

## EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM

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### Summary

The international monetary system is part of the institutional framework that binds national economies. Ideally such a system permits producers to specialize in those goods for which they have a comparative advantage, and savers to seek profitable investment opportunities on a global basis.

The gold standard evolved over time; it was not consciously invented or planned by international bureaucrats. The effective working of the gold standard required countries to follow simple “rules.” First, each country had to set the value of a unit of its currency in terms of gold. Second, there had to be freedom to move gold across national borders. Third, under the gold standard domestic money supply was linked (more or less automatically) to the stock of gold held. Advocates of the gold standard argue that it contributed to price stability, and particularly to the avoidance of inflation. The gold standard also contained an automatic adjustment mechanism for maintaining balance of payments equilibrium.

While there was a backlash against the first wave of globalization accompanying the gold standard, the pressures created by World War I, rather than unfavorable reactions to globalization, ultimately led to the breakdown of the international economy and its key international institutions. The post-World War I gold standard collapsed over the period 1931/33. The Great Depression, the associated collapse of the international economy in the early 1930s, the rise of Fascism, and the outbreak of World War II effectively destroyed the remnants of the pre-World War I international economy. The devastating depression of the 1930s makes clear the huge cost involved in the

breakdown of international institutions and the abandonment of rules guiding the conduct of the international financial system.

The outcome of the 1944 Bretton Woods Conference was an agreement to establish a global system of fixed (adjustable-peg) exchange rates, and the creation of a new international institution, the International Monetary Fund, to oversee the new arrangements. While the Bretton Woods system served the world well in the 1950s and 1960s, strains built up that resulted in the collapse of the system over the period 1971/73.

Following the breakdown of the Bretton Woods flexible-peg exchange rate system, a hybrid exchange rate regime emerged, in which some countries pegged their currencies to the U.S. dollar, some pegged to a basket of currencies, and others “floated” their currencies.

The volume of international financial transactions increased dramatically post-1973. The growth in world output, trade, and investment associated with a second wave of globalization (1980–2001) naturally caused the volume of financial transactions to grow. However, in the last decades of the twentieth century the rate of growth of financial transactions was far in excess of that of real variables. While the freeing up of financial markets benefited the global economy in many ways, the experience of the Asian financial crisis suggests that liberalization may lead to instability under some circumstances. The problems perceived with short-term capital flows have led a number of economists to support controls on capital movements.

A number of economists have argued that the post-1973 floating exchange rate system has failed in important ways, notably in failing to curtail exchange rate volatility. Some favor moving to a more stable system of exchange rates, perhaps by setting target zones for exchange rates. Any such system should be sufficiently flexible to allow exchange rates to adjust to underlying economic conditions, in particular to changes in prices and productivity, to avoid the mistakes of the Bretton Woods regime. It should also avoid the mistakes of the late twentieth century.

## **1. Introduction**

Countries engaging in international trade must make provision for handling transactions involving multiple currencies. Historically, various arrangements have been adopted for financing trade, ranging from barter to fixed and flexible exchange rate regimes. We refer to the complex arrangements governing the financing of trade as the international monetary system. Given that trade takes place across international borders, the international monetary system necessarily involves cooperation between sovereign nations. The international monetary system is part of the institutional framework that binds national economies together. Ideally such a system permits producers to specialize in those goods for which they have a comparative advantage, and savers to seek profitable investment opportunities on a global basis.

An international monetary system should possess a number of desirable features. First, it should facilitate flows of international trade and investment according to comparative

advantage. Second, it should be stable yet flexible. Stability in the market for foreign exchange minimizes the volatility of import and export prices, permitting producers and consumers to exploit fully the advantages of international specialization. Flexibility in the operation of the international monetary system permits the divergent objectives of national economic authorities to be reconciled with one another. Third, it should promote balance of payments adjustment to prevent disruptions associated with temporary or chronic imbalances, either by means of an automatic adjustment mechanism or through a mechanism that encourages domestic policy makers to correct any imbalances. Fourth, it should provide countries with sufficient liquidity to finance temporary balance of payments deficits. Fifth, given that firms engaging in international trade face many uncertainties, an ideal monetary regime would at least avoid adding further uncertainty. Sixth, as far as possible it should allow member countries to pursue independent monetary and fiscal policies. In other words, it should allow national economic authorities to pursue “divergent objectives.” As noted below, such national independence creates serious problems for the international monetary system.

One of the most dramatic developments in the international monetary system has been the phenomenal rise in the movement of funds across national borders, associated with the worldwide liberalization of financial markets that began in the 1980s, with global currency movements in the year 2000 averaging over US\$1.3 trillion per day. The process of financial globalization, however, should not be thought of as exclusive to the late twentieth century. The world economy experienced the first wave of globalization in the nineteenth century when international capital flows, measured in terms of national production, actually exceeded today’s levels.

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### **Biographical Sketch**

**Associate Professor Keith Trace** has a B.A. (Hons.) from Nottingham University, an M.A. (Economics) from the University of Illinois, and a Ph.D. from the University of Melbourne. He is employed as associate professor in the Department of Economics at Monash University. Teaching interests include courses entitled The International Economy since 1945, Business in Asia, and Economic Development of Asia. He has also taught economics and business strategy courses for the Monash and Monash Mt. Eliza MBA programs.

Keith Trace's research interests include transport economics and Asian economies and his expertise in shipping and ports is internationally recognized. His publications include articles, books, and conference papers on the globalization of the container shipping market, trade in shipping services, shipping policy in the ASEAN countries and Australia, the Australian National Line, the trans-Tasman shipping trade, and the Alice Springs-Darwin rail line. He has recently completed entries on the IMF and the WTO for Fitzroy Dearborn's *Reader's Guide to the Social Sciences*, and was program adviser for the “Living with Globalisation” and “Managing Globalisation” programs in the ABC Radio National/Monash University *Money, Markets and the Economy* radio series.

Keith Trace was seconded to the Productivity Commission in 1999/2000, working on its inquiry into Part X of the *Trade Practices Act*. Recent consultancies include a study of the impact of maritime policy reforms for APEC, together with a follow-up study of the benefits of maritime transport liberalization for the Department of Transport and Regional Services, as well as advising the ACCC in its investigation of shipper complaints relating to the Trade Facilitation Agreement operating in the Australia-Southeast Asian trade. In April/May 2001, Keith Trace visited China as a member of the PRC 2020 Project.