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## The Contributions of Leland B. Yeager to International Economics

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Throughout his career, Leland B. Yeager has extended his contributions to domestic monetary theory to the realm of international economics. While he has written in the area of pure trade theory (Yeager and Tuerck 1976, for example), his most significant contribution is probably his *International Monetary Relations* (1966, 1976), a landmark book which soon became the standard reference in the field of international money and finance. This paper focuses on the many contributions of that seminal work.

At the time of publication, Yeager's book was unique in several ways. First, it was highly unusual for a book in international economics to focus solely on the monetary aspects of the subject. By the time of the second edition, a monetary approach to international economics had again become fashionable. Second, his book is evenly divided between theory and historical narrative. (Friedman and Schwartz's 1963 narrative had been published only three years earlier.) In the latter half of his text Yeager provides a history of the international monetary system in the twentieth century. His purpose is to focus on the policy lessons that can be learned from the historical experiences in the light of economic theory. Third, his book was probably the most balanced and thorough presentation of the case for freely floating exchange rates.

The first half of the book focuses on the automatic adjustment mechanisms that operate under a system of fixed and freely floating exchange rates. These two systems provide a contrast to the system then in existence: the Bretton Woods system of fixed-but-adjustable exchange rates. Unlike the other two systems, this one lacked any automatic

adjustment mechanism. The consequences of this deficiency are developed throughout the book.

### **The adjustment mechanisms under fixed and floating rates**

Under a fixed rate system, a country experiencing a balance-of-payments deficit must undergo deflation. If prices are not sufficiently flexible for full adjustment, then real income must also fall. This much is standard fare. However, Yeager focuses on two other mechanisms that are often overlooked: the cash-balance effect and relative price adjustments.

One of the themes of Yeager's domestic monetary theory is the cash-balance effect, which he here applies to the international sector. He argues (1966, p. 64):

In the...deficit country, the cash balances of individuals and business firms shrink.... Out of concern not to let their cash balances shrink too far, people in the deficit country become less eager than before to buy capital assets and consumption goods alike. Decisions about buying and selling and managing cash balances interlock. It is strange that this adjustment effect should have been so widely overlooked even in the traditional analysis relying on the quantity theory of money; for anything better than a purely mechanical version of the quantity theory must emphasize how the money supply interacts with demands for cash balances so as to affect people's market behavior and thereby--rather than is some direct magical way--affect prices....

Yeager also emphasizes the role of shifts in the relative prices of traded and non-traded goods. The prices of the former are determined on world markets and therefore tend to move by smaller percentages than the prices of a country's non-traded goods. Hence, a deficit country

will experience a relative decline in the prices of its domestic goods and services, which include factors of production. He argues (1966, p. 65):

Because domestic goods become relatively cheaper,...[the residents] shift their buying away from imports and exportable goods onto domestic goods and...concentrate their production and sales efforts on the more favorable foreign market....These substitution effects are important and deserve attention far out of proportion to the space needed to state them.

Yet the popular strong version of the monetary approach to the balance of payments assigns a minor role to relative price changes.<sup>1</sup>

A system of fixed exchange rates has a transmission aspect as well as an adjustment aspect. Monetary inflation abroad would be transmitted to the home country through the process of "imported inflation." A country can import inflation in two major ways. First, the home country's balance of payments exhibits a surplus as the inflating countries increase their purchases from the home country. To maintain the fixed rate, the monetary authority buys up the excess foreign exchange, thereby increasing the domestic money supply. Inflation then follows, as explained by monetarist theory. Second, inflation abroad gets transmitted to the prices of the home country's imports and exports. Prices of traded goods are linked to prices of non-traded goods to some degree. Thus, inflation occurs at home through the direct transmission of higher prices. Yeager emphasizes the process of imported inflation throughout his text, providing numerous examples at length.<sup>2</sup>

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<sup>1</sup>Rabin and Yeager (1982) make the distinction between "strong" and "weak" versions of the monetary approach to the balance of payments.

<sup>2</sup>Some examples of imported inflation that are cited by Yeager are: Cuba, Portugal, and Switzerland during World War II; France in the early 1960s; and Germany after 1950. Yeager devotes an entire chapter to "The German Struggle

In his exposition of freely floating exchange rates, Yeager coins the term “quasi flexibility” of prices and wages. He elaborates on this idea in the second edition (pp. 104-105):

The greater ease of changing one price than many suggests how fluctuating exchange rates can in effect put flexibility into sticky wages and prices....Flexible exchange rates could make the prices of each country's labor and products flexible, after all, as translated into the currencies of other countries. This we shall call “quasi flexibility.” If demand for a country's products falls off, exchange depreciation could partly absorb the impact by lowering their foreign-currency prices and so helping to sustain foreign purchases. It would also benefit the country's import-competing industries and ease some transfer of resources out of the damaged export industries.

The case for freely floating exchange rates can probably best be summarized in these two examples taken from his 1966 text:

The gold-standard [or fixed-rates] mechanism changes a wrong exchange rate into a right one not by changing the rate itself but by adjusting everything else. This approach reminds Professor Ropke of a circus clown who, seeing that the chair was too far from the piano, tried, with sweat streaming down his face, to push the piano towards the chair. Exchange-rate adjustment pushes the chair instead; it is a more delicate and selective method, operating directly where changes are really required--in

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Against Imported Inflation.”

the markets for internationally traded goods and services (p. 96).<sup>3</sup>

“The free-exchange system eliminates...the most important carrier of the boom and depression bacillus—namely, the flow of money across frontiers” (p. 105).<sup>4</sup>

Under floating rates, countries can avoid imported inflation as well as imported deflation by gaining control over their domestic money supplies.

### **Fixed-but-adjustable exchange rates**

The Bretton Woods System of fixed-but-adjustable exchange rates had no automatic adjustment mechanism operating. On the contrary, it actually promoted disequilibrium. For countries were encouraged to “ride out” their deficits unless they were a “fundamental disequilibrium.” Just what a fundamental disequilibrium consisted of was never fully explained. Deficit countries avoided the necessary adjustment of deflation by sterilizing any contradictory effects of the deficit on the money supply. Moreover, they would devalue their currency as a last resort rather than face deflation. On the other hand, surplus countries which experienced increases in their money supplies were more prone to inflate; revaluation was usually not a viable option. Yeager argues that the Bretton Woods system thus had an inflationary and devaluation bias.

At the time of publication of the first edition, it was customary to speak of three problems of the Bretton Woods system: the liquidity,

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<sup>3</sup>Yeager also presents Milton Friedman’s classic example of daylight saving time.

<sup>4</sup>This statement is a quotation from Haberler (1958, p. 446).

confidence, and adjustment problems. The “liquidity problem” stemmed from the need for more international liquidity so countries could “ride out” their deficits. Yet more liquidity meant that the United States, the main supplier of international liquidity, would have to run large deficits. Confidence in the dollar would be affected; hence the “confidence problem.” The “adjustment problem” has already been alluded to. The system had no automatic adjustment mechanism operating. On the contrary, the system was a disequilibrium one in which deficit countries were encouraged by the International Monetary Fund to refrain from devaluing their currency to correct their deficits; they should “ride them out.” While the liquidity problem held most economists’ attention, Yeager argued that this emphasis on liquidity was misplaced; for the liquidity problem and confidence problem both derived from the lack of an automatic adjustment mechanism. With an adjustment mechanism operating, the other problems would not arise. Without such a mechanism, problems would persist. Indeed, he even hints at the eventual demise of the Bretton Woods system, which did occur seven years after publication of the first edition.

A major argument in Yeager’s criticism of fixed-but-adjustable rates is the opportunity for one-way-option speculation. He argues (1966, p. 206):

Those who speculate on adjustments in pegged exchange rates have practically a sure thing, a so-called one-way option. When a currency is under suspicion, everyone knows whether it is overvalued or undervalued. There may be some doubt about whether the government will make a rate adjustment, and to what extent, but there is practically no doubt about the direction of any change.... [In the case of an overvalued currency] the possibilities are simply devaluation or no change. Devaluation gives

the bear speculators an easy profit; no change lets them break even.<sup>5</sup>

Moreover, "bear speculation against a weak currency may actually force the hoped-for devaluation" as the country's reserves are depleted (1966, p. 207). Even worse, rumors of a currency's impending devaluation, even if untrue, might force devaluation through destabilizing speculation and thus make themselves true after all (1966, p. 207). This point is often overlooked by the profession. Even if fundamentals do not justify a devaluation, speculation on a devaluation can be self-fulfilling.

### **"Reconciliation" and "rehabilitation"**

Yeager (1976, chapter 9) reconciles the three approaches to balance-of-payments analysis: the elasticities, absorption, and monetary approaches. Each approach is a framework that furnishes distinctive views of reality; the approaches are compatible and even complementary.<sup>6</sup> Rather than provide the reconciliations here at length, I shall briefly summarize one of Yeager's astute observations. Residents of a deficit country are being subsidized by the monetary authority, which is selling foreign exchange at an artificially cheap price. Hence, from the private point of view, real incomes are greater than they would be without this subsidy. Ending the subsidy would decrease over absorption of goods and services (and securities).

Yeager also rehabilitates the purchasing-power-parity doctrine. He emphasizes the stabilizing-pressures aspect of the doctrine rather than the rate-calculation aspect. Moreover, he argues that the doctrine

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<sup>5</sup>Yeager does recognize that some transaction costs are incurred by speculators if devaluation does not take place.

<sup>6</sup>Mundell (1968) also provides a reconciliation of the three approaches.

is “basically a theory of monetary influences on exchange rates” (1976, p. 214).

### **The lessons of history**

Yeager reconsiders some of the “lessons of history” in the second half of his book. He explains (1966, p. 331):

Now, historical associations, by themselves, never teach lessons. Lessons derive from history as interpreted in the light of theories.

He argues that the true gold standard actually ended in 1914. “The gold standard of the late 1920s was hardly more than a facade” (1976, p. 334). The automatic mechanisms of the gold standard were prevented from operating; disequilibriums were the rule rather than the exception. He argues (1976, p. 334):

The...system has aptly been described as “a temporary exchange pegging device;” it consisted of “pegging operations on a vast scale.”<sup>7</sup>

“The systems instituted after both world wars resembled each other in that respect,” as Yeager notes in an article of 1996 (p. 80).

Yeager carefully reexamines four episodes of the interwar period, which Ragnar Nurkse (1944) cites as examples of the horrors of fluctuating exchange rates. In particular, Nurkse focuses on the horrors of destabilizing speculation that supposedly characterized the floating rates at the time. Yeager argues that the rates were not allowed to float

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<sup>7</sup>The quote about pegging comes from Brown (1940, p. 805). According to Yeager, the epithet “facade” is also Brown’s.



freely; rather, they were poorly managed by the authorities.<sup>8</sup> He argues (1976, p. 366):

The examples suggest, at most, that fluctuating rates do not work well when exchange-rate pegging does not work at all and has in fact broken down. The examples are instructive in showing some of the conditions that do give rise to actually or apparently disruptive speculation: domestic inflation and disordered government finances; the shock of suddenly unpegging a previously overvalued currency under attack by bear speculation, and the reaction from that shock; prospects for unorthodox fiscal and monetary measures, such as deliberate manipulation of the gold value of a currency as a means of influencing prices and business conditions; domestic policies regarded as hostile to business; and clumsy official intervention in the exchange market, particularly when it repeatedly presents speculators with “one-way options.”

Yeager (1976, p. 374) also exposes the myth that competitive exchange depreciation dominated the period:

This “beggar-my-neighbor” policy of “competitive exchange depreciation” was far less widespread, however, than subsequently came to be alleged in sweeping and superficial historical generalizations about the 1930s.

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<sup>8</sup>Yeager (1976, chapter 14) explains how intervention by authorities might increase the volatility of floating exchange rates. He also provides some historical examples of disruptive intervention by authorities.

It is ironic then that the Bretton Woods system of fixed-but-adjustable exchange rates grew out of the interpretation of the experiences of the interwar period, especially the "horror of fluctuating exchange rates and competitive exchange depreciation and faith in the virtues of deliberate international monetary cooperation" (1976, p. 402). While the first edition of his text provides a warning about the problems inherent in a system of fixed-but-adjustable exchange rates, the second edition provides a careful analysis of the breakdown of the Bretton Woods system, to which we now turn.

In 1971 the United States experienced its greatest balance-of-payments deficit up until then. A large U.S. deficit meant large surpluses for foreign countries, along with enormous growth in their money supplies through the process of imported inflation. "During the single year 1971, foreign monetary authorities added more dollars to their official reserves than in all of human history up to that time" (1976, p. 605).

Several points should be emphasized concerning this episode. First, repeated efforts to maintain the Bretton Woods system finally collapsed; intellectually, it never was abandoned (1976, p. vii). Second, it was this last-ditch defense of the system that led to the acceleration of worldwide inflation around 1973 (1976, p. 605). Third, the system was not only a transmitter but also a generator of inflation (1976, p. 134). Inflation in the United States in 1971 was actually less than in the rest of the world. It was the export of money, not prices, from the United States that led to the worldwide acceleration of inflation through the process of "imported inflation." Fourth, floating exchange rates often get blamed unfairly for events that resulted from the breakdown of a previous system. Yeager argues (1976, p. 605):

The charges that floating exchange rates promoted inflation...are further examples of something dreadfully familiar in monetary history: floating exchange rates, left on the scene after fixed rates have broken down, are

routinely blamed for the economic disorders that had caused the breakdown and to which the fixed rates had themselves contributed. Actually, both the Bretton Woods system and its collapse had inflationary consequences.... The trouble came from the way that the system collapsed, that is, from its last-ditch defense that stretched out over several years.... Speculators against pegged exchange rates enjoyed one-way options on a mammoth scale.... Speculative funds surged across boundaries and oceans, inflating the countries of destination without deflating the countries of origin.

## **Conclusion**

Yeager (1998) extends his historical analysis to the present day:

Financial crises of the kind experienced in Mexico and East Asia repeat speculative episodes experienced within the European Monetary System and earlier under the Bretton Woods system and still earlier, as in 1931, when pegged exchange rates came under attack. What needs to be said about such crises is much the same, I'm afraid, as I have been saying for 45 years or so. But I'll try to add something new....

....The key to avoiding crises is not international gimmickry. Instead of fiddling with exchange-rate arrangements, policymakers should pay attention to the currencies themselves. So far, absurdly, these remain undefined in value; and their values depend precariously on the changeable policies of central banks, which are constantly badgered with short-run-oriented advice from home and abroad.

For Yeager, fundamental reform is the answer to the problem of chronic exchange-rate crises. The reform he prefers is the privatization of money as in his BFH system, which provides for a money of stable value (cf. Yeager 1997, pp. 337-425).

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