EVOLUTION OF INTERNATIONAL MONETARY SYSTEM

The Gold Standard

Under the classical gold standard, from 1870 to 1914, the international monetary system was largely decentralized and market-based. There was minimal institutional support, apart from the joint commitment of the major economies to maintain the gold price of their currencies. Although the adjustment to external imbalances should, in theory, have been relatively smooth, in practice it was not problem-free. Surplus countries did not always abide by the conventions of the system and tried to frustrate the adjustment process by sterilizing gold inflows. Deficit countries found the adjustment even more difficult because of downward wage and price stickiness. Once the shocks were large and persistent enough, the consequences of forfeiting monetary independence and asymmetric adjustment ultimately undermined the system.

The gold standard did not survive World War I intact. Widespread inflation caused by money-financed war expenditures and major shifts in the composition of global economic power undermined the pre-war gold parities. Crucially, there was no mechanism to coordinate an orderly return to inflation-adjusted exchange rates. When countries, such as the United Kingdom in 1925, tried to return to the gold standard at overvalued parities, they were forced to endure painful deflation of wages and prices in order to restore competitiveness. Though this was always going to be difficult, it proved impossible when surplus countries thwarted reflation.

During the Great Depression, with an open capital account and a commitment to the gold-exchange standard, the United States could not use monetary policy to offset the economic contraction. Fidelity to gold meant that the deflationary pressures from the United States spread quickly, further weakening the global economy. Unable to adjust to these pressures, countries were forced to abandon the system. Though deficit countries experienced the first crisis, all countries suffered from the eventual collapse – a lesson that was repeated in subsequent systems.

Bretton Woods

What Was the Bretton Woods Agreement and System?

The Bretton Woods Agreement was negotiated in July 1944 to establish a new international monetary system, the Bretton Woods System. The Agreement was developed by delegates from 44 countries at the United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire.

Under the Bretton Woods System, gold was the basis for the U.S. dollar and other currencies were pegged to the U.S. dollar's value. The Bretton Woods System effectively came to an end in the early 1970s when President Richard M. Nixon announced that the U.S. would no longer exchange gold for U.S. currency.

Approximately 730 delegates representing 44 countries met in Bretton Woods in July 1944 with the principal goals of creating an efficient foreign exchange system, preventing competitive devaluations of currencies, and promoting international economic growth. The Bretton Woods Agreement and System were central to these goals. The Bretton Woods Agreement also created two important organizations—the International Monetary Fund (IMF) and the World Bank. While the Bretton Woods System was dissolved in the 1970s, both the IMF and World Bank have remained strong pillars for the exchange of international currencies.

Though the Bretton Woods conference itself took place over just three weeks, the preparations for it had been going on for several years. The primary designers of the Bretton Woods System were the famous British economist John Maynard Keynes and American Chief International Economist of the U.S. Treasury Department Harry Dexter White. Keynes' hope was to establish a powerful global central bank to be called the Clearing Union and issue a new international reserve currency called the bancor. White's plan envisioned a more modest lending fund and a greater role for the U.S. dollar, rather than the creation of a new currency. In the end, the adopted plan took ideas from both, leaning more toward White's plan.

It wasn't until 1958 that the Bretton Woods System became fully functional. Once implemented, its provisions called for the U.S. dollar to be pegged to the value of gold. Moreover, all other currencies in the system were then pegged to the U.S. dollar's value. The exchange rate applied at the time set the price of gold at $35 an ounce.

Benefits of Bretton Woods Currency Pegging

The Bretton Woods System included 44 countries. These countries were brought together to help regulate and promote international trade across borders. As with the benefits of all currency pegging regimes, currency pegs are expected to provide currency stabilization for trade of goods and services as well as financing.

All of the countries in the Bretton Woods System agreed to a fixed peg against the U.S. dollar with diversions of only 1% allowed. Countries were required to monitor and maintain their currency pegs which they achieved primarily by using their currency to buy or sell U.S. dollars as needed. The Bretton Woods System, therefore, minimized international currency exchange rate volatility which helped international trade relations. More stability in foreign currency exchange was also a factor for the successful support of loans and grants internationally from the World Bank.

The IMF and World Bank

The Bretton Woods Agreement created two Bretton Woods Institutions, the IMF and the World Bank. Formally introduced in December 1945 both institutions have withstood the test of time, globally serving as important pillars for international capital financing and trade activities.

The purpose of the IMF was to monitor exchange rates and identify nations that needed global monetary support. The World Bank, initially called the International Bank for Reconstruction and Development, was established to manage funds available for providing assistance to countries that had been physically and financially devastated by World War II. In the twenty-first century, the IMF has 189 member countries and still continues to support global monetary cooperation. Tandemly, the World Bank helps to promote these efforts through its loans and grants to governments.

The Bretton Woods System's Collapse

In 1971, concerned that the U.S. gold supply was no longer adequate to cover the number of dollars in circulation, President Richard M. Nixon declared a temporary suspension of the dollar's convertibility into gold. By 1973 the Bretton Woods System had collapsed. Countries were then free to choose any exchange arrangement for their currency, except pegging its value to the price of gold. They could, for example, link its value to another country's currency, or a basket of currencies, or simply let it float freely and allow market forces to determine its value relative to other countries' currencies.

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The Bretton Woods Agreement remains a significant event in world financial history. The two Bretton Woods Institutions it created in the International Monetary Fund and the World Bank played an important part in helping to rebuild Europe in the aftermath of World War II. Subsequently, both institutions have continued to maintain their founding goals while also transitioning to serve global government interests in the modern-day.