had a damaging effect on employment abroad. The foreign response involved retaliatory trade restrictions and preferential trading agreements among groups of countries. A measure that raises domestic welfare is called a *beggar-thy-neighbor policy* when it benefits the home country at the cost of worsening economic conditions abroad.

Uncertainty about government policies led to sharp reserve movements for countries with pegged exchange rates and sharp exchange rate movements for those with floating rates. Many countries imposed prohibitions on private financial account transactions to limit these effects of foreign exchange market developments. This was another way of addressing the trilemma. Trade barriers and deflation in the industrial economies of America and Europe led to widespread repudiations of international debts, particularly by Latin American countries, whose export markets were disappearing. In short, the world economy disintegrated into increasingly autarkic (that is, self-sufficient) national units in the early 1930s.

In the face of the Great Depression, most countries resolved the choice between external and internal balance by curtailing their trading links with the rest of the world and eliminating, by government decree, the possibility of any significant external imbalance. By reducing the gains from trade, that approach imposed high costs on the world economy and contributed to the slow recovery from depression, which in many countries was still incomplete in 1939. All countries would have been better off in a world with freer international trade, provided international cooperation had helped each country preserve its external balance and financial stability without sacrificing internal policy goals. It was this realization that inspired the blueprint for the postwar international monetary system, the **Bretton Woods agreement**.

Case Study

The International Gold Standard and the Great Depression

One of the most striking features of the decade-long Great Depression that started in 1929 was its global nature. Rather than being confined to the United States and its main trading partners, the downturn spread rapidly and forcefully to Europe, Latin America, and elsewhere. What explains the Great Depression's nearly universal scope? Recent scholarship shows that the international gold standard played a central role in starting, deepening, and spreading the 20th century's greatest economic crisis.[8]

In 1929, most market economies were once again on the gold standard. At the time, however, the United States, attempting to slow its overheated economy through monetary contraction, and France, having just ended an inflationary period and returned to gold, faced large financial inflows. Through the resulting balance of payments surpluses, both countries were absorbing the world's monetary gold at a startling rate. (By 1932 the two countries alone held more than 70 percent of it!) Other countries on the gold standard had no choice but to engage in domestic asset sales and raise interest

[8] Important contributions to this research include Ehsan U. Choudhri and Levis A. Kochin, "The Exchange Rate and the International Transmission of Business Cycle Disturbances: Some Evidence from the Great Depression," *Journal of Money, Credit, and Banking* 12 (1980), pp. 565–574; Peter Temin, *Lessons from the Great Depression* (Cambridge, MA: MIT Press, 1989); and Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* (New York: Oxford University Press, 1992). A concise and lucid summary is Ben S. Bernanke, "The World on a Cross of Gold: A Review of 'Golden Fetters: The Gold Standard and the Great Depression, 1919–1939,' " *Journal of Monetary Economics* 31 (April 1993), pp. 251–267.

rates if they wished to conserve their dwindling gold stocks. The resulting worldwide monetary contraction, combined with the shock waves from the October 1929 New York stock market crash, sent the world into deep recession.

A cascade of bank failures around the world only accelerated the global economy's downward spiral. The gold standard again was a key culprit. Many countries desired to safeguard their gold reserves in order to be able to remain on the gold standard. This desire often discouraged them from providing troubled banks with the liquidity that might have allowed the banks to stay in business. After all, any cash provided to banks by their home governments would have increased potential private claims to the government's precious gold holdings.[9]

Perhaps the clearest evidence of the gold standard's role is the contrasting behavior of output and the price level in countries that left the gold standard relatively early, such as Britain, and those that chose a different response to the trilemma and instead stubbornly hung on. Countries that abandoned the gold standard freed themselves to adopt more expansionary monetary policies that limited (or prevented) both domestic deflation and output contraction. The countries with the biggest deflations and output contractions over the years 1929–1935 included France, Switzerland, Belgium, the Netherlands, and Poland, all of which stayed on the gold standard until 1936.

The Bretton Woods System and the International Monetary Fund

In July 1944 representatives of 44 countries meeting in Bretton Woods, New Hampshire, drafted and signed the Articles of Agreement of the **International Monetary Fund (IMF)**. Remembering the disastrous economic events of the interwar period, statesmen in the Allied countries hoped to design an international monetary system that would foster full employment and price stability while allowing individual countries to attain external balance without restrictions on international trade.[10]

[9] Chang-Tai Hsieh and Christina D. Romer argue that the fear of being forced off gold cannot explain the U.S. Federal Reserve's unwillingness to expand the money supply in the early 1930s. See "Was the Federal Reserve Constrained by the Gold Standard During the Great Depression? Evidence from the 1932 Open Market Purchase Program," *Journal of Economic History* 66 (March 2006), pp. 140–176.

[10] The same conference set up a second institution, the World Bank, whose goals were to help the belligerents rebuild their shattered economies and to help the former colonial territories develop and modernize theirs. Only in 1947 was the General Agreement on Tariffs and Trade (GATT) inaugurated as a forum for the multilateral reduction of trade barriers. The GATT was meant as a prelude to the creation of an International Trade Organization (ITO), whose goals in the trade area would parallel those of the IMF in the financial area. Unfortunately, the ITO was doomed by the failures of Congress and Britain's Parliament to ratify its charter. Only much later, in the 1990s, did the GATT become the current World Trade Organization (WTO).


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