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The Reconstruction of the International Economy, 1945-1960

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Economics, University of California at Berkeley

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Department of Economics

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The Reconstruction of the International Economy, 1945-1960

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The reconstruction of the international economy was one of the grand achievements of the post-World War II era. The starting point was the almost total cessation of normal international economic relations. The achievement was the most remarkable boom in international trade and lending the world has ever seen. Between 1950 and 1965 the volume of world trade grew at a rate of nearly 8 per cent per annum. International lending recovered more slowly but by the second half of the 1960s was poised to explode. This buoyant expansion of international economic transactions did much to fuel the tripling of world output over the third quarter of the 20th century.

Looking back, it is tempting to characterize these trends as inevitable. Declining transportation costs, new modes of communication and advances in computer technology reduced the costs of undertaking international transactions. The interwar period of high tariffs and quotas came to appear as an aberration; normalcy was the fluid and integrated world economy of 1870-1913, elements of which were successfully reconstructed after World War II. On the output side, the industrial economies benefited from the scope for growth offered by "catch up." Europe had fallen far behind the United States due to the destructive effects of two wars and the depression-ridden interlude between them. Now it could grow by emulating the U.S. example -- by exploiting U.S. technologies and restructuring work organization along American lines. Trade and growth could feed on one another in a virtuous circle.

It is the historian's responsibility to resist any argument that conveys a sense of inevitability. Thus, it is necessary to emphasize that, in the wake of World War II, it was by no means certain that events would turn out this way. There were widespread fears that the international economy would not be rebuilt. The industrial nations, concerned to insulate themselves from destabilizing impulses emanating from abroad and to secure the freedom to pursue ambitious programs of economic planning, might decide to retain the commercial and financial controls imposed in the 1930s and exploited during the war. The disintegration of the international economy that had followed the onset of the Great Depression might become the norm. Moreover, the prevailing expectation in the wake of the war was not for a golden age of economic growth but for slump at least as severe as that through which the world had suffered in 1920-21, which barring concerted action might fester and transform itself into another depression.

The achievement of the post-World War II era was a set of policy initiatives that contained these dangers. They completed the reconstruction of the international economy and inaugurated a golden age of economic growth. Some of these initiatives were premeditated, others spontaneous. Some benefitted from years of planning while others reflected postwar policymakers' ability to think on their feet. Together they provided a remarkably successful framework for the reconstruction of the international economy.

The most famous of these initiatives produced the Bretton Woods Agreement to establish the International Monetary Fund, the World Bank and the International Trade Organization. Since the collapse of the gold standard and the subsequent manipulation of exchange rates were seen as having greatly aggravated the economic problems of the 1930s, discussion centered on the Fund, the entity that would oversee the international monetary system. In one sense, creation of the Fund was a singular achievement. This was the first time the nations of the world had designed an international monetary system from scratch. The 19th century gold standard had grown up spontaneously, while two international monetary conferences held earlier in the 20th century (at Genoa in 1922 and London in 1933) had come to naught.

A considerable literature, represented in this volume by John O'Dell and John Ikenberry, explores why the Bretton Woods negotiations succeeded. O'Dell and Ikenberry emphasize "expert consensus." Both words are crucial. A <u>consensus</u> about the desirable features of an international monetary order developed in response to the turbulence of the interwar years and in the course of wartime dialogue between British and American officials. Such a system, in the prevailing view, should aspire to a balance between rules and discretion. It should be sufficiently rules based that nations would be prevented from engaging in destructive manipulation of their exchange rates and pursuing beggar-thy-neighbor policies. But it should allow for sufficient discretion that nations could avoid having to respond to balance-of-payments pressures with potentially disastrous policies of deflation. <u>Expert</u> opinion provided a basis for communication, articulated ideas, and guided negotiations. Not surprisingly, popular histories of Bretton Woods are written as the tale of John Maynard Keynes and Harry Dexter White resolving their differences and bringing officials and politicians in their train.

Consensus there may have been, but there remained considerable disagreement between the British and Americans over the particulars of the Bretton Woods Agreement. And, as the chapter by Chiarella Esposito in this volume attests, experts from other countries like Canada and France championed different ideas of their own. The final document may have had more in common with the White Plan than its rivals, but the American delegation had to offer significant concessions in order to secure the agreement of the other signatories.

Expert consensus alone was insufficient, moreover, to guarantee adoption and implementation of the agreement. A concerted campaign of political lobbying was also required. Divisions existed within governments over the merits of the document negotiated at Bretton Woods. Such schisms were evident in disagreements between the U.S. State and Treasury Departments, for example. And getting national congresses and parliaments to ratify the agreement was an uphill battle. How this victory was won in the United States and how a combination of U.S. pressure and domestic political maneuvering combined to replicate it in other countries is a complex story deserving a volume of its own.

If there is a sense in which the establishment of the Fund and its sister institution, the Bank, was a singular success, there is also a sense in which it was a failure. The IMF played little role in international monetary affairs until the end of the 1950s. The quick transition to current account convertibility envisaged by the framers of the Bretton Woods Agreement never came to pass. Until January 1st, 1959, international monetary relations over the much of the world were regulated not by the IMF but by the European Payments Union, an arrangement for the multilateral clearing of inconvertible currencies that encompassed Western Europe, Europe's colonial dependencies and the British Commonwealth. Although the French had anticipated the need for a clearing union, nothing of the sort was negotiated at Bretton Woods. The World Bank, for its part, played little role in European reconstruction or, until the 1960s, in Third World economic development. It was crowded out by U.S. bilateral aid, as described below. The third Bretton Woods institution, the ITO, was stillborn. The charter for an institution with far-reaching powers to monitor and coordinate national trade policies was never ratified. More than the agreement on exchange rates, the charter on trade incorporated the concerns of countries like Britain that governments not be forced to deflate in order to maintain external balance and of countries like France that the international regime not hamper indicative planning. The ITO Charter featured clauses authorizing recourse to tariffs and quotas, permitting governments to support cartels and restrictive agreements, and strengthening host country control over foreign investment. As the chapter by William Diebold describes, the ITO was sunk by business opposition in the United States. It proved too interventionist and insufficiently free-market oriented for the American business community.

With U.S. failure to ratify the ITO Charter, the General Agreement on Tariffs and Trade was thrust into the breach. An interim arrangement intended to operate for three years until the ITO came into operation, the GATT became the permanent vehicle for efforts to liberalize trade. In contrast to the ITO, little if any legislative action and little direct support by business interests were needed in the participating countries. Difficult sectors such as agriculture and services were excluded. The ease with which signatories could withdraw heightened the fragility of the early GATT agreements, necessitating vigilance to sustain the precarious concessions negotiated in Geneva in 1947, Annecy in 1948 and Torquay in 1950. Yet throughout this period and into the 1970s, the GATT proved remarkably effective. Average tariff levels in the industrial countries were cut by half between 1940 and 1950 and by another 25 per cent by 1960.

What accounts for the fact that the Bretton Woods institutions, insofar as they functioned at all, took fully 15 years to come into operation? The explanation, as Richard Gardner's chapter in this volume explains, lies in the Cold War and the responses it provoked. The Soviet threat tipped the balance between expedients and principles. The imperative for Western politicians became to initiate recovery and sustain growth even at the expense of heartfelt ideals, in order to restore political stability in Europe and halt the westward march of communism.

The Marshall Plan was the most important initiative developed in response. Between 1948 and 1951 the U.S. extended some $13 billion in aid, or roughly 2 per cent of recipient country GNP, to the war-torn economies of Western Europe. The economic and political consequences of the program remain subjects of debate. Early histories of the Marshall Plan, written more often than not by persons present at the creation, trumpeted its economic benefits. Europe in 1947, these authors assert, was on the verge of starvation, economic chaos and political crisis. Marshall Plan funds played a critical role in restoring stability and paving the way for the resumption of growth.

Recent revisionism has challenged this view. Werner Abelshauser and Alan Milward, whose chapters in this volume summarize the arguments of longer books, insist that there is no evidence of economic crisis in 1947-48. Recovery from the war was underway. Annual measures of GNP rose without interruption. The Marshall Plan may have been a welcome gift from rich Uncle Sam, but there is no reason to think that Europe's recovery would have halted had this aid not been extended.

The obvious reason for insisting on the importance of the Marshall Plan is the external constraint. The threat to recovery in 1947 was the dollar shortage: European countries had no way of financing the inputs from the dollar area that recovery required. Knut Borchardt and Christian Buchheim argue that the critical hard-currency imports were intermediate goods. The textile industry, for example, could not substitute away from imported cotton, negligible quantities of which were grown in Europe and no adequate substitutes for which existed. Only when Marshall aid came on stream were European producers able to rebuild raw material inventories to working levels.

The question about this argument is its generality. Cotton, obviously, is an extreme case. For other commodities, like coal, it was easier for industry to economize on their use by, for example, substituting water power. As my chapter with Marc Uzan reports, input-output analysis indicates that while the elimination of Marshall-Plan-financed intermediate imports would have led to a noticeable decline in European production, that decline would have been a mere drop in the bucket compared to the expansion in European production over the Marshall Plan period of more than 50 per cent.

Milward argues that the external constraint on recovery was more likely to bind for investment goods than raw materials. Europe's postwar recovery was investment led. High levels of spending on imported capital goods had by 1947 all but exhausted Europe's hard currency reserves and outstripped its capacity to generate export receipts. In the absence of the Marshall Plan, governments would have had to cut back on investment. Whether growth just would have slowed or the negative multiplier effects would have plunged Europe into recession remains an unanswerable counterfactual.

Milward goes on to point out that prevailing levels of investment could have been maintained had governments compressed spending on other items, notably imported foodstuffs. Doing so was feasible technically; the question is whether it was viable politically. The issue was whose spending was to be compressed through income cuts, that of capitalists or of laborers. Each group understandably argued that the burden of adjustment should be borne by the other. Their refusal to concede tax increases or cuts in favored public programs led to budget deficits and open and repressed inflation. This characterization suggests that the Marshall Plan may have operated most powerfully through political channels. By increasing the size of the distributional pie, American aid moderated the sacrifices in consumption necessary to sustain investment. It limited the concessions needed to balance government budgets and halt inflation. Budget balance and inflation stabilization were prerequisites for decontrol, which was itself necessary for the market economy to begin operating again. The role of the Marshall Plan, in this view, was to facilitate an end the struggle over income distribution that had meant political instability, shortages and economic crisis.

The European Payments Union was another legacy of the Marshall Plan.

Postwar monetary adjustments, including devaluation (see Polak) and financial reform (see Gurley), had gone a long way toward removing inflationary threats and structural payments problems. But even after these adjustments had taken place, policymakers remained skeptical of the feasibility of the quick move to current account convertibility anticipated by the framers of the Bretton Woods Agreement. Following the 1947 debacle when the U.K., under pressure from the U.S., had attempted to restore current account convertibility but failed, Europe pursued a different course: a multilateral payments union. De facto current account convertibility was restored within Europe through multilateral clearing with credits, but discrimination against the dollar area remained.

In parallel with the literature on the Marshall Plan, there is a debate on the indispensability of the EPU. Early accounts by authorities such as Albert Hirschman and Robert Triffin, both of whom were involved in contemporary planning, insist that there existed no other option for multilateralizing Europe's trade. Recent scholarship, represented here by my article, suggests that there in fact existed a feasible alternative to inconvertibility, multilateral clearing and dollar discrimination, namely current account convertibility. Except for the U.K. and Ireland, where significant monetary overhangs remained, there was no technical obstacle to European countries moving more quickly to convertibility, perhaps as early as 1950.

The real argument for the EPU was not that convertibility was infeasible technically. Rather, it was that the EPU was more effective than unilateral convertibility for binding Germany into the international economy. Other countries were skeptical of Germany's commitment to openness, given memories of the Schachtian policies of the 1930s and the two world wars. Germany had been Europe's dominant supplier of capital goods and the single largest consumer of raw materials produced by other European countries. An arrangement which rendered credible Germany's commitment to intra-European trade would therefore go a long way toward reconstituting traditional patterns of comparative advantage, curing the dollar shortage and encouraging other countries to restructure their economies along export-oriented lines.

The EPU, together with the European Coal and Steel Community (negotiations over which are described by Richard Griffiths), provided a solution to these commitment and coordination problems. As a condition for participating in the payments union, countries accepted a schedule for intra-European trade liberalization. By February 1951, less than a year after the EPU went into effect, all trade measures were to be applied equally to imports from all member countries. An EPU Managing Board, housed at the Bank for International Settlements and working hand in hand with the Organization for European Economic Cooperation, monitored compliance and imposed sanctions. For those concerned to solve this commitment problem, the EPU was preferable to unilateral convertibility, which lacked the multilateral surveillance and conditionality that rendered the EPU a credible institutional exit barrier.

Out of this nexus of policies grew the European Economic Community. While impetus for regional integration existed in Europe itself, the U.S. did much to encourage it, as the chapter by D.C. Stone shows. The Marshall Planners sought to encourage European intra-European trade: they made progress on integration a condition for the extension of aid. As Michael

Hogan and Charles Maier explain, this reflected their understanding of the economic bases of America's international economic leadership at mid-century. Just as the U.S. benefitted from the economies of scale and scope offered by a continental market, Europe could hope to keep pace only if it availed itself of an integrated market of its own. And following the experience of two wars, it was desirable to use economic and ultimately political integration as an instrument to render war between France and Germany unthinkable.

These postwar initiatives combined to sow a fertile field for economic growth. While growth the world over was more rapid between 1950 and 1970 than in any comparable period before or since, the difference was most marked in Europe. The articles by Abramovitz and Dumke both emphasize the technological gap that existed between Europe and the United States, providing scope for catch-up. But catching up was far from automatic, as Abramovitz's analysis makes clear. Countries had to possess the social capacity to absorb the advanced organizational forms pioneered by the United States and to adapt them to local circumstances. They had to activate the catch-up process by boosting saving, plowing profits back into investment, and selling their products on an expanding international market. The various elements of the process had to be encouraged to feed on one another.

Here the international element was key. High levels of investment, supported initially by Marshall aid and subsequently by the savings generated by growing European incomes, augmented capacity and boosted productivity. The expansion of trade under the aegis of the GATT and the EPU allowed countries to specialize along lines of comparative advantage.

The wage moderation that allowed profits to be plowed back into investment could not have been sustained without the monetary reforms that insured the restoration of price stability and the nominal anchor provided by the Bretton Woods international monetary system.

In the 1970s productivity growth slowed, and the golden age drew to a close. The final selection by Richard Gardner suggests that this development can be attributed to widening divergences between the international structures created in the 1940s and the institutional requirements of the final quarter of the 20th century. The GATT proved less effective at liberalizing trade once tariffs had been reduced and the tangled undergrowth of nontariff barriers was revealed. The Bretton Woods international monetary system broke down from a combination of structural flaws and mismanagement and was succeeded by "nonsystem" of managed floating that worked to no one's satisfaction. International lending exploded the 1970s but evaded the World Bank's efforts to regularize it. The absence of commodity-stabilization agreements of the sort Keynes had proposed at Bretton Woods was underscored by the two oil shocks of the 1970s.

It may never be determined how much of the post-1971 slowdown was attributable to strains in the international economy and how much was due to exhausting the scope for catch up and to growing domestic rigidities. But so long as historians and economists study this question, they will have to start with the 1945-60 period that is the focus of this volume and with the topics under consideration here.

The Reconstruction of the International Economy, 1945-1960

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Table of Contents

John G. Gurley, "Excess Liquidity and the European Monetary Reforms, 1944-1952," American Economic Review 43 (1953), pp. 76-100.

4. The European Payments Union

Albert Hirschman, "The European Payments Union: Negotiations and Issues," Review of Economics and Statistics 33 (1951), pp. 49-54.

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