Remarks: The Future of the International Monetary System

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The purpose of the International Monetary System (IMS) is to allow private agents to trade freely and efficiently between countries in goods, services and financial instruments. The history of the IMS since the late nineteenth century is one of financial innovation from the fixed exchange rate gold standard regime to floating exchange rates today(Bordo and Flandreau 2003). The path of learning was not smooth .

According to the Trilemma story (Obstfeld and Taylor 2003), a fixed exchange rate system with free capital mobility only works when there is no monetary policy independence. The Classical gold standard worked moderately well in the period 1880-1914 for the advanced countries and for many emerging countries .It provided the environment for massive capital flows from Europe to the countries of new settlement. The gold standard had fixed exchange rates, free capital mobility but only limited monetary policy independence (with credibility central banks had some leeway to pursue stabilization policy within the target zone provided by the gold points. Bordo and MacDonald 2005).

The gold standard broke down in World War I and was reinstated in the mid 1920s as a Gold Exchange (GE) standard in which member countries held international reserves in gold and foreign exchange and the reserve currency countries, Great Britain and the U.S. ,held reserves in gold. The GE standard only lasted until 1936 when France left it (the rest of the world abandoned the gold standard between 1931 and 1936). The GE standard broke down primarily because of the asymmetric adjustment problem. The UK went back to gold at an overvalued parity in 1925 and France did so in 1926 at an undervalued parity. In addition, the U.S. and France (the largest gold holders sterilized gold inflows from deficit countries like the UK) and didn't allow the classical price specie flow adjustment mechanism to work. Thus the UK faced continuous deflationary pressure and a threat to adhering to gold while France and the U.S. sucked gold out of the IMS creating global deflationary pressure. In addition to asymmetric adjustment ,the adherents to the GE standard(because of the postwar dual mandate of full employment and gold convertibility Eichengreen1992) suffered from a lack of the credibility that had characterized the classical gold standard. The Bretton Woods System (BWS) was designed to rectify the faults of the GE standard. However, like the GE standard, it evolved into a gold dollar standard. Capital controls allowed monetary (and fiscal) policy independence) to stabilize the domestic real economy. In addition the BWS was an adjustable peg system allowing members to alter their parities in the face of permanent shocks and the International Monetary Fund (IMF) was established to smooth member countries current account imbalances.

Bretton Woods worked relatively well from 1959 to 1967 after current account convertibility was established by the European countries. It had both good price level and real output performance (Bordo 1993). During this period capital controls had considerable traction and the U.S. ,the reserve center country ,followed (at least until 1965) the rule to maintain price stability.

The BWS broke down because of the Triffin dilemma (the rise in outstanding dollar liabilities held by member countries relative to the U.S. gold reserves creating the eventual conditions for a run on the U.S. gold reserves): a run up in U.S. inflation after 1965 which was transmitted to the rest of the world; the loss of credibility of U.S. monetary policy; growing capital mobility and ease to evade the capital controls.

BWS was succeeded in 1973 by managed floating exchange rates. After a decade of learning characterized by high and variable inflation in virtually every advanced country, (except Germany and Switzerland), and volatile exchange rates, floating became relatively successful by the mid 1980s. Indeed many emerging countries reached the level of financial maturity to be able float in the subsequent two decades.

The ability of floating exchange rates to handle the series of shocks that have occurred since 1973 makes it difficult to understand why it should be replaced by a Bretton Woods type system loaded with fatal flaws. The recent financial crisis (which is not yet resolved for peripheral European countries) and its aftermath of slow recovery is an unusual episode. It was not caused by the IMS but by policy mistakes ,again largely by the United States (a flawed housing policy, failures in supervision and regulation and too loose monetary policy between 2002-2005), aided by financial innovation which increased leverage and risk taking. The financial crisis and subsequent serious recession were transmitted to the rest of the world through financial linkages and trade flows. The emerging countries, less financially connected to the U.S., and with a strong underlying growth dynamic, fared much better than the advanced countries. Once adjustment to the crisis/ recession and slow recovery has been made in the advanced countries, several years from now, it should be back to business as usual. The eurozone story is different from the rest of the IMS. It reflects serious flaws in its construct (e.g. the lack of a fiscal union and credible adherence by members to fiscal rules). The crisis revealed its fault lines and the outlook seems less optimistic.

However, there is a similarity between the GE standard and BWS on the one hand and the present system on the other—the asymmetric adjustment mechanism between surplus countries like China and deficit countries like the U.S. and U.K. Like France and the U.S. in the 1920s and 1930s and the U.S. in the 1960s, important countries like China are not playing by the rules of the IMS. In each case there is a good reason why these surplus countries sterilized gold and dollar inflows. In the case of France in the 1920s and 1930s, it was because of fear of a return to the high inflation of the early 20s. A similar fear drove U.S. policy makers. For the U.S. in the 1960s, it was because of the financing of the Vietnam War and social programs, along with the Keynesian takeover of the Fed (which led it to greatly downplay the commitment to gold convertibility and to low inflation, in favor of maintaining full employment and high growth). Similarly, today China undervalues its currency and sterilizes reserve inflows because it wants to follow the successful export –led domestic development strategy that other Asian countries did earlier in the twentieth century.

The key intractable problem today, as in the past, is the inability to force important sovereign countries to go against their perceived national interest. No one can force China to let its currency float or to remove its capital controls. The main difference in this regard between the GE standard and the BWS system in the past, versus the regime today is that a fixed exchange rate system (as in the earlier episodes) would eventually collapse in the face of the imbalances; whereas today flexible exchange rates in countries (other than China and several others) can act as buffers until China has reached the financial maturity to float. The U.S. dollar will continue to be the international reserve currency of choice for the foreseeable future because it's possible rivals are not yet ready (the eurozone is unstable and China is not financially developed enough to provide a reserve currency). Moreover, because of this there is little incentive for China or other surplus emerging countries to stage a run on the dollar like France did in the 1960s.Thus the floating exchange rate system will muddle through after the financial crisis becomes history.

One possible reform of the present system that could work to make it more efficient is for all countries to follow credible inflation targeting (or better still, price level targeting) rules at a common inflation rate, e.g. 1%, along with floating exchange rates. It would be like the classical gold standard but better because it would not be based on a commodity facing "the vagaries of the gold standard," and because the floating exchange rate could handle shocks to the real exchange rate. It would require countries to reach the financial maturity necessary to have a floating exchange rate and like under the gold standard to follow credible monetary (and fiscal) rules.

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