tasks, the bulk of the public policy agenda remained one of self-restraint, not very different from the laissez faire, laissez passer of French Physiocracy – was one of its great political attractions: this was true domestically, but even more so internationally, were in any case the institutions and instruments for coordinated action simply did not exist. At the same time, it is important to note that the
sustainability of the Gold Standard relied fundamentally on a number of circumstances and indeed of policy choices which cannot today be taken for granted. Firstly, the balance of payments adjustment mechanism did not normally operate with the swiftness – and the brutality – of inflation and deflation: a country in deficit did not have to face an immediate choice between falls in prices and wages, and insufficient demand leading to a recession. Rather, countries in deficit were able to cover significant imbalances for a number of years by borrowing internationally: symmetrically, Britain invested abroad between 5 and 12% of its national income, year after year, for the best part of four decades, rather than having to suffer inflation as its side of the “adjustment”. It is very probable that prices and wages were more flexible in the nineteenth century, than since then: unions were fewer and less powerful, product markets typically more competitive because of fewer large oligopolistic players: so it is especially significant to note that capital mobility was a major mechanism in the working of the adjustment process.

Moreover, by and large during the Gold Standard capital “flowed downhill” – from richer countries to poorer ones, where capital was scarce and therefore investment was bound to have higher marginal productivity. Globally, this has not been the case in the last four decades, during which ACP’s as a bloc, largely as a reflection of the chronic deficit of the United States, have not acted as a supplier of capital to the developing world. It is not obvious

Not only did capital move freely – so did labour, and it provided a further major adjustment mechanism to international imbalances. When cheap agricultural exports from the Americas and the Ukraine made western European agricultural uncompetitive, and created a serious farming depression, young Italian (and Irish, and German) peasants did not wait for opportunities to emerge in the new industries of textiles, light engineering etc.: they begged, borrowed and stole to secure a one way ticket to the New World. It is very difficult to imagine mass international migration playing a similar role in today’s circumstances.

Finally, and more controversially, a country’s ability to exercise political control, and to impose terms of trade, with dependent territories or “colonies” was interpreted (notably by Marxists) as a further condition for the temporary sustainability of a world economy of capitalist states. While much of this analysis has been abandoned, aspects of it have received further attention especially since the global agenda of trade
liberalisation stalled in the inconclusive negotiations of the Doha Development Round.
The political economy of the Golden Age

After two major conflicts within four decades, and an effective transfer of hegemony from Britain to the United States, a world bloc of countries characterized by private enterprise and representative democratic institutions (“the West” – though it included from the outset Japan, Australia and New Zealand) entered a unique period of full employment, fast economic growth, and greatly increased economic security through the “socialization of risk” in areas ranging from employment, to pensions, to health care and education. The institutions of this “Golden Age” still define the terms of the political economy debate today – a

4.1 War, the economy, society, and the state

In the climate of the 1920’s, the honour of central banks counted for more than any risk of temporary recession, and with very few exceptions (Italy and France, as well as Austria and Germany) countries chose to reverse the bulk of their wartime inflation, and re-establish the 1914 gold value of their currencies.

Yet contrary to the optimistic predictions of governments and central bankers, Europe’s return to the “normality” of gold convertibility in the 1920s was slow, and accompanied everywhere by painful contractions in economic activity – the result of high interest rates as central banks attempted to contain, or even reverse, inflationary pressures. Where Say’s Law had predicted that reducing the stock of money would push prices down without much impact on production, in reality prices and wages proved very difficult to cut, and the result of lower nominal expenditure was stagnation, rather than disinflation. The experience of those years led many to doubt whether governments could unwind the tremendous structural and social transformations of Europe’s war economies, as long as they remained committed to a “minimalist” role; already in the 1920’s Keynes wrote about “the end of laissez faire”.

In spite of these significant real costs, by 1927 a version of gold convertibility had been re-established throughout Europe and across the Atlantic economy. Expectations, however, were never restored to the full confidence in a constant long term gold value of each national money, which was necessary for orderly capital flows. As a result, many currencies remained vulnerable to sudden capital flight, whenever speculators saw the prospect of a devaluation. In practice, the need to
prevent capital flight led to interest rates rising precisely when a weak domestic economy could have benefited from a cut: these were the “golden fetters”, which made even mild counter-cyclical national economic policy impossible, and could even worsen the extent of a recession. Against this background of already defective performance of the international financial system, the international transmission of the Great Depression from the autumn of 1929 onwards shattered all remaining confidence in the self-adjusting mechanism of Say’s Law. Across Europe, as indeed in the United States, people and machines lay idle in the midst of real poverty: somehow, the very real economic needs of people (need for food, clothes, shelter) did not translate into “effective demand” (monetary expenditure), and societies were impoverished by a failure to employ their resources fully.

4.2 The Economic Lessons of the Inter-War period

Until the 1930’s, no respectable economist and few politicians had dared suggest that the international economy should be run on any other “rules of the game” than that of a reliably fixed exchange rate system: the Gold Standard had provided this until 1914, and the 1920’s was dominated by attempts to restore it. That system, however, involved a fundamental asymmetry in the way in which surplus and deficit countries could respond. Surplus countries could-and, especially in the case of France and the United States, did- merely absorb or “sterilise” the inflow of gold: there would be no impact on their domestic monetary conditions, if bond sales were used to absorb the additional liquidity generated by the trade surplus. In contrast, deficit countries would be forced to raise interest rates to finance the difference between imports and exports: the burden of adjustment was carried by the monetary policy, which had to respond in this way to maintain a stock of gold adequate to guarantee the convertibility of the currency at the Gold Standard rate. Increasingly, however, the channel of transmission of monetary policy was seen to be a domestic recession: higher interest rates cut total spending, and therefore improved the balance of trade as an incidental result of an overall slowdown of the domestic economy.

Most of those in positions of authority – not just in government, but on Wall Street and in the City also- shared a belief that the competitive devaluations and trade wars of the 1930’s had been a major contributory factor in the success of authoritarian
regimes, and in fomenting hostility in international relations. Charles Kindelberger’s “contracting spiral of international trade” – a diagram which presented the sharp decline in export volumes in 1929-1933 as a whirlpool - suggested the cumulative, self-sustaining nature of the process of protectionist measures and counter-measures: the architects of Bretton Woods were in no doubt about the need to prevent, at all costs, a repetition of that spiral.

4.2.1 The “external constraint” on full employment

At the same time, the conference participants could also already see that the post-war international economy would be dominated by two diametrically different outlooks. The United States, with nearly one half of the world’s industrial output and a massive lead in productivity, would be for the foreseeable future a strong net exporter, dependent on free access to take full advantage of its productive potential. Apart from access to foreign markets, America’s problem would be to find buyers in those markets-foreigners with dollars to spend. The main non-American voice at Bretton Woods was that of Britain; and Britain typified the position in which most of the rest of the “free world” would find itself after the war. Most European countries had experienced great difficulties in securing a balance of trade in the 1930’s; the war would further weaken their trading competitiveness. In continental countries, this was largely due to war damage; in Britain, the damage wrought by aerial bombing was on a lesser scale, but the economy had specialised in the provision of design and logistical services, rather than manufacturing: as a result, the “land aircraft carrier” would also find it very difficult to sell its good abroad. This, to different extents, was true of most European countries: at least for the duration of the reconstruction period, they all were likely to need energy, food, and capital equipment in excess of what they could produce domestically, and would therefore need to finance a significant proportion of their imports: they would in other words need to find, by means other than exports, the gold, dollar, or other international means of payments necessary to pay for their imports.
4.2.2 Letting international markets work: the “White Plan”

The prospect of a chronic, or structural, trade deficit of the rest of the world economy towards the United States informed the respective negotiated positions of the two groups. The American “White Plan” put a lot of faith in the “automatic” adjustment properties of the balance of trade between countries practising free trade: as a result, the main purpose of the proposed International Monetary Fund would be to organise and enforce the discipline of a system of fixed exchange rates, and the dollar would play the role of core reserve currency within it. Free trade and stable exchange rates were, in this view, the sufficient institutional framework for the post-war revival of international economic integration; in this view, trade liberalisation would be promoted by an International Trade Organisation. In contrast, no special arrangements would be needed to tackle large scale imbalances in the balance of trade: specifically, the Fund would not need large financial resources, with which to assist countries in balance of payments deficits; nor would there be a crucial need for large-scale long-term lending across borders.

4.2.3 Sharing the adjustment burden: the “Keynes Plan”

Unsurprisingly, these last two points were central to the European position, championed in the British “Keynes Plan”. Mindful of the “golden fetters” of the inter-War period, when the need to maintain the fixed exchange rate of their currencies against gold had forced countries into high unemployment, Keynes was adamant that the “burden of adjustment” to trade disequilibria should no longer fall primarily on the deficit country. Other things equal, the trade balance depended inversely on the level of economic activity: but a contraction in economic activity – a recession, with the unavoidable concomitant increase in unemployment - was an unacceptable high price to pay for restoring equilibrium in international payments. Having discovered the potential of expenditure management as a tool for securing the “high and stable level of employment”, which each Allied government had promised their people in various declarations of intent, White Papers etc. during wartime, politicians were not going to surrender the use of monetary and fiscal policy in obsequy either to the “barbarous relic” of yet another version of the Gold Standard, or even to the US dollar.
The conflict between internal and external balance could be avoided if the Fund had a large amount of reserves to lend to deficit countries; yet given that each of the existing sources of international liquidity – gold, and US dollars – was at that point heavily concentrated in American hands, to establish the IMF merely as a “credit co-operative”, a central repository for the bulk of international reserves, was equivalent to making it an American institution – effectively, the international branch of the US Federal Reserve System. Nobody favoured this solution: America feared an open-ended liability, while the British were extremely concerned about the power imbalance built into an “American Fund”.

Indeed, Keynes proposed that the Fund should be able to create international reserves by granting additional overdrafts to deficit member countries: this additional source of international reserves, which Keynes called the “bancor”, would remove the main incentive for countries to accumulate large foreign exchange reserves. xvi Additionally, a separate channel of long-term official lending should be created through the International Bank for Reconstruction and Development (the World Bank); this reflected the belief that without an intergovernmental guarantee, international lending would just not recover from its collapse during the 1930s, where a number of sovereign defaults, and the widespread adoption of foreign exchange controls, had increased the risk of lending across borders to a prohibitive level. Overall, the Keynes Plan aimed to creating an international financial architecture in which it would be easy to borrow.

Additionally, the “Keynes Plan” aimed to leave the pace of trade liberalisation firmly in the hands of national governments: both the convertibility of national currencies, and trade liberalisation, were to be determined by individual country choice, rather than being conditions for membership of the new international economic order.

In a moment of distraction during one of the many meetings, one of the British participants at the Bretton Woods conference composed a little rhyme including the line that “as White argues with Keynes, they [the Americans] have all the money, but we have all the brains”. Brains, however, did not in the end win out: in spite of Keynes magnificent powers of persuasion, the final Bretton Woods agreement implied more and faster liberalisation of trade than the British felt comfortable with, a smaller Fund than they had thought necessary (in terms of the reserves available to lend to its members), and too asymmetric an adjustment mechanism, with deficit countries having to undertake policy commitments (higher interest rates, cuts in government
budgets) as a condition for the Fund’s financial assistance, while surplus countries were under little if any pressure to eliminate the trade surplus. It could be argued that the original Bretton Woods design still reflected a fundamentally liberal belief in the self-adjusting properties of a free-trading world economy; as the next section shows, however, the managers of the system were prepared to modify their beliefs in the light of experience, and to depart from the original design when it appeared to come into conflict with the objectives of high and stable employment. xvii

This “world in depression” xviii brought about a further major economic role of the state, which became the “spender of last resort”. This change came about only slowly, battling against the obstinate insistence of governments and central banks to the liberal ideals of a balanced budget and gold-backed currency: it became known as the “Keynesian revolution”, after the Cambridge economist John Maynard Keynes, whose General Theory of Employment, Interest and Money (1936) crystallised the essence of the new role of government as the spender of last resort. In essence, the new view acknowledged that a shortfall in total nominal expenditure would result in a reduction in the level of economic activity. The economy could be “demand constrained”, as the experience of the 1930’s had shown: idle factories, unemployed workers, and yet no shortage of economic needs, which could be fulfilled if only effective demand had been there. Where Say’s Law had stated that “supply creates its own demand”, the Keynesian revolution introduced the opposite principle that, whenever the economy was below full employment, “demand creates its own supply”; moreover, governments had the means (by manipulating the interest rate, and setting the fiscal balance between public expenditure and taxation) and therefore the responsibility to “steer the economy” – to manage total expenditure, so as to minimise the volatility of total expenditure, keeping it in line with the economy potential output. Just as the central bank acted as “lender of last resort” to the benefit of financial stability, so the public sector would act as a “spender of last resort”, offsetting the volatility of private (especially investment) spending. It is paradoxical that the first time the Keynesian approach was accepted in policy practice in Great Britain – Kingsley Wood’s 1941 budget – it was not to justify an expansion in total spending to lift the economy out of recession, but to achieve the opposite – to contain the inflationary pressures created by the rapid expansion of war production, as Britain
rushed to keep its armed forces equipped with the tools of industrial warfare. It could be argued that politics – the Second World War first, and the justification for high defence spending during the Cold War during the Golden Age – did as much as the ideas and persuasion of Keynesian economists in bringing about large government budgets, which could “respectably” be used to stabilize the economy.

Bill Phillips’ “machine” stands as a testament to the Keynesian revolution. Its technocratic approach to the regulation of the circular flow of income, and its mechanical quantification of the impact of various policy instruments on the balance between leakages and injections, provided the basic understanding of the “activist” expenditure management of the 1950s and 1960s; later, married to Phillips’ other major legacy to macroeconomic analysis, the “Phillips curve” relating inflation to unemployment, it conceptualised the “policy menu” or “trade-off” between more jobs and faster rising prices which was central to the crisis (and more recent resurgence) of Keynesian economics.
The demand view: paradox of thrift + national control

Business Sector

Total Output/Income/\(GDP\)
Consumers’ Expenditure
Public Expenditure on Goods and Services
Business Investment
Exports

Public Sector

Public Sector

Financial Sector

Foreign Sector (RoW)

Household Sector

Net Taxes
Net Savings
Imports
4.1 National Economic Management

4.1.1 Expenditure Management
The third quarter of the twentieth century – the period between the end of the Second World War, and the oil shock of 1973/4 – is one of profound significance for the economic role of the state in advanced capitalist countries. A radical expansion in the ambitions and powers of the state in the economic sphere was accompanied by unprecedented growth rates, consistently low unemployment rates, contained – even if gradually rising, or “creeping” inflation, and fundamentally balanced current accounts. Many economic institutions were either created ex-novo (indicative planning in France and Japan); yet others – having being put in place as emergency measures in the turbulence of the 1930’s – developed into major elements of the post-war political economy, as in the case of Italy’s industrial holding company IRI, or unemployment insurance systems.

What role was played by institutions in general, and specifically by public policy, in this “Golden Age”?xix

Some interpretations of the Golden Age stress above all the potential for fast growth in the post-1945 world economy. Reconstruction was not, in fact, a central issue here: by most accounts, European economies in particular had reached back to their 1938 output levels by the end of the 1940’s. The major elements in this growth potential were above all

- the application of military technologies to civilian production;
- the spreading of technological best practice – in particular the mass production manufacturing methods (“Taylorism”, “Fordism”) – to the economies of Western Europe and Japan;
- the transfer of resources, especially labour, from lower productivity sectors such as agriculture to manufacturing.

In this perspective, the Golden Age was primarily a market-led, rather than a policy-made phenomenon: the economic role of governments was primarily the one already identified in the liberal tradition (the avoidance of inflation, the gradual liberalisation of trade).

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The alternative perspective acknowledges that resources (including the demographic dynamics of the labour force, and the technological ones of innovation) impose a ceiling on economic performance; it also typically accepts that where that ceiling is especially high relative to the current situation, natural catching up through private economic activity may play a robust role in determining growth. Yet left unmanaged, market dynamics could display both undesirable volatility, and long-term under-exploitation of available opportunities: in this view, successful policy played a major role in ensuring that the potential for fast growth in the post-war advanced capitalist countries (ACC’s) was fully realised, and that the resulting wealth was distributed in an equitable way – the Golden Age was a period of progressive convergence in income and overall living standards within each country, as well as between them.xx

As the Second World War came to an end in the summer of 1945, one long-term priority was universally clear to the political classes of the advanced capitalist countries of Western Europe, North America, and Australasia: the post-war economy would be a full employment economy. Official commitments to “high and stable levels of employment” had enshrined this commitment in the United States and in Britain; in Italy, the 1948 Constitution would define the new state as “a republic founded on work”; several historical episodes of the period show how safeguarding even relatively few jobs in specific industries and regions could come to dominate much broader political decisions.xxi Additionally, the Soviet Union’s industrial and employment successes – as they were perceived then – provided a powerful stimulus to make high employment a reliable feature of the economies of the free world.

The early generation of post-war policy makers, inspired by Keynes’ advocacy of active use of fiscal and monetary policy, had a clear, overriding commitment to securing full employment by what became known as the “discretionary” management of aggregate demand. This emphasis on supporting total expenditure in the economy has sometimes been caricatured as a lack of concern for price stability, a prejudice towards having always “a bit too much” expenditure (with full employment and some inflation) rather than a bit too little, at the risk of some unemployment. The caricature would certainly be less than fair of Keynes himself, who as early as 1945 had warned James Meade of the obvious problem: without significant unemployment to hold down the demands of workers for higher wages, what mechanism could ensure that wages did not rise ahead of productivity, thus increasing the costs per unit of output and therefore good prices?xxii The need for an “anchor” to the general price level was
recognised from the beginning of the age of Keynes: the initial Keynesian model suffered from a “missing equation”, it lacked an explanation of the average or general price level and of changes in it over time (inflation).

In the practice of the Golden Age, while the fixed exchange rates of Europe’s various national currencies against the dollar (the “Bretton Woods system”) were often discussed in terms of their contribution towards international financial stability, they also served the purpose of “anchoring” European inflation to the (low) American level, by ensuring that the monetary policies of the member countries moved approximately in step. Discussions of the relationship between the level of economic activity and inflation, however, were conducted primarily in terms of domestic variables, particularly after A.W. Phillips second major contribution to the Keynesian intellectual landscape, his discovery of a statistical relationship between the rate of unemployment and the rate of increase in money wages.

The “Phillips Curve” suggested the existence of a stable trade-off between two macroeconomic “bads”, unemployment and inflation (given that wage increases would generally translate in higher prices). This trade-off was a variable one (a higher reduction in unemployment for a given rise in inflation could be achieved when the initial level of unemployment was high) and “usable” in the specific sense that by “fine-tuning” aggregate expenditure in the economy to achieve a given target in unemployment, a government would be able to take into account the inconvenience or “cost” in additional inflation. It is true that some Keynesians could give the impression of considering that cost a trivial one, or indeed of considering moderate inflation a useful device for improving corporate profitability (if wages do not adjust immediately and fully) and therefore investment. It is however important to note that these discussions referred to a range of very moderate (by the later experience of the 1970s and 1980s) inflation, and indeed very high levels of employment: the “usable” range of the Phillips curve was that which related inflation rates of between 2 and 6% to unemployment rates of between 2 and 5%: to argue that discretionary aggregate demand management was unconcerned about inflation would indeed be a caricature.

A last characteristic of the intellectual climate of that time which seems worth of note is the general acceptance of a macroeconomic analysis which related aggregate variables for the whole of society (total consumption to total disposable income, for
example) without discussing fully the individual behaviours which would generate those relationships. Indeed, Keynes’ own explanation of why consumer expenditure would change in the same direction, but by less than the full amount of any change in disposable income, was based upon what he called a “fundamental psychological law”, and the General Theory is very rich in psychological observations relating to the behaviour of consumers, and entrepreneurs. Later Keynesians, however, retreated from such excursions into related social science discipline, perceived as amateurish and insufficiently rigorous, relying instead increasingly on the estimates of these macroeconomic relations which could be derived by statistical analysis of national account and monetary data: in other words, the various parameters which underpinned the operation of fiscal and monetary policy were those which appeared to have operated in the past, but were not explained in terms of the individual behaviour of firms and individuals, they did not have “microfoundations”.

Later, this came to be perceived as a damning weakness of the Keynesian construct, and rational, optimising individual behaviour provided the basis of a “counterrevolution” which argued that it would generally be difficult to improve by means of policy on the outcomes which individual economic operators could achieve through the decentralised co-ordination of the market system. This micro-foundations debate, however, only became a major issue in the 1970s: during the Golden Age, most economists and social scientists believed that the whole is something more, or at least different, from the sum of its parts, and could therefore be studied directly: this belief in the primacy of social structures over individual behaviour in social isolation is of course perfectly in tune with the general acceptance of an important economic role of the State, which is itself a major form of collective structure.

Within the framework of government-underwritten high demand, the post-war political economy or “Golden Age Consensus” included a number of other distinct features, all of them institutionalised above all at the national level.

4.1.2 The Mixed Economy

A first institutional characteristic encountered across the ACC’s was the direct involvement of the government in the production of market goods and services: nationalised industries, from the systematic form of Italy’s IRI to the more ad hoc recourse to public ownership in countries such as Britain, accounted for a significant
proportion of national output, investment, and employment. Nationalised industries – the “commanding heights” of the national economy - were seen as means to several distinct ends. As capital-intensive industries, they facilitated aggregate demand management by allowing an additional instrument for the control of investment expenditure: long-term investment programs could be timed to come on stream in a period of otherwise slack demand. As segments of the high productivity manufacturing and hi-tech sectors, nationalised industries could be “national champions”, and therefore natural recipients of industrial policy (R&D subsidies etc.). As suppliers of a number of crucial utility services, from water to energy to telecommunications, they could be used for redistributive purposes: cheaper household tariffs could be cross-subsidised out of supernormal profits on business contracts, remote area services out profitable urban networks etc.

4.1.3 The Welfare State

The “welfare state” was a second major feature of the post-war political economy. Its two major elements were the provision of a number of crucial services (in health, education, and public amenities such as libraries) which were free at the point of use, and financed through general taxation; and “national insurance” – the complex of unemployment, illness, and old age benefits which effectively socialised the major sources of individual economic uncertainty. With few exceptions, the services of the welfare state were provided directly by the state, through the public employment of teachers, nurses, doctors etc.: the Golden Age state did not merely pay for the merit and public goods of the welfare state: it did also supply them, and became through this route a major service sector employer.

4.1.4 Corporatism

Corporatism was the attempt to reconcile continuous full employment with an acceptable degree of price stability. In a situation in which workers feel very secure in their employment, and firms are confident that they will always find good demand for their output, price stability is at risk: the potential problem – recognised from the outset by Keynes himself, even if the answer was to prove elusive – is that unions are going to be tempted to ask for price increases in excess of productivity growth, leading firms to pass on the resulting unit cost increases into higher prices – the
"wage-price spiral". To avoid this, most countries developed corporatist institutions, attempting to centralise wage negotiations (“collective bargaining”) and to involve government directly in discussions leading to “incomes policies” agreed between government, industry, and the unions.

4.1.5 Regional Policy
Regional policies were also extensively used to address the spatial dimension of inequality in living standards: Italy’s politiche del Mezzogiorno, Germany’s Finanzausgleich, and equivalent policies elsewhere transferred resources towards the least prosperous regions, typically with an emphasis on investment; discretionary public expenditure was also, where possible, steered towards poorer areas; and centralised fiscal systems also worked as “automatic stabilisers”, raising revenue in prosperous regions and doling out subsidies in depressed ones.

4.1.6 Growthmanship
Finally, the post-war policy consensus did not end at full employment, redistribution, and relative price stability: it was also “growthmanship” – the belief that policy could improve the economy’s capacity to grow over time, either by subsidising business investment of private “national champions” (Italy’s FIAT, everybody’s national computer manufacturer from Italy’s Olivetti, to France’s Bull, to Britain’s ICL…), or by targeted public investment in science, technology and infrastructure.xxiii To the extent that environmental policy was part of the public policy system of the Golden Age, this too would have been almost exclusively a matter of national management: while it is useful to include a mention of this here, as advance notice of a policy area which is seen today as intrinsically supra-national, it must be recognised that awareness of the environmental costs of economic activity was only slowly emerging over the 1950’s and 1960’s:

4.2 The Bretton Woods system
The international dimension of the public policy of the “Golden Age” reflected a variety of considerations. At one level, the very fact that a major Allied Economic Conference was convened in Bretton Woods, New Hampshire as early as July 1944,
bears witness to the importance attached by America and Britain to agreeing a viable international economic framework for the post-war world. At another level, the post-war economic prospects of the United States and of Europe were fundamentally different, with the former likely to benefit directly from free trade and fixed exchange rates, while the latter would need at least for an extended initial period a variety of instruments to protect their balance of payments, and to support them financially. The eventual outcome of the international economic negotiations – the “Bretton Woods System” of IMF, World Bank, and GATT-constituted the “international financial architecture” of the third quarter of the twentieth century. We shall spend some time reviewing that system, both because its institutions still represent the bulk of today’s international economic governance, and because this review will allow us to identify a number of important connections between national economic management and international economic integration. The Bretton Woods System in practice

The Bretton Woods consensus on exchange rates, enshrined in the IMF’s Articles of Association signed at Savannah in 1946, required the US dollar to be convertible into gold at a fixed rate of thirty-five dollar an ounce, and the currencies of each member country to be convertible into dollar at a given rate. The aim was to prevent the competitive devaluations, which had plagued the 1930s and led many countries to resort to tariff and non tariff protection, in a “downward spiral” which quickly strangled international trade: but to achieve this in the new era of government commitment to full employment, it was necessary to prevent the fixed exchange rate from becoming an “external constraint”, a limit on the ability of governments to keep spending at full employment level. The Bretton Woods solution rested on two pillars:

- financial support in cases of short term, reversible balance of payments deficits. Each member could borrow from the Fund to cover short term needs, such as for example higher fuel imports during an especially cold winter. This type of deficit could be financed by future small surpluses, and did not indicate a long-term weakness in the competitiveness of the borrowing country;

- exchange rate adjustment in the case of “fundamental disequilibrium” – when the member country’s deficit appeared to be the result not of exceptional and temporary circumstances, but a chronic weakness in its international trade. Devaluations up to 10% could, in principle, be
declared unilaterally, while larger ones would require agreement from the 
Fund.

The system took some time to take shape: specifically, it was difficult to identify the 
“right” value of the exchange rate between the currencies of countries with very 
different balance of payment structures, speed of recovery from wartime disruption of 
the capital stock and production structure, etc… The American learnt at their cost that 
to push too hard for a return to convertibility could destabilize the system: when, in 
the summer of 1947, they prevailed upon the British government to declare a fixed 
exchange rate and to make sterling convertible, speculators sold sterling in such 
quantities that the Bank of England ran out of dollar reserves within weeks, and 
convertibility had to be suspended. Other countries experienced similar problems, 
and it was only in 1949 that the Bretton Woods system became operational, with 
many countries choosing a significantly devalued exchange rate against the dollar, as 
a safeguard against the “external constraint.”

Between 1949 (when the central exchange rates of each IMF member country against 
the US dollars were agreed) and 1973 (when, even before the disruption wrought by 
the oil shock, the system of fixed exchange rates was abandoned in favour of general 
floating) the “national management of the international economy” was conducted 
through the Bretton Woods institutions. By and large, the system provided its 
participants with sufficient safeguards and shock absorbers, to allow the rapid 
integration of their national economies without endangering the core domestic 
objectives of the post-war consensus, above all the maintenance of full employment. 
The initial fear of a shortage of international reserves, which may tempt countries into 
a mercantilist zero-sum game, with each country attempting to achieve a trade surplus 
and only managing to impoverish all of them (“beggar-thy-neighbour policies”), was 
disproved by successive phases of overall US balance of payments deficits, injecting 
the necessary additional liquidity initially through unilateral transfers (Marshall Plan, 
military assistance), later through international capital exports (the internationalisation 
of large US companies through FDI), and later still through a current account deficit.

The Bretton Woods system can be understood as a compromise between conflicting 
objectives in the management of the international economy. This perspective has 
become known as the “trilemma” or “impossible trinity”, and reflects the 
impossibility of reconciling fixed exchange rates and independent monetary and 
macroeconomic policy, in a situation of capital market integration, where capital
flows freely across national borders. The figure in the next page displays three objectives of a well-functioning international economy as the three sides of a triangle. These sides represent respectively

- **stable (real) exchange rates.** This is obviously an important characteristic, allowing firms to trade and invest internationally in response to clear price signals: as Krugman and others have noted, even if exchange rate instability does not hurt the volume of international trade, it creates confusion and results in both the maintenance by multinationals of wasteful spare capacity (so that some production can be shifted from country to country in response to exchange rate fluctuations), and in slower responses to shifts in comparative advantage (because the “signal” of exchange rate changes is less reliable when they are very volatile). In practice, fixed exchange rate systems (such as the Gold Standard) are the most likely to provide stable real exchange rates, because they provide a strong link between national price levels.

- **macroeconomic sovereignty.** This is the ability to use monetary (and fiscal) policy to respond to “asymmetric” shocks, to economic disturbances which are specific to one country: effectively, the essence of the “Keynesian revolution”. While during the 1980s and 1990s the importance of this economic role of the state has been challenged, and macroeconomic policy has been shifted from “discretion” to (monetarist) rules, over the last few years a “New Keynesian” consensus has been emerging, which considers monetary policy in particular has having not just a responsibility for medium-term price stability, but also for some degree of short term expenditure stabilisation: this is quite clear, for example, in the conduct of monetary policy in both Britain and in the United States, and is at the heart of (not only French) criticisms of the European Central Bank.

- **free capital mobility.** There is broad agreement that long term foreign investment is beneficial; the issue of short term capital mobility is much more controversial, with liberal economists welcoming the “discipline” of international capital markets on the sovereign borrowing of national governments and public enterprises, while Keynesian critics remain
concerned by the risk of instability due to sudden, and ultimately self-fulfilling, changes in “investors’ sentiment”. In practice, however, changes in financial technology as well as international financial regulation have made capital mobility, if not fully an objective, at least an inescapable characteristic of the international economy.

Each point in the diagram represent a particular trade-off or choice between the three aspects just described. In the bottom right corner we find system which sacrifice national monetary sovereignty to a combination of free capital movements and stable real exchange rates: point “A” thus represents the classical Gold Standard, in which each country’s interest rate could only be used to ensure that the central bank’s reserves retained enough gold to fulfil convertibility. In this context, EMU is the ultimate stable exchange rate, as countries share the same currency and the same monetary policy: it represents, therefore, a “return to the convertibility principle”.

Bretton Woods is shown here as a compromise position, securing stable exchange rates, and some degree of monetary independence (moving towards the top corner) at the cost of tighter restrictions on capital mobility.

When Bretton Woods broke down, some countries chose to rely on a domestic monetary management, privileging price stability: Germany, with strong political consensus borne out of the national memory of its interwar hyperinflation, simply accepted that capital mobility and a commitment to price stability may imply large variations in its international price competitiveness, if other countries made different monetary choices. The figure represents Germany’s choice as a direct shift from “B” to a point “D”, and points out that a shift to price-stability as the main goal of independent monetary policy also happened in the USA and in Britain at the very end of the 1970s. It should be noted, however, that the “German monetary model” tried to contain the volatility of real exchange rate: this was achieved by several attempts to create at least a regional “zone of monetary stability” within Europe (an attempt that began with the “Snake” of the 1970’s, and led to the 1979 Giscard d’Estaing-Helmut Schmidt agreement which created the European Monetary System (EMS); and it was facilitated by the fact that Germany’s exporters had significantly shifted away from price competition, increasingly selling their products on quality (reliability, superior technological characteristics etc.).
Other countries reacted to the end of the Bretton Woods constraint by allowing inflation to rise significantly in response to the distributional conflict of the 1970s. In those years, there was a clear struggle over income shares between some major economic interests: OPEC demanded a higher price for its energy exports, through two successive oil shocks; the labour unions resisted any slow-down in the growth of real wages, through increased militancy, such as Italy’s “hot autumn” of 1969; businesses, used to pass on any cost increases in higher prices, were not prepared to see their profits cut by higher wages and fuel prices; and governments were faced with the rising cost of their welfare provisions. In this situation, inflation appeared as a safety valve – uncomfortable, but still preferable to a “show-down” between monetary policy and domestic price and wage setters, which risked pushing the economy into recession. In a “last Keynesian Hurrah”, governments thought they could tolerate inflation, at least as an emergency response, and offset the loss of price competitiveness by managing a devaluation of the exchange rate: Italy’s real exchange rate chart on the following page shows the result of the Lira’s much higher inflation rate on the exchange rate, which falls rapidly from the end of Bretton Woods until the early 1980s.
The combination of high inflation and controlled currency depreciation is represented in the triangle by the dashed line leading from “B” (Bretton Woods) to “C”. In practice, this proved to be a chimera: the triangle makes it clear that to manage depreciation successfully, governments would need to be able to control capital flows – yet this was impossible in a time of large short term borrowing needs (to absorb the short term impact of higher oil prices) and growing Euromarkets, where non-residents were able to trade foreign currencies freely. Increasingly, the relevant interest rate on Lira deposits, and the Lira-dorra exchange rate, were not set by administrative controls in Italy, but freely established through the speculative dealings in the Euro-lira market in London: the differential between the domestic and “off-shore” interest rate was a clear signal of the lack of confidence in Italy’s currency by international investors. The vicious circle between speculative expectations, wage demands, and the exchange rate, is captured in the figure entitled “The problem with floating exchange rates”: once expectations become dominant, because monetary policy has lost its “anchor” and is in the hands of policy-makers subject to short term political pressures, it is speculators such as George Soros, not politicians such as Norman Lamont, who determine either the exchange rate, or the domestic interest rate; expectations of the future dominate the behaviour of crucial economic variables today, with all the volatility which characterizes financial market opinion.

“C’” was thus the worst of all worlds: it subjected countries such as France and Italy to significant short term volatility, and to the very real risk of an inflationary spiral (see for example how, in spite of continuing depreciation, the real exchange rate of the Lira begins to appreciate in the early 1980s, as indexation systems such as the wage escalator (“scala mobile”) lead to prices rising even faster than the Lira is losing value); at the same time, these countries suffered from the menu, distributional, and informational costs of high inflation.

By the mid-1980’s, most European countries (and many across the world) had become disillusioned about the use of managed exchange rates as a policy instrument, and were ready to move back to some “anchor”: for most European countries, that anchor was the Deutschmark, and the strategy was a move from “C’” to the right bottom corner of the triangle.
MACROECONOMIC TRADE-OFFS
AND THE CHOICE OF EXCHANGE RATE REGIME

A: the Gold Standard as an “anchor” to the price level
B: the Bretton Woods compromise
C, C’: the (old) Keynesians’ Last Hurrah (Mitterrand experiment)
D: the German model, Mrs Thatcher’s and Volcker’s monetarist experiment

THE PROBLEM WITH FLOATING RATES

If total expected returns are quickly equalised by arbitrage...

\[ K (1 + i_{h}) = K \times \frac{1}{e_{0}} (1 + i_{w}) \times e_{1} \]

…any change in the exchange rate expected to prevail in the future will generate an immediate change in today’s interest rate and/or exchange rate:
The pace of domestic structural change, while exceedingly rapid especially in Europe, was always controlled in a way which privileged “pull” factors – the availability of typically higher –productivity, higher-wage jobs in expanding industries, above all manufacturing – over the “push” pressures of labour redundancy from declining industries; indeed, in some cases – agriculture everywhere, Belgian coal-mining – economic efficiency took second place to the social objective of minimising the human and geographical upheavals of structural change.

The demographics of the post-war “baby-boom”, with a rapid expansion of the workforce in conditions of sustained full employment, provided a painless “pay-as-you-go” financial support for the expansion of the services of the welfare state: educational, health care, and national insurance provisions were significantly increased across the OECD, and contributed significantly to the maintenance of the social consensus.

The exclusion of public procurement from the regulation of international trade allowed national governments to subsidise “national champions”, whether in engineering, manufacturing, or information services: from Olivetti to Bull to ICL to Siemens, every European country nurtured its own computer world-beater.

Maybe the most striking feature of this period was the flexibility with which governments – not least that of the hegemon country- were prepared to modify their instruments of intervention in the light of experience. The White Plan was based on the belief that each country’s balance of payments is fundamentally self-adjusting, at least in the absence of government interference: yet – as noted earlier - the disastrous attempt by Britain to restore sterling convertibility in the summer of 1947, far from leading the US government to blame the “socialist” British government of the time for economic incompetence, resulted in a much more gradual approach to the restoration of convertibility: for the IMF as a whole, this was only achieved at the end of the 1950s, and even then only for current account transactions, allowing member countries to retain often very strict controls on capital movements. Similarly, in spite of their suspicion in principle of the vertically integrated – and therefore intrinsically oligopolistic – structure of Germany’s coal-steel combines, the American administrators of the International Authority of the Ruhr were prepared to let the old industrial structure re-emerge, when it became apparent that the recovery of
Germany’s industrial base could be best achieved by institutions which reflected German business culture, rather than an imported ideal.

International public policy in the Golden Age was characterized by the role played within it by a leading or “hegemonic” country: just as Britain under the Classical Gold Standard had provided some basic requirements for the orderly conduct of international trade and investment, so the United States had chosen to use its industrial and financial power to ensure stability across the Western world. Specifically, the role of the “hegemon” has been seen as the provision of some crucial “international public goods”, such as

- a stable “reserve currency”, which everybody can use for trade and investment because of its universal acceptability;
- a steady provision of savings available for international borrowing, assisting both in short-term liquidity shortages, and for long-term investment to speed up economic development;
- a set of “rules of the game” which, while imposing constraints on individual countries freedom of action (for example in commercial policy, or in devaluing the currency) still offered all participants sufficient confidence in the long-term advantage of belonging to the club, that short term costs would be accepted as a worthwhile price.

The crucial question, posed above all by Charles Kindleberger, is whether periods of hegemonic stability, by allowing the followers to catch up with the hegemon and therefore diluting over time its economic dominance, bring about their own demise: in this pessimistic scenario, as the economic dominance of the hegemon (the United States) is diluted by the successful convergence of the followers (Germany and Europe as a whole, Japan), the costs of managing the system become less acceptable to the hegemon, and its legitimacy in imposing and policing the rules more difficult to enforce. As a result, the hegemonic structure breaks down, and the international system reverts to a period of potentially dangerous anarchy.\(^{xxv}\)