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THE RESPONSIBILITIES OF A CREDITOR NATION

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JEL Classification:  400, 430, 440.
If we command our wealth, we shall be rich and free; if our wealth commands us, we are poor indeed.

Edmund Burke (Letters on a Regicide Peace)

The growing international economic turbulence of recent years has coincided with the United States' loss of net creditor status and with Japan's rise to prominence as the world's leading creditor nation. In the eyes of some observers, these events are not just coincident but causally related. The rise of international economic instability is the result, in this view, of America having lost the stabilizing capacity of a creditor nation and of hesitation by Japan and other net foreign creditors to accept the responsibilities implicit in their newfound status. Allegedly, the failure of these nations to shoulder the responsibilities of international creditors has left the world economy teetering on the brink of inflation and collapse.

Once one moves from generalities to specifics, it is far from clear what the responsibilities of a creditor nation entail. Japan has been criticized for shirking her responsibilities by, inter alia, exporting too much, importing too little, saving too much, restricting access to domestic financial markets, and maintaining an inappropriate exchange rate. At the same time the United States (while still a net foreign creditor) was blamed for not accepting her responsibility to run less expansionary fiscal policies, Germany was blamed for not accepting her responsibility to run more expansionary fiscal policies.

One source of confusion is that the word "responsibilities" has both positive and normative connotations. Another is that those who offer a
particular interpretation of the responsibilities of a creditor nation rarely specify the model upon which it is predicated. Constructing a realistic model of the international economy in which creditor countries bear disproportionate responsibility for global economic stability is not straightforward. The central assumptions upon which most such models are predicated -- notably the concept of international public goods -- tend to be vague and difficult to implement.

In this paper I critique the literature on the responsibilities of creditor nations. After indicating the limitations of existing theoretical formulations, I analyze the role that creditor countries have played historically in the operation of the international economy, considering first "responsibilities" related to the operation of international capital markets, where the asymmetry between debtor and creditor countries is by definition especially pronounced, before turning to other areas where net foreign creditors might be expected to play a special role. This evidence leads me to a largely negative assessment of explanations that impute disproportionate responsibility to creditor nations for global economic stability.

I. A Review of Implicit Models

The popular rationale for assigning creditor countries special responsibility for the smooth operation of the international economy is that global economic stability has the character of an international public good.1/ Countries that invest in systemic stability enhance not just their own welfare but that of their trading partners. They are unable to exclude other countries from the benefits of their own investments in stability, which is the defining feature of a public good. It follows from this
characterization of global stability that large countries will tend to play a leading role in its provision. Small countries which enjoy only a minute fraction of the benefits of their own contribution to global stability have an incentive to shirk investing in its provision, leaving their larger counterparts liable for a disproportionate share of the costs of collective supply. Hence large countries which internalize nonnegligible shares of the benefits of provision must shoulder this responsibility as the only feasible solution to the free rider problem that would otherwise doom the international economy to instability.\(^2\)

Accepting (only) momentarily the validity of the international public good characterization, it still need not follow that creditor countries have a disproportionate responsibility for provision. Large countries, which are normally thought to be in the best position to internalize the externalities associated with international public good provision, and creditor countries are not one and the same, as recent events have underscored. Why creditor countries should bear special responsibility is far from clear. One might imagine a supply-side rationale, along standard Heckscher-Ohlin lines. Relative to other activities, the production of international public goods intensively utilizes international financial resources. Since creditor countries are abundantly endowed with these resources, comparative advantage dictates that they should export international public goods in return for the private goods of other nations. Thus, it is up to the governments of the creditor countries to repair the market failures or remove distorting policies which prevent them from reaping the gains from trade.
Alternatively, one might imagine a demand-side rationale for singling out creditor countries. The argument would be predicated on the notion that global economic stability imposes more serious costs on those who invest abroad than on parties engaged in other transactions. Since foreign investors reap a disproportionate share of the benefits of the provision of international economic stability, they can be expected to demand that their governments supply it. This is a variant of the standard trade-theoretic argument that patterns of production and trade among large countries will be influenced by tastes as well as factor endowments.

Both rationales are problematic. The argument that creditor countries have a comparative advantage in the provision of systemic stability suffers from several deficiencies. It is far from clear that the net foreign investment position of a country is the appropriate indicator of comparative advantage in supplying a stabilizing influence. One could plausibly argue that a country's share of global production, global commodity exports or global financial transactions is a better indicator of its capacity to exert a stabilizing influence over the international economy. Neither does it follow from the observation that one country has a comparative advantage in the production of a good that it bears special responsibility for remedying any market imperfections that prevent it from reaping gains from trade. It is equally plausible a priori that responsibility for remedying those imperfections lies on the demand side — as when for example other countries as free riders are unwilling to compensate the potential exporter on terms that make production attractive.3/ Similar deficiencies undermine the argument that creditor countries bear the responsibility of financing the international public good of systemic stability because their citizens suffer
disproportionately from its absence. It is not clear that those who invest abroad rather than those engaged in foreign or even domestic commodity transactions in fact bear a disproportionate share of the costs.

Each of these models tacitly assumes that global economic stability in fact possesses the distinguishing characteristics of a public good. The validity of this assumption has been called into question from several different directions. Some authors such as Vaubel (1983) have questioned the assumption of incomplete appropriability that gives rise to a conflict between individual and group objectives and that provides the largest participants a disproportionate incentive to finance collective-good provision. They argue that policymakers appropriate all the benefits of their contributions to economic stability, implying that there is no tradeoff between domestic economic objectives and international economic stability.

Critics of the present international economic order argue in contrast that the advanced economies derive disproportionate benefits from the stability and the continued operation of existing international economic arrangements. They see the benefits of these arrangements neither as international public goods nor as of concern only to individual countries. Rather, they characterize the stability of international economic relations as beneficial for industrial and detrimental for industrializing countries. The extreme form of this argument, in which the stability of existing international arrangements benefits only the dominant economy, implies that the international public good analogy is fatally flawed.

Similarly, contributors to the recent literature on international policy coordination emphasize that spillovers of policies across national borders need not be positive, as the public-good analogy assumes, but may be
negative, as in the case of "international public bads." Popular examples include beggar-thy-neighbor tariffs and currency devaluations which stimulate output and employment at home but at the expense of output and employment abroad, and which can create deadweight losses which reduce the size of the pie to be divided between trading partners.6/ Here the problem is not underprovision of a policy from which positive externalities (e.g. public-good characteristics) arise, but overprovision of policies which give rise to negative externalities because the benefits are enjoyed at home while some of the costs are borne abroad.

Just as in the case of international public goods, the essence of the problem is that national policymakers fail to take into account external effects and the interdependence of decisions. Game-theoretic treatments have emphasized two approaches to internalizing at least some of these externalities. First, countries can engage in mutually advantageous policy trades, agreeing to modify a policy that is advantageous at home but has negative effects abroad if other countries do the same. In this way the players can move toward the core of cooperative solutions. Again there is no obvious reason why creditor nations should play a special role in initiating or sustaining this process, however. International policy coordination is a game which both creditor and debtor can play. Alternatively, one country can adopt the role of Stackelberg leader, taking the anticipated reaction of its foreign counterpart into account when formulating its own policy. This at least internalizes induced marginal changes in the externalities associated with foreign policies. But it is not clear that net foreign creditors have more to gain than debtors from adopting the leadership role. While it is
possible, as I have shown elsewhere, to construct examples in which this is
the case, it is difficult to see why this should be a general rule.\footnote{7}

Thus, possible problems associated with the public good analogy and
clear problems with the rationale for treating creditor countries
asymmetrically render the theoretical literature inconclusive. If these
models are to be successfully reformulated, theorists require guidance from
actual experience on the appropriate assumptions and structure to impose. I
turn therefore to historical evidence on the influence creditor countries
actually have exercised over the stability of the international economy.

II. Roles Related to the Operation of Capital Markets

1. Maintaining a Stable Volume of Foreign Lending

A logical starting point for an analysis of the impact of foreign
creditors on the stability of the international economy is the operation of
international capital markets. Creditor countries most obviously can
exercise a stabilizing influence by steadying the volume of foreign lending.
Conversely, they can destabilize the global economic environment by
permitting their lending to fluctuate excessively.

The importance of a stable volume of foreign lending is readily
illustrated by counterexample. In the half century prior to 1913, overseas
lending by the leading international creditor, Great Britain, passed through
alternating decades of scarcity and ample supply.\footnote{8} One interpretation of
the Kuznets cycle emphasizes how the international economy was displaced by
autonomous shifts in Britain's propensity to lend. In decades when British
investors were disinclined to lend abroad, conditions elsewhere were
relatively depressed. In decades when British investors turned their
attention overseas, construction activity and other forms of investment in the recipient countries, most notably in North America and other regions of recent settlement, were stimulated by capital inflows. The rapid real wage growth associated with this prosperity stimulated immigration, raising (or at least damping the decline in) the labor/capital ratio and the return to capital, and setting in motion a virtuous cycle. Only the autonomous interruption of Britain’s willingness to lend abruptly halted the process. Thus, it is thought that the world economy was pushed through alternating periods of boom and slump by these largely autonomous shifts in the volume of British lending overseas.9/

In the interwar period, the successive phases of the cycle were compressed, but the interpretation is the same. Foreign lending was depressed in the wake of World War I and remained so through 1924. At that point the low-interest-rate policies of the Federal Reserve unleashed a torrent of foreign lending, mainly by the United States (see the top panel of Figure 1).10/ This initiated a period of easy credit and growth throughout the developing world. After less than five years, however, in the summer of 1928, U.S. lending declined abruptly, as the gathering boom on Wall Street siphoned off available funds, pushing borrowing countries into recession even before the Great Depression struck the United States.11/ Following the onset of sovereign default in 1931, foreign lending remained depressed through the remainder of the 1930s. Lending by the other leading creditor country, Great Britain, exhibited essentially the same time profile although the amplitude of the fluctuations was relatively modest (Figure 1). Debtor countries had no choice but to engineer recovery without significant access to foreign
funds. Thus, interwar experience places in relief the destabilizing impulse that creditor countries can impart through this channel.

A similar story can be told about the decades following World War II. Initially, U.S. foreign lending remained at moderate levels. With some interwar defaults unsettled and the memory of others still fresh, the bond market was largely inactive. Lending took the form of direct foreign investment, augmented by Export-Import Bank loans and an increasing volume of bank credit. Then came the dramatic surge in bank lending of the 1970s attributable to accommodation of the OPEC shock by creditor-country monetary authorities, and its collapse after 1981 following the adoption of anti-inflationary policies by the same central banks. Just as in the 1890s and the 1930s, in the presence of imperfect information the negative signal conveyed by some countries’ debt-servicing difficulties was generalized to others, interrupting the flow of credit to all potential borrowers. But for the absence of default, the policies of austerity adopted by developing-country debtors to fend off default bear a striking resemblance to their difficulties in the years immediately following 1929.12/

Thus, for those who interpret these swings in foreign lending as autonomous shocks imparted by the creditor countries, the historical record provides extensive evidence, mainly of a negative sort, that the stability of the volume of foreign lending had a first-order impact on the stability of the international economy. There are two problems, however, with the interpretation which imputes to net foreign creditors control over the volume of foreign lending. First, at any point in time, creditor countries and lending countries need not be one and the same. Nations become net foreign creditors as a result of past lending, but debtors can attempt to join their
ranks by starting to lend themselves. Second, there are competing interpretations of events such as the Kuznets cycle which imputes less influence to the actions of the lenders. One such interpretation is that autonomous events in the borrowing regions -- the spread of industrialization and the completion of transportation networks, for example -- induced the migration which stimulated the demand for housing and infrastructure and attracted foreign capital. The consensus view, to the extent that one exists, is that swings in the volume of foreign lending responded to autonomous developments in debtor and creditor regions alike. Similarly, eclectic views of the interwar period emphasize the impact of events in both debtor and creditor nations. The surge of lending after 1924, for example, was stimulated by the restoration of economic and political stability in the borrowing regions, not just by U.S. monetary policies, while the collapse of lending after the first half of 1928 was a function not just of the Wall Street boom but of the steady deterioration in the terms of trade of the capital-importing countries. The comparable interpretation of the 1980s is that the collapse of foreign lending was a function in part of unsustainable economic policies in capital-importing countries, such as the maintenance of overvalued exchange rates which created balance-of-payments difficulties for the borrowing countries. For all three periods, most observers would conclude that events in both debtor and creditor countries contributed to the observed instability in the volume of foreign lending.

2. Adopting Sound Lending Practices

Section II.1 highlighted the sensitivity of the flow of foreign lending to default by foreign borrowers. Simultaneous default by several governments typically brought lending to a standstill, where it remained until a
settlement was negotiated, often with dire implications for the stability of international capital markets.\textsuperscript{13} 

Historians of foreign lending have been critical of creditor countries for failing to discriminate adequately between good and bad credit risks. In the 19th century it was not Britain, the most experienced creditor, but France and Germany that lent to countries which lapsed repeatedly into default. The distinguishing feature of British lending was London’s tendency to direct capital toward projects that promised to make available a stream of export revenues to be used to service the additional debt, the prototypical example being the bonds of American railways linking the grain fields of the Midwest with the ports of the East. In contrast, Paris and Berlin lent heavily to governments in Eastern and Central Europe and in the Middle East engaged in costly military campaigns and other forms of unproductive spending.\textsuperscript{14} There was no reason to expect that export revenues to service these loans would become available in due course. The incidence of default on French- and German-style revenue loans to central governments was naturally much greater than on British-style development loans. Whenever default broke out, French and German lending fell off, rendering the volume of lending by Paris and Berlin especially volatile.

Government interference in the operation of the market is frequently assigned a significant share of the blame for the problems with French and German lending practices. The French and German governments actively sought to influence the direction of foreign lending in the interest of diplomatic goals. If subtle, this influence was effective. In Fishlow's (1985, p.55) words, "the informal and continuing contacts between the financial community and the French and German foreign offices were perhaps even more vital [than
overt intervention] in signaling official enthusiasm and displeasure."

Political objectives such as alliance building consistently dominated any
desire to influence the direction of foreign lending in such a way as to
smooth the operation of capital markets.

In the 1920s, it was the U.S. as the newly-emergent international
creditor that was indicted for failing to discriminate adequately among
credit risks. In a frantic scramble for foreign business, American issue
houses allegedly pushed loans on borrowers with little regard for their
ability to repay. As new entrants to the market, U.S. lending institutions
had not yet solved the principal-agent problem resulting from the fact that,
while shareholders may have been interested in maximizing profits, junior
loan officers were interested in maximizing the volume of loans.15/

Overcoming internal disagreement, the creditor country government
involved again acknowledged its regulatory responsibility for the lending
process. Banks originating foreign loans were instructed to inform the U.S.
State Department prior to offering an issue to American investors. State
consulted Treasury and Commerce before announcing whether or not it had an
objection to the loan. But the central concern of the American Executive was
not to discourage dubious loans which might pose a threat to the stability of
the capital market, but rather to use private lending abroad in pursuit of
other objectives, notably the negotiation of an acceptable payment schedule
for war debts owed the U.S. Thus, for example, Washington objected to a
prospective Rumanian loan in 1922 on these grounds and prevented the
flotation of refunding issues for France until that country negotiated a war
debt settlement.
In view of this history, criticisms of U.S. foreign lending in the 1970s have a familiar ring. Guttentag and Herring (1985) argue that the rates charged sovereign borrowers on bank loans could not have adequately incorporated country-risk premia because they varied so little. The problem of overlending once again is attributed to the principal-agent problem arising from the divergent interests of shareholders and senior management on the one hand versus junior loan officers on the other, and to the failure of individual banks to take into account the impact of their own marginal loans on the riskiness of their competitors’ existing loan portfolios.

Thus, for those who locate the problems in the international intermediation process on the lenders' side, there is evidence, again of a negative sort, that the success with which creditor countries discriminated between good and bad credit risks has strongly affected the stability of the international capital market and hence of the international economy. But a complete explanation would emphasize the counterpart to sound lending practices, namely sound borrowing practices. For every foreign lender who failed to adequately acknowledge the riskiness of a foreign project, there is a foreign borrower who similarly underestimated project risk or squandered borrowed funds on uneconomical uses. One must recognize the role of lending and borrowing decisions alike in the smooth operation of the intermediation process.

3. **Maintaining Stable Real Interest Rates**

A second channel through which creditor countries can contribute to illiquidity and insolvency which threatens the smooth operation of the international capital market is by failing to maintain stable real interest rates. There is extensive historical evidence that creditor countries have
contributed to instability in this way, but little evidence that they have attached much weight to the stability of the international capital market when formulating policies affecting interest rates.

Two examples are the periods beginning in 1928 and 1979, when the course of real interest rates was similar, although the channels through which capital markets were affected differed substantially. The rise in (ex post) real interest rates starting in 1928 (see the top panel of Figure 2) was due first to the increasingly stringent monetary policy adopted by the Fed to counter stock market speculation and then to the collapse of the price level.\textsuperscript{16} The real interest rate shock associated with the collapse of prices increased debt-to-income and debt-to-export ratios.\textsuperscript{17} Previous studies have shown that these ratios were leading indicators of the incidence and extent of default.\textsuperscript{18} Not that policy makers were cognizant of the impending crisis. Although officials in the U.S. and Europe voiced concern over the collapse of the price level for a number of reasons, the added LDC debt-service burden and the threat posed to the stability of the international capital market were not among their primary concerns.

In contrast to 1929, the post-1979 real interest rate shock was due not to inadvertent deflation but accelerating inflation followed by premeditated disinflation. On average, the inflation of the 1970s was not incorporated into required rates of return, implying negative real interest rates (Figure 2). As the decade progressed, investors recognized the inflationary trend, and nominal interest rose to meet and exceed the rate of inflation. Another consequence of high and variable inflation was that lenders indexed the rates on an increasing share of long-term loans. With debt bearing floating interest rates, high inflation translated automatically into higher interest
charges and higher nominal debt-servicing burdens. Lenders argued that higher nominal interest rates simply represented compensation for inflation and that the added burden on the debtors was offset by the erosion of the real value of the outstanding debt. But their argument neglected the "tilt effect": by more quickly eroding the real value of principal, higher inflation and nominal interest rates increased the pace of amortization, adding to the immediate debt-service burden. Moreover, the argument that changes in nominal interest rates merely represented compensation for inflation ignored changes in real interest rates. The post-1979 monetary squeeze had a dramatic impact on real rates, which shot upward, reaching a peak in the neighborhood of 16 per cent in early 1981.

The coincidence of these interest-rate shocks with the outbreak of the debt crisis underscores the influence of policies affecting interest rates over the stability of international capital markets. Historically, creditor countries have played a leading role in the determination of those interest rates. Whether this will continue to be the case in the future remains unclear, however. For the first time, the country that is home to the leading global financial market is also a net foreign debtor. While this has various implications, it does not imply that this country will have no influence over global interest rate levels. There is no reason to doubt that the U.S., as a net debtor nation but a large player in international financial markets, will continue to exercise an important influence on the determination of real interest rates worldwide for the foreseeable future. It is mainly large countries, and not just debtor or creditor nations, that bear the responsibility for preventing interest rate shocks.

4. Providing Exceptional Liquidity
Even when countries fail to prevent the development of capital shortages and liquidity crises, they can soften their impact by providing resources to tide over illiquid borrowers. In considering the provision of exceptional liquidity, I shall distinguish balance-of-payments loans designed to fend off financial crises (considered in Section I.5 below) from liquidity provided for other reasons.

A first form of exceptional liquidity is what Kindleberger (1973) refers to as countercyclical lending. His argument is that international economic stability requires of creditor countries that they provide foreign loans to other countries in economic difficulty. Assessing this argument requires distinguishing the different problems to which the provision of exceptional liquidity is an appropriate response. There is little question that new money for countries unable to service existing debts can at least delay defaults which threaten the operation of the international capital market. Again, the proof lies in instances (1890, 1931, 1982) when new money was not forthcoming in volumes sufficient to prevent serious disruptions. In contrast, there is considerable question that countercyclical lending can prevent or ameliorate a global recession. If debtor and creditor countries are simultaneously threatened by recession, it is not clear that transferring funds (and aggregate demand) from one to another will enhance the stability of the world economy. 19/ Only if business cycles are not synchronized across debtor and creditor countries will countercyclical lending be unambiguously beneficial by cooling off overheated economies in the expansionary phase of the cycle while at the same time moderating the slump in countries in the contractionary phase. As international business cycles become increasingly
synchronized, the case for countercyclical lending becomes increasingly problematic.

The more compelling form of the argument focuses not on the cycle but on capital shortages following major shocks. Prototypical examples are the periods of reconstruction following World Wars I and II. In the first instance, the United States refused to write down debts incurred during the war or to endorse proposals for the establishment of an international facility to transfer funds to the European Continent, where the capital shortage was most severe. European proposals for an international credit facility to provide loans to countries whose reconstruction needs were extensive, in principle to be funded by a number of countries but in practice to obtain the bulk of its resources from the United States, fell on deaf ears.20/

In the second instance, U.S. policy was very different. Whether they had learned from the mistakes of the previous generation, taking to heart the criticism that their failure to address the capital shortage following World War I had undermined political stability in Europe and thereby contributed to World War II, or had been galvanized into action by the perceived Communist threat to Western Europe, U.S. policymakers took seriously America’s responsibility as a creditor nation. The American government’s initial strategy for relieving the dollar shortage that constrained Europe’s ability to import materials required for reconstruction was to extend long-term loans at interest rates approximating market levels. But the failure of the European harvest in 1947 combined with the rising prices of American exports to render the funds available through this channel wholly inadequate. The Truman Administration’s response was the Marshall Plan, under whose
provisions the U.S. provided economic aid to uncommitted nations in excess of $10 billion through June 1951. That recovery proceeded more smoothly after the Second World War than after the First surely had much to do with the Marshall Plan. The contrast highlights the contribution to international economic stability of the provision of exceptional liquidity by creditor countries.

5. **Containing Financial Disturbances**

A final channel through which disturbances to the financial sector can disrupt the smooth operation of the international capital market is the propagation of financial crises. A panic in one national market can quickly spill over to others, bringing normal international financial transactions to a halt.

International propagation can be equally rapid whether the disturbance originates in the banking sector or in security markets. The "Great Crash" of 1929 and the "Great Correction" of 1987 illustrate that the links among national security markets are at least as intimate as those among national banking systems. But a stock market crash differs fundamentally from a financial crisis. The features distinguishing financial crises from financial disturbances are the linkages running to and from the banking system. A crisis develops when those linkages are allowed to operate, permitting disturbances originating elsewhere in the economy to spill over to the banking system and to feed back to other financial markets.

Linkages to the banking system are critical because they have the capacity to magnify and generalize disturbances. The capacity of bank failures to magnify disturbances arises from their tendency to feed on themselves (the phenomenon of contagion). Since depositors possess
incomplete information about the solvency of individual financial institutions, a failure can undermine depositor confidence in other institutions with similar observable characteristics, threatening the stability of the entire financial system. Contagion can spread among countries as readily as within them, propagating crises across national borders.

The capacity of bank failures to generalize financial disturbances arises from the dependence of other markets on bank credit. Bank failures which lead to disintermediation immediately disrupt transactions in all markets in which bank credit is utilized. As banks threatened by runs call in loans, interest rates rise and credit is rationed. As indebted investors lose access to credit, they are forced into distress sales of assets, especially of securities purchased on margin. Since it is not unusual for investors to obtain credit from foreign banks (if not directly then through foreign credits extended to domestic banks) and to purchase assets on foreign as well as domestic markets, and since contagion can spread directly across national borders, the disturbance can be generalized among countries as readily as within them.24/ Hence the containment of bank failures is a critical step breaking the circuit threatening to translate national financial disturbance into international financial crisis.25/

But a critical point from the perspective of this paper is that responsibility for containing bank failures weighs as heavily on debtor as on creditor nations. The 1931 financial crisis illustrates the point. That crisis originated not in the creditor countries but in two of the principal debtors: Austria and Germany. It was quickly transmitted across national borders by the dependence on foreign credits of the Austrian and German banking systems. As a result of Austria's early stabilization and League of
Nations sponsorship of her foreign borrowing, the Austrian banking system 
previously had experienced a sizeable inflow of foreign funds. The leading 
Austrian bank, the Credit-Anstalt, used these resources to absorb other banks 
and extend loans to domestic industry. When on May 11, 1931 it published its 
balance sheet for 1930, which revealed that many of these loans and 
investments had gone sour, large-scale withdrawals by both domestic and 
foreign borrowers were provoked. A $14 million credit obtained after some 
delay through the offices of the Bank for International Settlements was 
quickly exhausted, forcing the Austrian government to freeze all remaining 
foreign balances.

These developments destabilized neighboring banking systems through 
several mutually reinforcing channels. First, depositors requiring liquidity 
whose Austrian balances were frozen were forced to draw down their foreign 
accounts. Second, foreign creditors were led to question whether loan 
portfolios in Germany, Hungary and Rumania, whose economies and banking 
systems bore more than a superficial resemblance to Austria’s, had 
deteriorated as markedly as the Credit-Anstalt’s. Third, by vividly 
illustrating the danger that governments might respond to the crisis by 
freezing foreign deposits, events in Austria impelled investors in creditor 
countries to repatriate their foreign balances. The crisis quickly spread to 
Germany, culminating in the failure of the Darmstädter Bank on July 13, 1931 
and in the closure of all German financial institutions. Next it spread to 
Britain. Although the clearing banks reinforced their position and succeeded 
in fending off runs, the Bank of England did not, forcing it to suspend the 
convertibility of sterling on September 19, 1931.26/ Although with Britain’s 
success in avoiding bank failures their spread to other countries slowed, the
devaluation of sterling led to liquidation of foreign dollar deposits which contributed to the weakness of the American banking system.

If the events of 1931 demonstrate that containing bank failures is a shared responsibility of debtor and creditor countries, creditor-country governments still may have a special role to play as international lender of last resort. Domestic financial instability can lead to the flight of deposits to safe havens abroad, destabilizing the exchange rate and reinforcing the crisis. One way to halt the vicious spiral is to intervene to prevent the exchange rate’s collapse. It is here that creditor countries, by definition those with financial resources, can play a special role. In both the Austrian and German cases, creditor-country governments were called upon to extend foreign credits to offset the withdrawal of private deposits and buttress the banking system and the exchange rate. In both cases they can be criticized for responding with insufficient speed and generosity, permitting a localized disturbance to be generalized. In the case of Austria it first took from May 14 to May 31 for the B.I.S. to raise a modest $14 million from 11 countries.27/ Whether the delay was due to the Austrian government’s hesitation to guarantee borrowing by the Credit-Anstalt or to French insistence on renunciation of plans for an Austro-German customs union remains in dispute. Within a week the Austrian National Bank requested a second credit, and this time there is no question that France delayed Austria’s access to foreign funds by insisting that plans for the customs union be abandoned. In the case of Germany, foreign loans were bound up not with the customs union but with reparations. France pressed for modifications in Hoover’s proposal for a reparations moratorium before endorsing plans for a German loan. As a result of this maneuvering, the loan
was delayed beyond the date on which the Reichsbank was obliged to publish its weekly balance sheet, which revealed the deterioration in its position and did much to undermine remaining confidence in the Germany banking system.

6. Recapitulation

This assessment of policies affecting the operation of international capital markets suggests that there is little justification for singling out the role of the policies of creditor countries in the maintenance of global economic stability. The policies of both creditor and debtor countries have a role to play. This is not to imply that creditor-country policies conducive to the maintenance of a stable volume of lending, sound lending practices and stable real interest rates are unimportant, only that they have counterparts in debtor-country policies affecting these variables. Where creditor countries are likely to play a singular role is in the provision of exceptional liquidity in response to foreign exchange market shocks and threats of financial crisis.

III. Other Responsibilities

1. Contributing to the Stability of the International Monetary System

It frequently is argued that international monetary stability has the characteristics of an international public good, and that the presence of a dominant economic power is needed to insure that this public good is not undersupplied.28/ One can identify two variants of the argument, one which emphasizes the role of a leading country in the provision of international reserves, the other which emphasizes its role in the international coordination of economic policies.
Table 1
Growth and Composition of Foreign-Exchange Assets, 1900–1913
(in millions of dollars)

<table>
<thead>
<tr>
<th></th>
<th>End of 1899</th>
<th>End of 1913</th>
<th>Change</th>
<th>1913 index (1899=100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Official Institutions</td>
<td>246.6</td>
<td>1,124.7</td>
<td>878.1</td>
<td>456</td>
</tr>
<tr>
<td>(2) known sterling</td>
<td>103.1</td>
<td>425.4</td>
<td>322.3</td>
<td>405</td>
</tr>
<tr>
<td>(3) known francs</td>
<td>27.2</td>
<td>273.1</td>
<td>245.9</td>
<td>1,010</td>
</tr>
<tr>
<td>(4) known marks</td>
<td>24.2</td>
<td>136.9</td>
<td>112.7</td>
<td>566</td>
</tr>
<tr>
<td>(5) other currencies</td>
<td>9.4</td>
<td>53.3</td>
<td>43.9</td>
<td>590</td>
</tr>
<tr>
<td>(6) unallocated</td>
<td>80.7</td>
<td>232.0</td>
<td>151.2</td>
<td>257</td>
</tr>
<tr>
<td>(7) Private Institutions</td>
<td>157.6</td>
<td>497.8</td>
<td>340.2</td>
<td>316</td>
</tr>
<tr>
<td>(8) known sterling</td>
<td>15.9</td>
<td>16.0</td>
<td>0.1</td>
<td>100</td>
</tr>
<tr>
<td>(9) known francs</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>(10) known marks</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>(11) other currencies</td>
<td>62.0</td>
<td>156.7</td>
<td>94.7</td>
<td>253</td>
</tr>
<tr>
<td>(12) unallocated</td>
<td>79.7</td>
<td>323.1</td>
<td>243.4</td>
<td>405</td>
</tr>
<tr>
<td>(13) All Institutions</td>
<td>404.2</td>
<td>1,622.5</td>
<td>1,218.3</td>
<td>401</td>
</tr>
<tr>
<td>(14) known sterling</td>
<td>121.0</td>
<td>441.4</td>
<td>320.4</td>
<td>365</td>
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<tr>
<td>(15) known francs</td>
<td>27.2</td>
<td>273.1</td>
<td>245.9</td>
<td>1,010</td>
</tr>
<tr>
<td>(16) known marks</td>
<td>24.2</td>
<td>136.9</td>
<td>112.7</td>
<td>566</td>
</tr>
<tr>
<td>(17) other currencies</td>
<td>71.4</td>
<td>212.0</td>
<td>140.6</td>
<td>257</td>
</tr>
<tr>
<td>(18) unallocated</td>
<td>160.4</td>
<td>537.1</td>
<td>376.7</td>
<td>347</td>
</tr>
</tbody>
</table>

(19) Sum of sterling, francs, marks, and unallocated holdings:

|                | 432.8       | 1,410.5     | 977.7  | 424                   |
| (20) all institutions | 237.2       | 1,069.4     | 832.2  | 451                   |
| (21) official institutions | 95.6       | 341.1       | 245.5  | 337                   |


Notes: Details may not add up to totals due to rounding.

The 1913 totals fall slightly short of the corresponding magnitudes in Table 2 owing to the exclusion from Table 3 of a few individual series for which data were available for 1913 but not for 1899.
According to the first variant, an adequate supply and a stable demand for reserves require that they be provided by a key-currency country with a credible commitment to avoid inflation and depreciation. "The monetary systems of the past were relative stable when a single currency dominated: sterling through most of the 19th century, the dollar in the early postwar period." 28/ This dominant currency provided the dominant source of international reserves. Foreign deposits already comprised a significant component of international reserves under the classical gold standard, as Table 1 shows. 30/ The supply of monetary gold being relatively inelastic in the short run, the only way under the gold standard to meet a sudden increase in the demand for reserves, short of sustained deflation, was for central banks to augment their deposits in the financial centers of the creditor countries: London prior to 1913, New York after 1945.

Consequently, doubts about the desire and ability of creditor countries to maintain the value of their currencies could provoke other countries to liquidate their foreign exchange holdings. The panic flight of capital across borders threatened to destabilize other exchange rates, while the destruction of reserves and scramble for less risky international assets threatened to unleash a deflationary spiral. Both consequences were evident following Britain’s failure to defend the convertibility of sterling in 1931. 31/ As a rule, the statutes empowering central banks to hold some portion of their reserves in the form of foreign exchange limited them to currencies convertible into gold. Hence when Britain devalued other central banks were forced to replace sterling reserves required to back their liabilities with gold or other convertible currencies. Moreover, countries such as Belgium which had been tempted to get out of sterling prior to
Britain's devaluation but had restrained the impulse in response to Bank of England pressure for support moved to liquidate their dollar reserves to avoid another round of capital losses in the event of a U.S. devaluation. As speculative pressure shifted from sterling to the dollar, not only Belgium but Poland, Czechoslovakia and Bulgaria cashed in their dollar balances, undermining confidence in the dollar and forcing more restrictive monetary policies on the Federal Reserve. The reserve-liquidation effect operated powerfully: between the end of 1930 and 1931 the share of foreign exchange in the reserve portfolios of 23 central banks fell from 35 to 19 per cent (see Table 2).

Similar trends were evident in the 1960s (Table 3), especially once France began to swap her dollars for gold and other countries began to diversify their reserve portfolios into European currencies and yen. There remains dispute over the extent to which this growing hesitation to hold dollars was due to America's failure to accept the responsibilities of a key currency nation -- a failure which manifested itself in the tendency to adopt inflationary policies which eroded confidence in the dollar -- or to other factors -- in the case of France de Gaulle's opposition to U.S. foreign policies combined with France's traditional preference for gold, in the case of other countries the inexorable tendency, noted by Robert Triffin, for the ratio of dollar reserves to gold to rise as the global demand for reserves expanded along with the world economy.32/ Whatever the source of the dollar's problems, their causal role in the collapse of Bretton Woods is undeniable.33/

One way in which a country can render its currency attractive to other nations demanding international reserves is by insuring that its exchange
### Table 2

**Gold and Foreign Exchange Reserves of Central Banks, 1924-32**

<table>
<thead>
<tr>
<th></th>
<th>Total for 24 Countries</th>
<th>Total for 23 Countries (Excluding France)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Exchange</td>
<td>845</td>
<td>2145</td>
</tr>
<tr>
<td>Gold</td>
<td>2281</td>
<td>2903</td>
</tr>
<tr>
<td>Total</td>
<td>3126</td>
<td>5048</td>
</tr>
<tr>
<td>Foreign Exchange as % of total</td>
<td>27</td>
<td>42</td>
</tr>
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</table>

Table 3
Sources of Reserve Change, 1963-72
(in billions of SDRs)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>1. Gold Reserves</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Monetary gold</td>
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<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gold transactions (acquisitions —) by IMF, BIS, and European Fund</td>
<td>0.1</td>
<td>-0.1</td>
<td>0.3</td>
<td>-0.9</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>-2.2</td>
<td>-1.0</td>
<td>-0.5</td>
</tr>
<tr>
<td>Countries' gold reserves</td>
<td>1.0</td>
<td>0.6</td>
<td>1.0</td>
<td>-1.0</td>
<td>-1.4</td>
<td>-0.6</td>
<td>0.2</td>
<td>-2.0</td>
<td>-1.1</td>
<td>-0.3</td>
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<tr>
<td>2. Special Drawing Rights</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>Allocation of SDRs</td>
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<td></td>
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<tr>
<td>IMF holdings of SDRs (increase —)</td>
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<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3.4</td>
</tr>
<tr>
<td>Countries' SDR holdings</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3.1</td>
</tr>
<tr>
<td>3. Reserve Positions in the Fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>U.S. dollars</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. deficit on official settlements</td>
<td>1.9</td>
<td>1.5</td>
<td>1.3</td>
<td>-0.2</td>
<td>3.4</td>
<td>-1.6</td>
<td>-2.8</td>
<td>10.8</td>
<td>30.4</td>
<td>10.2</td>
</tr>
<tr>
<td>U.S. reserve assets (including foreign exchange) used in transactions with countries</td>
<td>-0.4</td>
<td>-0.2</td>
<td>-1.2</td>
<td>-0.8</td>
<td>-0.1</td>
<td>0.9</td>
<td>1.3</td>
<td>-3.0</td>
<td>-3.1</td>
<td>-0.2</td>
</tr>
<tr>
<td>(i) Official claims on United States</td>
<td>1.5</td>
<td>1.4</td>
<td>0.1</td>
<td>-1.1</td>
<td>3.4</td>
<td>-0.8</td>
<td>-1.5</td>
<td>7.7</td>
<td>27.4</td>
<td>10.0</td>
</tr>
<tr>
<td>(ii) Identified official holdings of Euro-dollars</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Official sterling claims on United Kingdom</td>
<td>0.4</td>
<td>0.5</td>
<td>-0.9</td>
<td>-0.1</td>
<td>-1.3</td>
<td>-0.5</td>
<td>0.8</td>
<td>0.5</td>
<td>1.3</td>
<td>0.7</td>
</tr>
<tr>
<td>c. Official deutsche mark claims on Germany</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. Official French franc claims on France</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>e. Foreign exchange claims arising from swap credits and related assistance</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>f. Correction for effect of realignment on stock of reserves</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>g. Unidentified Euro-currencies and residual</td>
<td>0.4</td>
<td>-1.0</td>
<td>0.5</td>
<td>-1.1</td>
<td>0.4</td>
<td>1.2</td>
<td>2.1</td>
<td>4.6</td>
<td>5.2</td>
<td>12.7</td>
</tr>
<tr>
<td>Countries' holdings of foreign exchange</td>
<td>2.3</td>
<td>1.3</td>
<td>-0.6</td>
<td>0.2</td>
<td>2.1</td>
<td>1.8</td>
<td>1.2</td>
<td>14.4</td>
<td>29.1</td>
<td>20.6</td>
</tr>
<tr>
<td>Total reserve change</td>
<td>3.4</td>
<td>2.2</td>
<td>1.6</td>
<td>0.2</td>
<td>0.1</td>
<td>2.0</td>
<td>1.7</td>
<td>16.5</td>
<td>29.4</td>
<td>23.1</td>
</tr>
</tbody>
</table>

rate does not become seriously misaligned. The dollar's dramatic rise
between 1980 and 1985 followed by three years of equally dramatic decline has
illustrated the havoc that misalignments can wreak and the problems they can
create for central bankers seeking to manage their reserve portfolios.
(Their responses are summarized in Table 4.) The increasing overvaluation of
the dollar during the final years of Bretton Woods when the dollar price of
gold remained pegged despite the acceleration of U.S. inflation shows another
form that the same syndrome can take (in this case, by giving rise to the
danger of capital losses). Similar interpretations have been offered to
explain some of the international monetary difficulties of the 1920s and of
the final years of the classical gold standard. It is argued that the
exchange rate system of the 1920s came under stress as a result of
ill-advised decisions to peg the French franc and the British pound at
misaligned rates, the pound some ten per cent too high, the franc some ten
per cent too low.34/ It is asserted similarly that sterling became
increasingly overvalued in the years leading up to World War I, although this
is not a hypothesis that is easy to quantify nor a problem in which policy
played a conscious role.35/

Thus, the importance of the key-currency country in maintaining both the
stability and adequate supply of reserve assets seems to be borne out by the
historical evidence. But, critically, it is not obvious that key-currency
and creditor countries need be one and the same. Historically, they have
been. But one can imagine that the United States, despite its newly acquired
status as a net foreign debtor, if it succeeds in avoiding inflation could
remain a key currency country for some years. The sheer size of the U.S.
economy, in conjunction with the traditional international role of the
dollar, may suffice to sustain that role into the 21st century.

According to the other variant of the argument, creditor countries can
lend stability to the operation of the international monetary system by
providing a focal point for the harmonization of national economic policies
that is a prerequisite for exchange rate stability. Germany serves as the
anchor of the European monetary system because of her reputation for price
and monetary stability. It is straightforward for other countries to
coordinate macroeconomic policies by adapting domestic policies to the stable
and predictable stance of the Bundesbank. Similar arguments have been
applied to the early years of the Bretton Woods System and to the heyday of
the classical gold standard, when the Federal Reserve and the Bank of
England, respectively, served as focal points for policy coordination. What
is not obvious, however, is that creditor countries have a comparative
advantage in serving as foci for policy coordination. Countries seeking to
harmonize their policies internationally might be inclined to focus on the
policies of large countries rather than creditor countries per se, as when
for example they wish to minimize changes in the competitiveness of their
goods in that large country’s markets. One can imagine that the U.S. in the
1990s, as a net foreign debtor yet at the same time the world’s leading
industrial economy, might continue to serve as a focal point for the
macroeconomic policies of other industrial nations, and that industrializing
countries in Latin America, Asia and elsewhere might wish to peg their
currencies to the dollar.
Table 4
Official Holdings of Reserve Assets, End of Year 1980–85 and End of March 1986
(in billions of SDRs)

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>All countries</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total reserves excluding gold</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fund-related assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserve positions in the Fund SDRs</td>
<td>16.8</td>
<td>21.3</td>
<td>25.5</td>
<td>39.1</td>
<td>41.6</td>
<td>38.7</td>
<td>38.0</td>
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<tr>
<td>Subtotal, Fund-related assets</td>
<td>11.8</td>
<td>16.4</td>
<td>17.1</td>
<td>14.4</td>
<td>16.5</td>
<td>18.2</td>
<td>18.6</td>
</tr>
<tr>
<td>Foreign exchange</td>
<td>28.6</td>
<td>37.7</td>
<td>43.2</td>
<td>53.5</td>
<td>58.0</td>
<td>56.9</td>
<td>56.6</td>
</tr>
<tr>
<td>Total reserves excluding gold</td>
<td>321.4</td>
<td>330.2</td>
<td>327.7</td>
<td>360.8</td>
<td>405.8</td>
<td>403.6</td>
<td>389.4</td>
</tr>
<tr>
<td>Gold</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quantity (millions of ounces)</td>
<td>953.0</td>
<td>953.3</td>
<td>948.7</td>
<td>947.4</td>
<td>946.3</td>
<td>948.9</td>
<td>948.7</td>
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<tr>
<td>Value at London market price</td>
<td>440.5</td>
<td>325.5</td>
<td>392.9</td>
<td>345.2</td>
<td>297.6</td>
<td>282.5</td>
<td>266.7</td>
</tr>
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</table>

Share of National Currencies in Total Identified Official Holdings of Foreign Exchange
End of Year 1977–85
(in percent)

<table>
<thead>
<tr>
<th></th>
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<td>All countries</td>
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<td></td>
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<td></td>
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<td>1985</td>
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<tr>
<td>U.S. dollar</td>
<td>80.3</td>
<td>78.2</td>
<td>75.2</td>
<td>69.0</td>
<td>73.1</td>
<td>71.7</td>
<td>72.2</td>
<td>70.5</td>
<td>65.1</td>
<td>56.4</td>
</tr>
<tr>
<td>Pound sterling</td>
<td>1.8</td>
<td>1.8</td>
<td>2.1</td>
<td>3.1</td>
<td>2.2</td>
<td>2.5</td>
<td>2.7</td>
<td>3.1</td>
<td>3.2</td>
<td>2.9</td>
</tr>
<tr>
<td>Deutsche mark</td>
<td>9.3</td>
<td>11.2</td>
<td>12.8</td>
<td>15.6</td>
<td>13.4</td>
<td>12.9</td>
<td>12.0</td>
<td>12.8</td>
<td>15.5</td>
<td>14.2</td>
</tr>
<tr>
<td>French franc</td>
<td>1.3</td>
<td>1.2</td>
<td>1.4</td>
<td>1.8</td>
<td>1.4</td>
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<td>Swiss franc</td>
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<td>2.4</td>
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<td>Netherlands guilder</td>
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<td>0.9</td>
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<td>1.4</td>
<td>1.2</td>
<td>1.2</td>
<td>0.9</td>
<td>0.8</td>
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<td>Japanese yen</td>
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<td>4.7</td>
<td>5.0</td>
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<td>2.8</td>
<td>3.5</td>
<td>3.8</td>
<td>3.9</td>
<td>15.2</td>
</tr>
</tbody>
</table>

2. Providing Open Markets

A question of particular relevance to the ongoing debate over the international economic policies of Japan is whether creditor countries have a special responsibility for access to commodity markets, in the sense of both providing ready access to their domestic market and pressing their trading partners to do likewise. Critics of Japan assert that her policies pose a threat to the international trading system because she provides inadequate domestic market access. The $50 billion trade surplus with the U.S., it is argued, is attributable to Japanese as well as American policies, and political pressures for the U.S. Congress to restrict access to the American market will prove irresistible unless action is taken by Japanese as well as American policymakers. The implication is that an open trading system will survive only if the major trading nations, including Japan, actively invest in its maintenance.

Support for this interpretation derives from "hegemonic stability theories" of international commercial regimes, which posit that a dominant commercial power in a position to internalize the externalities associated with the international public good of an open trading system is needed to sustain a free trade regime.36/ Stephen Krasner has noted that eras of relatively free trade have coincided with periods when a single nation played a dominant role in international commerce, Britain's dominance of mid-19th century commerce and U.S. dominance of post-World War II trade serving as examples. Charles Kindleberger has pointed to the association of proliferating trade restrictions in the 1920s and 1930s with the absence of a dominant commercial power.37/ The implication is that without pressure by the powerful, free trade will be unobtainable.
The interpretation of free trade as an international public good whose provision is in the interest of the principal creditor nation founders on two problems. First, neoclassical models of trade uniformly imply that large countries have the most to gain from the imposition of trade restrictions while small countries have the most to lose. Large countries, by definition, possess monopoly power in international markets which they can exploit by taxing imports and exports. Small countries, by definition, lack market power. Trade theory implies that one would expect to observe a relatively open trading system in periods when commerce takes place between a relatively large number of small economies, none of which stands to gain significantly from restrictions.38/

This problem begins dissolve if the international public good takes a form distinct from the gains from trade. One is reminded of the lesson Cordell Hull drew from the trade warfare of the 'thirties: nations that trade freely with one another are less likely to go to war. Hull's notion that free trade has positive externalities in the diplomatic sphere provided the rationale for U.S. efforts to reduce trade barriers following both the passage of the Reciprocal Trade Agreements Act in 1934 and the formation of the GATT.39/ As the players with most to gain in narrowly economic terms, large countries, it could be argued, have a special responsibility to recognize the existence of spillovers between economic and noneconomic arenas and to restrain the impulse to consider only economic benefits.

This reconciliation leaves a second problem, however, since it suggests only why large countries might wish to invest in the defence of free trade, not why creditor countries should have a special interest. One hypothesis is that unrestricted trade entails large trade imbalances at periodic intervals.
Table 5
Defense Expenditures as % of Gross Domestic Product in Purchasers' Values

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Belgium</td>
<td>3.4</td>
<td>3.3</td>
<td>3.2</td>
<td>3.3</td>
</tr>
<tr>
<td>Denmark</td>
<td>2.5</td>
<td>2.4</td>
<td>2.3</td>
<td>2.3</td>
</tr>
<tr>
<td>France</td>
<td>4.1</td>
<td>4.2</td>
<td>4.1</td>
<td>4.1</td>
</tr>
<tr>
<td>Germany</td>
<td>3.4</td>
<td>3.4</td>
<td>3.3</td>
<td>3.3</td>
</tr>
<tr>
<td>Greece</td>
<td>6.9</td>
<td>6.3</td>
<td>7.2</td>
<td>7.1</td>
</tr>
<tr>
<td>Italy</td>
<td>2.6</td>
<td>2.7</td>
<td>2.7</td>
<td>2.7</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>1.2</td>
<td>1.2</td>
<td>1.2</td>
<td>1.2</td>
</tr>
<tr>
<td>Netherlands</td>
<td>3.2</td>
<td>3.2</td>
<td>3.2</td>
<td>3.1</td>
</tr>
<tr>
<td>Norway</td>
<td>3.0</td>
<td>3.1</td>
<td>2.8</td>
<td>3.2</td>
</tr>
<tr>
<td>Portugal</td>
<td>3.4</td>
<td>3.4</td>
<td>3.3</td>
<td>3.2</td>
</tr>
<tr>
<td>Turkey</td>
<td>5.2</td>
<td>4.8</td>
<td>4.4</td>
<td>4.4</td>
</tr>
<tr>
<td>Britain</td>
<td>5.0</td>
<td>5.3</td>
<td>5.3</td>
<td>5.4</td>
</tr>
<tr>
<td>Canada</td>
<td>2.1</td>
<td>2.0</td>
<td>2.2</td>
<td>2.2</td>
</tr>
<tr>
<td>U.S.</td>
<td>6.4</td>
<td>6.6</td>
<td>6.5</td>
<td>6.9</td>
</tr>
</tbody>
</table>

Note: France is a member of the Alliance without belonging to the integrated military structure; the relevant figures are indicative only.
Creditor countries, it could be argued, have a comparative advantage in accommodating the strains created by those imbalances, presumably by lending freely to countries required to finance external deficits. In its crude form, the argument makes little sense, since if surplus countries did not lend, other countries could not run deficits (since the current and capital accounts sum to zero by definition). Rather, the argument must be that lending by creditor countries permits countries to adjust at relatively low cost to the shocks which create incipient current account deficits, and which would provoke the imposition of trade restrictions if they were forced to bear those costs without the aid of capital inflows.

3. Financing Defence and Foreign Aid

In this section, I touch briefly on the provision of mutual defence and foreign aid. While it might seem curious to juxtapose this pair of expenditure categories, in fact the same analytical framework can be used to understand the problems posed for their provision.

International security is a classic example of a collective good. Just as all residents of a country are thought to derive benefits from the provision of national defence, justifying the collection of taxes and organization of defence expenditures at the national level, all members of an alliance derive benefits from contributions to their collective security.40/ Hence the standard free rider problem arises. Mancur Olson and Richard Zeckhauser (1966) noted that large and small countries are likely to face different incentives.41/ Small countries reap only a minuscule fraction of the returns to their own contribution (since those benefits are spread over the residents of all alliance members), while the share of large countries
Table 6
Net Official Development Assistance from DAC Countries to Developing Countries and Multilateral Agencies

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td></td>
<td>$ millions</td>
<td>As % of GNP</td>
<td>$ millions</td>
<td>As % of GNP</td>
<td>$ millions</td>
<td>As % of GNP</td>
<td>$ millions</td>
</tr>
<tr>
<td>Australia</td>
<td>443</td>
<td>0.49</td>
<td>667</td>
<td>0.48</td>
<td>882</td>
<td>0.36</td>
<td>753</td>
</tr>
<tr>
<td>Austria</td>
<td>79</td>
<td>0.19</td>
<td>178</td>
<td>0.23</td>
<td>326</td>
<td>0.36</td>
<td>158</td>
</tr>
<tr>
<td>Belgium</td>
<td>363</td>
<td>0.52</td>
<td>595</td>
<td>0.50</td>
<td>499</td>
<td>0.59</td>
<td>479</td>
</tr>
<tr>
<td>Canada</td>
<td>910</td>
<td>0.50</td>
<td>1075</td>
<td>0.43</td>
<td>1197</td>
<td>0.41</td>
<td>1429</td>
</tr>
<tr>
<td>Denmark</td>
<td>226</td>
<td>0.54</td>
<td>481</td>
<td>0.74</td>
<td>413</td>
<td>0.77</td>
<td>395</td>
</tr>
<tr>
<td>Finland</td>
<td>49</td>
<td>0.16</td>
<td>110</td>
<td>0.22</td>
<td>144</td>
<td>0.29</td>
<td>153</td>
</tr>
<tr>
<td>France</td>
<td>2168</td>
<td>0.60</td>
<td>462</td>
<td>0.63</td>
<td>4034</td>
<td>0.74</td>
<td>3815</td>
</tr>
<tr>
<td>Germany</td>
<td>1666</td>
<td>0.36</td>
<td>3567</td>
<td>0.44</td>
<td>3352</td>
<td>0.48</td>
<td>2716</td>
</tr>
<tr>
<td>Ireland</td>
<td>8</td>
<td>0.09</td>
<td>30</td>
<td>0.16</td>
<td>47</td>
<td>0.27</td>
<td>33</td>
</tr>
<tr>
<td>Italy</td>
<td>202</td>
<td>0.10</td>
<td>683</td>
<td>0.15</td>
<td>811</td>
<td>0.20</td>
<td>834</td>
</tr>
<tr>
<td>Japan</td>
<td>1226</td>
<td>0.21</td>
<td>3553</td>
<td>0.32</td>
<td>3023</td>
<td>0.38</td>
<td>3761</td>
</tr>
<tr>
<td>Netherlands</td>
<td>748</td>
<td>0.79</td>
<td>1630</td>
<td>0.97</td>
<td>1472</td>
<td>1.07</td>
<td>1195</td>
</tr>
<tr>
<td>New Zealand</td>
<td>57</td>
<td>0.44</td>
<td>72</td>
<td>0.33</td>
<td>65</td>
<td>0.28</td>
<td>61</td>
</tr>
<tr>
<td>Norway</td>
<td>232</td>
<td>0.74</td>
<td>486</td>
<td>0.87</td>
<td>559</td>
<td>1.03</td>
<td>584</td>
</tr>
<tr>
<td>Sweden</td>
<td>651</td>
<td>0.84</td>
<td>962</td>
<td>0.78</td>
<td>987</td>
<td>1.02</td>
<td>754</td>
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<tr>
<td>Switzerland</td>
<td>112</td>
<td>0.19</td>
<td>253</td>
<td>0.24</td>
<td>252</td>
<td>0.25</td>
<td>320</td>
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<tr>
<td>United Kingdom</td>
<td>968</td>
<td>0.40</td>
<td>1834</td>
<td>0.35</td>
<td>1800</td>
<td>0.37</td>
<td>1610</td>
</tr>
<tr>
<td>United States</td>
<td>4041</td>
<td>0.25</td>
<td>7138</td>
<td>0.27</td>
<td>8202</td>
<td>0.27</td>
<td>8081</td>
</tr>
<tr>
<td>Total DAC</td>
<td>14519</td>
<td>0.34</td>
<td>27297</td>
<td>0.37</td>
<td>27777</td>
<td>0.38</td>
<td>27592</td>
</tr>
</tbody>
</table>

Note: Excluding administrative costs, except for the United States.

can be substantial. Hence, large countries will be inclined to contribute a larger proportion of their national resources to the common defence, a tendency for which Olson and Zeckhauser found evidence in data on NATO expenditures (see also Table 5). But even if one moves from the observation that some countries contribute disproportionately to their mutual defence to the conclusion that they have a responsibility to do so (or, equivalently, that other countries are shirking their responsibilities), from the perspective of this paper the problem remains that this is a statement about large and small countries, not about debtors and creditors.

One might search for a solution to this problem in the fact, noted by Olson and Zeckhauser, that alliances in fact produce a mixture of national and international public goods. Countries whose national borders are not far removed from Soviet tank divisions are likely to perceive disproportionate benefits from NATO expenditures, for example. There is no obvious reason that creditor countries should necessarily appropriate a disproportionate share of the benefits, however. Another complication is that countries may have different tastes for the public good component. This is one way of interpreting the otherwise paradoxical pattern of foreign aid donations. The same framework that Olson and Zeckhauser applied to the analysis of NATO contributions can be applied to foreign aid expenditures. Foreign aid which raises living standards within developing countries and strengthens ties with the donating bloc presumably enhances the welfare of all potential contributors with an interest in relations with the developing world. Once again, the free rider problem creates an incentive for individual countries to undercontribute. In the case of foreign aid, the paradox is that many large countries, notably the U.S., which according to this theory have the least
incentive to free ride, contribute the smallest shares of their GNP to foreign aid (Table 6). To explain this behavior, the OECD (1985) invokes international variations in "tastes" or "attitudes" toward aid. Again, however, there is no obvious reason why these tastes should vary systematically across debtor and creditor countries (as distinct from rich and poor or large and small ones).

4. **Institutional Design**

A final responsibility frequently imputed to creditor nations is that for institutional design. International institutions have obvious appeal as a solution to the free-rider problem that impedes international public good provision and to the defection and coordination problems that hinder efforts to harmonize economic policies across borders. Institutions can systematize the provision of international public goods and provide sanctions against renegades. Similarly, institutional arrangements can provide a focal point for the international coordination of economic policies and threaten sanctions against countries tempted to defect. Many of the institutional arrangements around which international trade and finance have been organized can and have been interpreted in this light.

The question is whether to impute special responsibility for institutional design to creditor countries. Those who do so emphasize the "deep pockets" of the creditors: that they alone possess the international assets needed to finance set-up costs of international institutions. To illustrate the point they lean heavily on the example of the U.S. in the wake of World War II and, at least implicitly, on the contrast with the aftermath of World War I. In the wake of World War II, U.S. policymakers saw the renovation of international institutions as a necessary condition for
preventing the reappearance of international economic disorder like that which had undermined the stability of the international economy in the 1930s. The U.S. played a leading role in initiating the negotiations that led to the establishment of the Bretton Woods System, the World Bank and the GATT. American officials were particularly concerned to prevent the reemergence of foreign-exchange-market turbulence like that of the 1920s, of competitive devaluations like those of the 1930s, and of preferential trading systems like those adopted in the years preceding World War II. For this reason they convened the negotiations that led to establishment of the Bretton Woods System, which was designed to provide rules for exchange-rate management, of the International Monetary Fund, which was designed to serve as international lender of last resort, of the World Bank, which was designed to supplement the private capital market in providing long-term finance, and of the General Agreement on Tariffs and Trade, which provided a framework for trade liberalization.

The importance of these institutions to the relative stability and prosperity that characterized the first two postwar decades is easily exaggerated. The viability of the postwar institutions to which so much importance often is attached was predicated on a predisposition to coordinate policies and to resist the temptation to adopt beggar-thy-neighbor initiatives, in part because of lingering memories of interwar experience. Seen in this light, the Bretton Woods institutions were a consequence of the existence of the preconditions for international economic stability, rather than an independent cause. Given those preconditions, the new institutions then provided a useful focal point for policy convergence and an effective mechanism for implementing the desired policy coordination.
So too is there a tendency to exaggerate the role of the principal creditor country in institutional design. In fact, the United States was forced to make important concessions in the design of the Bretton Woods institutions, notably on the use of exchange rate adjustments without IMF approval and of exchange controls for capital transactions. Still, it is impossible to imagine the Bretton Woods agreements in the absence of effective U.S. pressure, and equally difficult to imagine such effective pressure had large parts of the world not depended so heavily on U.S. reconstruction finance.

The contrast with the aftermath of World War I is striking. In the 1920s Britain pushed for institutional reforms on both financial and commercial fronts, but without success. The Genoa resolutions, designed to relieve the danger of a deflationary reserve shortage, elicited little U.S. or French cooperation and were stillborn. Proposals to establish an international credit facility along the lines of the World Bank (see Section II.4 above) met the same fate, in large part because the leading creditor, the United States, was unwilling to help defray the cost. British efforts to roll back trade barriers through a series of tariff truce conferences held under League of Nations auspices were similarly undermined by American refusal to join the League and by the inability or lack of desire of successive U.S. administrations to moderate domestic protectionist pressures. Had the U.S. endorsed these efforts rather than retreating toward isolationism, European efforts at institutional reform surely would have been more successful.

Admittedly, other periods of institutional innovation fit less neatly into this mold. Britain as international creditor played little conscious
role in the emergence of the classical gold standard, for example. Rather than a construct of the creditor country, the movement toward gold was largely a response to the desire for a metallic standard and the persistence of silver inflation. While other countries were attracted to gold both by the fact that it insured exchange-rate stability vis-a-vis the leading commercial nation and because it promised easier access to the British capital market, the result was not one that Britain used her leverage as creditor to achieve. Still, the weight of the evidence, especially that for the 20th century, suggests that pressure and finance by creditor countries have played an important role in the process of institutional reform. Creditor countries have leverage in international negotiations by virtue of the dependence of other nations on the funds they provide, leverage which they can utilize in negotiations over institutional design.

IV. Conclusion

In this paper I have examined historical evidence on the influence of creditor countries over the stability of the international economy. The central question has been why, if the policies of both debtor and creditor nations affect the international economy, those of net foreign creditors should be singled out for their impact on systemic stability. My answer in large part is that they should not. International economic stability is a state to which all countries, particularly large ones, can contribute, whether they are net-foreign creditors or net-foreign debtors. Insofar as creditor nations can exercise a disproportionate influence, this is limited mainly to those markets over which they exercise singular leverage, namely international capital markets, where they can exert a stabilizing influence through the provision of exceptional liquidity. To the extent that their
leverage carries over to the operation of the international monetary system, there also may be reason to single out creditor countries for their role in the maintenance of international monetary stability. But as one moves from there to the maintenance of an open trading system, the funding of defence and the finance of foreign aid, any special role of creditor countries is greatly attenuated.

On the question of what happens when policies appropriate for the maintenance of systemic stability conflict with domestic objectives, the historical evidence is sobering. It has been rare for creditor countries -- or any countries for that matter -- to be sufficiently far-sighted to unilaterally sacrifice short-run domestic objectives in the interest of long-run international stability. More commonly, initiatives aimed at the maintenance of systemic stability have required international cooperation. Cooperation in the form of policy coordination not only has permitted the costs of investing in systemic stability to be shared internationally but has minimized those costs by ameliorating the conflict between domestic and international objectives.

The historical evidence also suggests that the international harmonization of policies has been difficult to achieve on a case-by-case basis. Typically, international institutions or conventions have been required to realize gains from trade among policymakers. And creditor countries, which possess the resources needed to construct such institutions, and the leverage needed to achieve a successful conclusion to negotiations, have often played a prominent role in institutional design. In a period when the international trade is under attack, the international capital market is in disarray, and the international monetary system is all but nonexistent, a
strong case can be made that the most pressing responsibility of creditor nations is that for institutional design.
1. A leading exponent of the public-good characterization of international economic stability is Kindleberger (1973), whose arguments are considered below. For another assessment of attempts to apply this perspective to the international monetary system, see Eichengreen (1988a).

2. This is one foundation of the "theory of hegemonic stability," which posits that the presence of a hegemon, or dominant power, is necessary for the stability of a given structure of international relations. For applications see Gilpin (1975) and Krasner (1976). Note the shift in the text from creditor countries to large countries, a distinction to which I return momentarily.


4. Kindleberger (1981), whose work is associated with the "hegemonic stability" view, in his discussion of the distinction between hegemonic leadership and hegemonic exploitation acknowledges that there may be limits to the applicability of the public good analogy.

5. Feldstein's (1988) argument that the U.S. should not be diverted by calls for international policy coordination from its need to let the dollar fall can be read in the same way: policies which are optimal for the domestic economy are also optimal for the world economy; there need be no conflict due to lack of appropriability.

6. A compendium of recent work in this tradition is Buiter and Marston (1985). Deadweight losses are not always a concomitant of these kind of policies, as Eichengreen and Sachs (1985) emphasize.

7. In previous work, I constructed an example where net foreign creditors in fact derive disproportionate benefits. In my analysis of the Bank of England's role in insuring the smooth operation of the classical gold standard (Eichengreen, 1987), I characterized the potential for instability as the danger that, by engaging in a noncooperative struggle for scarce gold reserves, countries would pursue excessively deflationary policies which put downward pressure on prices and production worldwide. Two options for addressing the problem that the Nash solution to this noncooperative game is pareto inefficient -- equivalently, that the public good of global price stability was underproduced -- were for the participating countries to move toward the core of cooperative solutions and, failing that, for one of the participants to adopt the role of Stackelberg leader, formulating its policy taking into account the anticipated reactions of the other players. I showed that a net foreign creditor, in this context 19th century Britain, which derived exceptional benefits from relatively high interest rates, had an incentive to adopt the role of Stackelberg leader. Compared to other countries, the net foreign creditor holds
smaller gold reserves, and other countries, enjoying larger reserves, adopt more expansionary policies which relieve the downward pressure on prices and production worldwide.

8. The classic account emphasizing the instability of this series and its repercussions is Cairncross (1953).


10. Alternative interpretations of the developments that reignited the process of foreign lending are described in more detail in Eichengreen (1988b). Unless otherwise noted, descriptions of foreign lending in the interwar period draw on this source and on Eichengreen and Portes (1986).

11. The curtailment of capital inflows is the common explanation for the timing of the downturn in Germany (Temen, 1971) and Australia (Eichengreen, 1988c), for example.

12. The two episodes are compared by Fishlow (1985) and Eichengreen and Portes (1987).

13. This is not to imply that countries which defaulted experienced greater subsequent difficulty in borrowing than those which did not, but that much of the impact of default on creditworthiness was external to the defaulting country. Given imperfect information about the debtor's intentions and about the situation in individual countries, default by one borrower might make it more difficult for all borrowers with similar characteristics to obtain access to credit, depressing the volume of lending overall. See Eichengreen (1988b).

14. Two accounts emphasizing this distinction are Feis (1930) and Fishlow (1985).

15. See for example U.S. Senate (1932), pp.845-848 or Stoddard (1932), p.106. In her famous study of the bond market in the 1920s, Ilse Mintz (1950) showed that a small number of inexperienced issue houses that entered the market for foreign bonds relatively late were responsible for a disproportionate share of the foreign dollar loans that subsequently lapsed into default.

16. The ex post real interest rate is computed as the nominal rate on time money, 3 and 4 months, minus the three month ahead rate of inflation.

17. One should not neglect the large volume of short-term credits, extended typically by creditor-country banks and acceptance houses to banks and traders abroad. See Eichengreen and Portes (1987), pp.25-27. I analyze their significance in Section I.5 below.

18. Diaz-Alejandro (1983) and Eichengreen and Portes (1986) both provide quantitative evidence on the relationship.
19. Kindleberger (1973, p.306) may have meant to acknowledge this point when, in his discussion of the Great Depression, he concluded that "even with anti-cyclical capital movements, there would have been a depression."

20. A summary of these proposals, submitted to both the 1920 Brussels Conference and the 1922 Genoa Conference, and of the reception with which they met is Traynor (1949).

21. Eichengreen (1988b), Table 9. While U.S. aid took the form of commodities rather than capital, this was a substitute for financial aid insofar as it permitted the recipients to shift their available financial resources toward other purchases. A caveat is the criticism of the U.S. for providing more agricultural products than were needed, on the grounds that doing so was in the interest of influential agricultural interests in the U.S. See Hartmann (1968), p.63.

22. Analyses which emphasize this channel are Kindleberger (1984) and Bordo (1985).

23. This distinction is elaborated in Eichengreen and Portes (1987).

24. Containment is not synonymous with prevention. Regulators face a well-known tradeoff between the instabilities that may result if bank failures are permitted free rein and the moral hazard problem that will arise if bankers realize that regulators will bail them out of any difficulty.

25. This argument differs from that of Bordo (1985), who assumes that bank failures operate through monetarist channels, by leading to a contraction of the money supply. Bordo contrasts the monetarist approach to financial crises against the Kindleberger (1984) view which emphasizes propagation through liquidity crises, panic sales of stocks, and confidence.

26. Grossman (1988) analyzes the absence of bank failures in Britain in 1931, emphasizing the special structure of the British banking system, which concentrated foreign assets in discount and acceptance houses with ready access to Bank of England credit. Cairncross and Eichengreen (1983) conclude that the 1931 sterling crisis was a result of bank failures on the Continent which undermined confidence in British institutions.


31. This account relies on Eichengreen (1989).

32. This possibility that a gold-dollar standard was inherently unstable was first noted by Triffin (1947). Others have questioned whether the instability was intrinsic; see for example Nau (1988).

33. One can see signs of the operation of these same mechanisms in the final decade of the classical gold standard’s operation. Sterling’s role as the key currency of the prewar gold standard came under strain in the years 1900–1913. Growing political tension in Europe signalled that sterling or even the British economy itself might come under attack. The Boer War marked the end of the long peace of the 19th century and undermined the willingness of potential belligerents to hold their reserves as deposits in London. In addition, the relative decline of British economic power compared to that of Germany and the United States raised doubts about Britain’s ability to continue to defend the sterling parity and to remain principal supplier of exchange reserves. Hence in the final decade prior to World War I, the gold-exchange standard showed signs of reverting to a pure gold standard. de Cecco (1984), p.125.

34. A long line of authors have questioned why, if the pound sterling simply was ten per cent too high, the British economy could not adjust through an additional ten per cent fall in wages and prices. For recent rehearsals of the arguments, see DeLong (1987) and Matthews (1986). In Eichengreen (1986), I have questioned whether undervaluation of the franc following the Poincare stabilization was principally responsible for France’s balance of payments surpluses, while Charles Wyplosz and I (1988) have questioned the view that the exchange rate was mainly responsible for the subsequent course of the French macroeconomy.

35. The argument that sterling became increasingly overvalued over the course of the gold standard period appears in de Cecco (1984) and is analyzed in Eichengreen (1989a).


38. This paradox is noted by Conybeare (1987). A classic derivation of the benefits of trade restrictions for large and small countries is Meade (1952). Harry Johnson (1953/4) considers the issue in the presence of retaliation.


40. I consider qualifications to this statement below.

41. See also Russett and Sullivan (1971) and Ruggie (1972).
42. This recognition has fueled recent complaints in the U.S. that America's allies are not footing the bill for an adequate share of NATO expenditures. Viz. New York Times (May 8, 1988), p. 33.
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