

The Cold War International Economy

FOR THE forty years following World War II, the fierce political struggles of the Cold War and the distinctive international economy created in response to those struggles dominated international affairs. Since its beginning in the sixteenth century, the world economy has in fact passed through several phases, generally beginning and ending with political upheaval and a major war. The first period from the sixteenth to the end of the eighteenth century was labeled the "age of mercantilism." Following the end of the Napoleonic Wars in 1815, the victorious British laid the political foundations for an international market economy that led to the first great era of economic globalism. This era ended with the outbreak of World War I, and the period from the end of World War I to the end of World War II witnessed economic chaos, severe contraction of international trade, and fierce conflict among rival great powers. Then, at the Bretton Woods Conference near the end of World War II, the United States assumed leadership of efforts to revive a global world economy.

The beginning of the Cold War in the late 1940s frustrated this effort to create a truly unified international economy, as that economy divided into what Stalin called "the two systems"—the command or Communist economies of the Soviet bloc and the capitalist economies of the "free world." Under American leadership, the members of the Western alliance created an international economy based on agreed-upon rules and close cooperation. During the Cold War, for the first time in world history the dominant capitalist powers cooperated with one another as the exigencies of survival necessitated that they subordinate parochial interests to alliance unity. International economic institutions such as the World Bank and the International Monetary Fund reflected this commitment to an overriding political purpose. With the end of the Cold War, and therefore of an obvious need for close allied cooperation, the political understandings that underlay the Cold War

international capitalist system began to weaken, and the continued well-being of the world economy was threatened.

The evolution of the post-World War II international economy and the Cold War were intimately joined in every particular. With the end of the Cold War, although mutual economic interest in the survival of an integrated and stable international economy still encourages nations to cooperate, conflicting national ambitions and interests increasingly threaten to undermine the cooperation on which the world economy has been grounded. Therefore, a more secure political foundation for the world economy must be constructed to replace the crumbling underpinnings of the international economy.

POST-WORLD WAR II ECONOMIC ACHIEVEMENTS

The quarter century from the end of World War II to the early 1970s was the most prosperous in human history. Following a period of reconstruction in the late 1940s and early 1950s, the rate of economic growth of the industrialized economies reached a historically unprecedented level. Western Europe grew by about 4.5 percent annually in the 1950s, and by nearly 5 percent annually in the 1960s.²¹ Even more extraordinary was the case of Japan; in the 1950s and 1960s, Japan grew at the unprecedented rate of approximately 10 percent a year. The United States was laggard, growing at about 3 percent in the 1950s and about 4 percent in the 1960s. The less developed economies did not share in this spreading postwar prosperity. The Communist or command economies had isolated themselves from the larger world economy; among them, only the Soviet Union enjoyed rapid economic growth. Economic growth in the West and Japan was accompanied by, and in fact stimulated by, rapid expansion of international trade. As national economic barriers fell, international economic interdependence among the capitalist economies grew rapidly in trade, money, and investment. The Western and Japanese economies left behind the economic miseries of the 1930s and committed themselves to the re-creation of an open, multilateral world economy.

Underlying the extraordinary economic growth were propitious economic and political factors. Supplementing positive supply and

demand were favorable political and institutional factors. The political factors responsible for rapid economic growth and trade expansion included American international leadership and every industrial economy's commitment to develop economic policies to promote full employment. In addition, new international rules and institutions provided a stable framework within which the world economy could flourish. Favorable economic factors constituted the sufficient conditions for the extraordinary performance of the post-World War II economy; the political and institutional environment provided the necessary conditions.

In the early 1970s, however, the postwar era of rapid economic growth came to an abrupt end, and the advanced industrial economies (with the notable exception of Japan) settled into a decade-long stagflation characterized by an unprecedented combination of low rates of economic growth, high rates of unemployment, and very high rates of inflation. Although the causes of this reversal in economic fortunes are still debated, the most important cause was the dramatic slowing of the rate of productivity growth in the United States and Western Europe. Several other developments were undoubtedly also significant. It is certain that the irresponsible and highly inflationary economic policy of the United States accompanying escalation of the Vietnam War in the mid-1960s and the simultaneous expansion of social welfare programs were major contributing factors. The 1973 oil crisis also contributed greatly to these unfortunate developments. Changes in a number of policies and institutions, including environmental and other regulations that decreased economic efficiency, have also been put forth as possible causes. The 1970s setback concluded with the triumph of central bankers committed to strict anti-inflation policies and with the deep recession that ended the stagflation, but at a very high price.

FOUNDATIONS OF POSTWAR ECONOMIC SUCCESS

Several highly favorable economic factors were vital to the outstanding success of the early postwar economy. On the demand side, the war itself had created a large unsatisfied demand in the United States and other industrial economies. Western Europe and Japan not only needed

to rebuild after the devastation of World War II, but wished to "catch up" with the United States as mass consumer societies; indeed, although the United States had developed a mass market for automobiles as early as the 1920s, the European and Japanese mass markets did not develop until after World War II. On the supply side, there was a huge backlog in the United States—including developments in World War II military and industrial research and development—of unexploited technologies and productive techniques. Domestic investment in these technologies provided a huge stimulus to productivity growth, and economic growth in Western Europe and Japan was accelerated by the process of technological catch-up with the United States.

Investment rates in most Western European countries and Japan (especially in the 1960s) reached extraordinary heights. Moreover, both Western Europe and Japan had large supplies of excess labor that migrated from the countryside to industrial areas in the postwar years and contributed to economic growth. Until the energy crisis of 1973, the advanced economies enjoyed very favorable terms of trade in oil and other commodities. Finally, the opening of markets and the expansion of trade further stimulated both investment and economic growth. In short, favorable demand conditions, rapid accumulation of productive factors, and high productivity growth contributed to an era of rapid economic growth.

In addition to these favorable economic conditions, the United States assumed economic and political leadership. After World War II the United States had thrown itself into the effort to create a stable and prosperous world economy. The realization that failure to create a viable world economy after World War I, along with the enormous costs of the Great Depression, had been major causes of World War II caused the United States and many other nations to decide to make the international economy work to avoid a return to the previous disastrous economic conditions. Important economic interests in the United States (industry, finance, agriculture) realized that they had a vital stake in a prosperous world economy. This shift in American thinking was manifest in the crucial role played by the United States in the creation of the Bretton Woods System embodying the belief that a rule-based international economy and international institutions to manage these rules were necessary.

A fundamental change in political thinking and emergence of a novel domestic consensus in Western Europe and in the United States supported a liberal world economy. Central to the new consensus was a distributional settlement between capital and labor in which the major economic powers pledged themselves to pursue full employment policies and to guarantee the welfare of their populations. In effect, governments attempted to convert organized labor to the idea of supporting a world economy based on free trade and to thus help solve the distributional problems that would inevitably arise as nations opened their economies to imports and international competition. Recognizing that free trade would create losers as well as winners, governments also promised to compensate the losers through full employment and social insurance policies. This general commitment took different forms in each of the advanced industrial countries. American enactment of the Full Employment Act (1946), the French system of "indicative" economic planning, and the German concept of the social market, along with the distinctive Japanese commitment to lifetime employment and export-led growth, exemplified this new commitment. New domestic political consensus in many countries supported national economic policies based on the price system and private property. At the international level, the new consensus facilitated agreement on economic policies that promoted an open world economy based on free trade.

However, we must remember that this domestic political consensus rested on certain important conditions. In the early postwar years, national economies were generally closed, and therefore governments were relatively free to pursue economic policies promoting rapid economic growth and full employment. As economies were opened after successive rounds of trade negotiations and increases in international economic flows, governmental ability to pursue expansionary economic policies became more constrained; this resulted in increasing tension between national policy autonomy and the commitment to an open world economy.

Rapid economic and productivity growth also supported the domestic consensus; the distribution issue was, in large part, solved by the expanding economic pie. However, when the rates of economic and productivity growth slackened in the 1970s, new distributional conflicts arose. Also, although rapid economic growth and expansion of the

welfare state had been considered complementary and not conflicting, growth of a more conservative political ideology in the late 1970s led citizens to question the costs of the welfare state and even to assign to the welfare state responsibility for the economic woes associated with stagflation. Thus, when the favorable conditions underlying the postwar domestic consensus began to erode in the 1970s, the political foundations of an open world economy were weakened, at least in the United States and Western Europe.

BRETTON WOODS SYSTEM

The institutional framework of the postwar world economy was constructed at the Bretton Woods Conference in 1944 and reflected American and British thinking. The small number of players involved in formulating the agreement accounts in large part for the extraordinary success of the conference and is in marked contrast to subsequent efforts to agree on rules to govern the world economy. Although a number of disagreements divided the American and British negotiators, the conference succeeded in formulating unifying principles to be embodied in the institutions comprising the Bretton Woods System (BWS).

The major economic powers agreed that trade and other economic activities should be regulated by binding rules and that states were not to interfere in the determination of international economic outcomes. These rules were based on several fundamental principles, including the following: (1) commitment to trade liberalization via multilateral negotiations incorporating the principle of nondiscrimination, (2) agreement that current account transactions should be free from controls but that controls on the freedom of capital movement were permissible, and (3) agreement that exchange rates should be fixed or pegged and that, while an individual nation could modify its exchange rate, it had to consult with the IMF before making major changes. In addition to establishing guidelines and institutions for the international economy, the Bretton Woods Conference also permitted governments to pursue economic stabilization and social welfare policies; that is, individual nations would be free (within prescribed limits) to pursue

economic growth and full employment. These fundamental principles and the international institutions embodying them provided the framework within which the postwar international economy flourished.

The original BWS has been repeatedly and significantly modified in response to economic and political realities. The prostrate European and Japanese economies, the "dollar shortage" experienced by those economies in the years before the Marshall Plan, and especially the exigencies of the Cold War brought about major changes in the original BWS.²² In the interest of forging an alliance system against the Soviet Union, the United States reversed its prior positions on a number of international economic issues and maintained a decisive role in the world economy. Allied cooperation had a major impact on the original BWS and, in the late 1940s, became a major factor in the continued development of the postwar international economic order. For example, the Marshall Plan, which more than anything else transformed American-Western European relations and the postwar international economy, could never have passed the U.S. Congress if there had been no Soviet threat.

The world's foremost creditor nation, the United States, used its financial reserves, primarily through the Marshall Plan, to facilitate rebuilding the West European economies as a buffer against Soviet expansion. From 1947 to 1951, the United States dispersed to its European allies approximately 2 percent of its GNP annually, such a sizable transfer of wealth was unprecedented. In addition to providing this financial assistance, the United States, despite its historic aversion to trading blocs, encouraged West Europeans to pursue economic integration. As a precondition for receiving American assistance, governments were required to lower barriers to intra-European cooperation and to coordinate their economic plans through the Organization for European Economic Cooperation (OEEC, the forerunner of the Organization for Economic Cooperation and Development [OECD]); they were also encouraged to carry out domestic economic reforms, including adoption of America's more productive manufacturing and management techniques. The United States even tolerated European discrimination against American agricultural and manufactured exports. It also used its financial and other resources to help rebuild the Japanese economy and integrate it into the Western system. Thus, during the early

years of the Cold War, the postwar international economic order and the international security order became intimately joined.

Two international regimes (rules) embodied in institutions were particularly important to the early success of the international economy. The International Monetary Fund (IMF) administered the international monetary system based on fixed but adjustable exchange rates. The General Agreement on Tariffs and Trade (GATT) was developed to manage the international trading system; responsibility for that regime was diffused among a number of nations, and as this number increased the trading regime became more and more unwieldy.

International Monetary System of Fixed Rates

The most important BWS regime was the monetary system designed by experts from a number of countries with shared views on technical issues. The system had to provide monetary reserves in sufficient amounts to enable member governments to maintain the exchange rates for their currencies at predetermined values. The IMF was designed to solve this problem by using contributions from member countries and offering reserve credits to states with international payments problems. In addition, the monetary system had to anchor its members' monetary policies to some objective standard in order to prevent global inflation or devaluation. Stabilization of a monetary system can be achieved by tying every currency to a "nonmonetary" asset (gold being the asset of choice), by coordinating national monetary policies, or by following a leader whose past policies promise that it will provide the desired degree of economic stability in the future. Although all three methods were in fact employed in the early postwar years, the monetary policies of member states were anchored by tying every currency to the dollar, which in turn was tied to gold, and the major powers also informally coordinated their economic policies.

This monetary system, which lasted until the early 1970s, was extraordinarily successful. Designed to provide both domestic policy autonomy and international monetary stability, the system in effect provided a compromise between the rigid gold standard of the late nineteenth century, under which governments had little ability to manage their own economies, and the monetary anarchy of the 1930s, when

governments had too much license to engage in competitive devaluations and other destructive practices. To achieve both autonomy and stability, the system was based on the following principles: fixed or pegged exchange rates but sufficient flexibility to enable individual states to deal with extraordinary situations, including pursuit of full employment; reliable reserve credit in the event of an international payments problem; agreement among member countries to peg their currencies to gold at \$35 an ounce or to the dollar; IMF approval of exchange rate adjustments in the event of a fundamental disequilibrium in a nation's balance of payments; and monetary reserves that could be made available to deficit countries. These principles governed the system quite successfully for nearly three decades.

Nevertheless, the ways in which the system actually functioned did not fulfill the intentions and expectations of its founders. A significant difference was that, although the IMF had been assigned responsibility for maintaining reserves, in practice it was the buildup of the dollar reserves held by member governments that actually achieved this goal. In this way the American dollar became the keystone of the international monetary system. Cooperation among the United States and its allies and, until 1971, the passive U.S. attitude toward the dollar's exchange rate made IMF actions unnecessary in this area. Members also followed U.S. policy preferences in the early postwar era, and they were assured that this would provide stability to the system. However, by the time of the Vietnam War in the 1960s, the United States had ceased to pursue a policy of price stability, and the acceleration of inflation caused by the war eventually led to abandonment of the fixed rate system by the Nixon Administration in August, 1971. Even so, the United States and the dollar remained central to the system.

The key role of the dollar in the international monetary system facilitated the American alliance system and the functioning of the world economy; the international role of the dollar as both a reserve and a transaction currency became a cornerstone of America's global economic and political position. Because, for political as well as for economic reasons, America's major allies and economic partners were willing to hold dollars, the international role of the dollar conferred on the United States the right of "seigniorage"; this means that the provider of the currency for an economy, in this case the international economy,

enjoys certain privileges. As President Charles de Gaulle of France bitterly complained in the 1960s, the "hegemony of the dollar" conferred "extravagant privileges" on the United States, because that country alone could simply print dollars to fight foreign wars, could buy up French and other businesses, and could go deeply into debt without fearing negative consequences.

However, a fundamental contradiction existed at the heart of this dollar-based system. While the huge outflow of American dollars to finance the rebuilding of Western Europe and Japan and the American military buildup during both the Korean and Vietnam Wars helped solve certain problems, this outflow of dollars meant that the United States would one day be unable to redeem in gold, and at the agreed price, those dollars held by private investors and foreign governments. A distinguished economist predicted that confidence in the dollar would be undermined as the American balance of payments shifted from a surplus to a deficit. This problem became acute late in the 1960s when escalation of the Vietnam War and its inflationary consequences caused deterioration in international confidence in the value of the dollar. As that confidence declined, the foundations of the Bretton Woods System of fixed rates began to erode.

Decreased confidence in the dollar also led to intensifying speculation in gold, and this was followed by attempts to find ways to recreate confidence in the system. In the late 1960s, the creation of Special Drawing Rights (SDRs) as a new reserve asset to complement the dollar was important. However, as Benjamin Cohen has convincingly argued, the actual solution attained was essentially political.²³ America's Cold War allies, fearing that a collapse of the dollar would force the United States to withdraw its forces from overseas and to retreat into political isolation, agreed to hold overvalued dollars. Also such export-oriented economies as West Germany and, at a later date, Japan wished to keep access to the lucrative American market.

Throughout the postwar era the United States always had one primary partner helping it to defend the dollar and hence the U.S. international position. In the early postwar period, the American position and support for the dollar were based on cooperation with the British; this "special relationship," begun between the First and Second World Wars, had been solidified by wartime experience. The Anglo-Saxon

