JEKEM
An ICA Institute Publication

INDIA, CHINA AND AMERICA INSTITUTE
1549 CLAIRMONT ROAD, SUITE 202 ● DECATUR, GA 30033 USA
WWW.ICAINSTITUTE.ORG

BRICS at the gate: Modern international monetary system in conditions of balanced uncertainty

Sourabh Gupta & Ashok K. Roy

Journal of Emerging Knowledge on Emerging Markets
Volume 3
November 2011

BRICS at the gate: Modern international monetary system in conditions of balanced uncertainty

Sourabh Gupta
Samuels International Associates, Inc.

Ashok K. Roy
Kennesaw State University

Journal of Emerging Knowledge on Emerging Markets
Volume 3
November 2011

Every international order invokes its sense of permanence, yet contradictions within the ordering and the inner flux of its constituent parts render such permanence fleeting. The modern international economic and monetary order has been no different. On three occasions in the past one hundred years --- in the mid-1920s after the First World War; in the mid-1940s in the immediate aftermath of the Second World War; and in the late-1960s/early-1970s at the time of the collapse of the Bretton Woods system--a lasting permanence was sought to be endowed to the modern international monetary system (IMS). On each occasion, the ordering collapsed, or is collapsing, as its hitherto impregnable monetary anchor --- and its handmaiden, confidence --- had dissolved, or is dissolving, under the weight of the system's inner contradictions.

The new *gold-exchange standard* of the 1920s, revived like Phoenix from the ashes of the pre-Great War gold standard, dissolved under the competing reflationary policy objectives of national governments during the Great Depression. Its Bretton Woods successor, effectively, a *gold-dollar standard*, collapsed at the turn of the 1970s under the dynamic instability generated by mobile capital flows that exposed the dollar's misalignment within the pegged exchange rate system and rendered it unworkable.

Peering into the future, the stability of the extant dollar-dominated *global paper standard* appears equally untenable in a global economic order hurtling towards economic multi-polarity and characterized by extensive imbalances and volatile capital flows.

During each period of the system's operation, the seeds that were to sow its demise have emerged within the national and international political economy during its immediate predecessor period. The rigidity/stickiness of prices and wages that gummed-up the global economic adjustment mechanism during the late-1920s and 1930s, leading to loss of confidence in that era's gold-exchange standard, had its origins in the emergent power of labor unions and parliamentary politics that had been, both, a product of and a reaction to the *laissez faire* adjustment mechanism of the prior gold standard system. The destabilizing capital movements that were to undo the convertibility mechanism that undergirded the post-World War II Bretton Woods system had its origins in the inter-war period, when cross-border capital flows tended to aggravate rather than alleviate the dilemma of global financial imbalances.

The build-up of global economic imbalances that have cascaded in the loss of the U.S.' global creditor status and called into question the dollar's reserve currency role within the current global paper standard has its origins in the Bretton Woods era which, at once, endorsed a growth model built on international trade and export surpluses while simultaneously --by way of permitting capital controls and repressing convertibility – frustrated the adjustment mechanism.

Each iteration of the ordering, further, has tended to be anchored in an international reserve currency linked ever more tenuously to metal (gold). Diminishing credibility accorded to the durability of reserve assets denominated in that currency has, in turn, shadowed each successor regime. An upshot of such phenomena has been the ever-increasing tendency of central bank reserve accumulation, such that formal elimination of the special role of gold following the breakdown of the Bretton Woods fixed exchange rate regime has also witnessed an attendant explosion in global reserve holdings.[i] Further, with domestic money supply now no longer chained even tenuously to gold, the inflationary consequences of ever-faster global liquidity issuance loom potentially large.

Clearly, the monetary anchor and the mechanism for adjustment in each successive ordering of the international monetary system has, for reasons deriving from both lack of will and imperfection of design, been overwhelmed by economic circumstances. When the seeds that sowed the ordering's demise have coincided, further, with a transition in international economic and monetary leadership -- as was the case between 1915 and 1935 when the American economy and its currency, for all intents and purposes, permanently dethroned the British pound as the system's anchor currency --- the process of adjustment also has been especially unstable.

In important structural respects, many of the contradictions that ruthlessly exposed the shortcomings of past international monetary orderings are disturbingly evident today – and worse. Rejuvenated by the telecommunications revolution, the revival of quick-silver capital flows across national borders in the post-Bretton Woods age bears resemblance to the free flowing age of capital during the gold standard era, a century and a quarter ago. Yet, unlike the latter era though whose essential monetary anchor was underwritten in gold, the de facto anchor of the current monetary system is anything but golden. A dollar saved in the early-1970s is worth 18 cents today in terms of purchasing power (Lehrman, 2011). A survey of more than 80 central banks, multilateral institutions and sovereign wealth fund managers suggests that a "portfolio of currencies" instead will likely be the next candidate for global reserve currency status.

Lacking a durable monetary anchor, a free floating regime of convertible currencies –-- it is presumed --- will provide a seamless mechanism of adjustment among today's contending fiat currencies. Yet the brief experience of a clean, free floating currency regime in the early part of the 1920s in the immediate aftermath of the First World War, suggests otherwise. Monetary and exchange rate unilateralism and priority attached to domestic policy objectives carried the day, overriding the imperative for international financial coordination.

The emergence of the BRICS (Brazil, Russia, India, China, South Africa) phenomenon, meantime, and the powerful re-rise of China as a global strategic peer competitor to the United States is likely to heap an additional layer of complication to the task of international financial coordination. Beijing's formidable global export penetration paired with the incipience of its currency internationalization point to a period of international economic and monetary co-habitation. This is because of Beijing's inability to provide an internationally dependable, risk-free reserve asset and its unwillingness to allow the burden of global economic imbalances to be adjusted on the back of its savings surplus.

Historically, adapting to a hegemonic leadership transition even among close cultural cousins within the international economic and monetary system was a destabilizing affair. Hence, adjusting to an extended period of international economic and monetary cohabitation between peer competitors who share none of the political, cultural, historical and strategic proximities is likely to be of an altogether different order of magnitude.

It is against this canvas of the fluid state of the current international monetary system and the looming challenge ahead of accommodating the rise of China and BRICS powers as full stakeholders within the international system that this paper will undertake a brisk review of the evolution of the modern international monetary system.

From the gold standard to the gold-exchange standard to the gold-dollar standard, at each turn, the operation of the system will be refracted via the lens of its monetary anchor and the internal mechanism for adjustment of imbalances. Beyond providing a snapshot of the history of the system, the purpose of this review is to provide a quick reading of the inexorable forces in international political economy that have laid bare the internal tensions within each ordering, leading to its collapse.

DOI: 10.7885/1946-651X.1050

Building on these lessons of the past, this paper will lay out the fundamental tensions that underlie the extant *de facto* dollar-denominated system today, particularly as it grapples with the loss of the U.S.' net creditor status (since the late-1980s), the loss of its AAA credit rating by Standard & Poor (since earlier this year), the rise of the BRICS phenomenon, and the accumulated imbalances within the global trading system. Parallel features with past orderings will be identified; mechanisms for smoothing systemic imbalances will be proffered. All along, the analysis will hew consistently to the theme of anchor and adjustment mechanisms within the international monetary system.

A key takeaway that emerges from this paper is that the modern international monetary order is neither self-executing nor self-equilibrating. The history of the system has been the history of managing a fundamental trade-off: either the monetary anchor be irredeemably joined to, and be backed by, metal with assured automaticity of convertibility (adjustment) or, alternatively, the adjustment mechanism to rectify intra-systemic imbalances – be it floating exchange rates, capital controls, coordinated international intervention, or a combination thereof -- be proactively scaled commensurately to compensate for the lack of durability of the monetary anchor. Attempts to weave this balance have tended to break down over time as developments in the global economy typically have overwhelmed the founding design of each monetary order.

Going forward, an international monetary order characterized by a paucity of global reserve assets and overly dependent on an insufficiently credible U.S. dollar as its sole monetary tether, yet employing only a fitful adjustment mechanism, will stand equally little chance of survival in a world of unlimited capital flows. Concurrently, a presumed future global multicurrency order characterized by hybrid exchange rate regimes and free capital mobility, yet bereft of anchoring mechanism and backed by only a weak and fragmented governance structure that is repeatedly trumped by narrow and domestically generated political compulsions, will have equally great difficulty accommodating the economic forces unleashed by its rising powers.

Overend, Gurney Panic of 1866: A Shot across the Bow of the *Gold Standard*

In May 1866, panic was sowed in Britain's financial markets following the insolvency of a London-based bill broker, Overend, Gurney and Company. Founded in 1800, Overend, Gurney had assumed an indispensible intermediary role within London's money markets, discounting commercial bank-issued bills of exchange that were linked to Britain's burgeoning global trading interests. So central were its operations to the smooth functioning of the market that the discount house was often known as "the banker's banker" (Flandreau and Ugolini, 2011).

Because of the leveraged nature of its business, Overend and all other money market players, were acutely vulnerable to sharp liquidity shocks and, in ultimate recourse, dependent on the good graces of the Bank of England discount (liquidity) window. When this window was kept firmly shut in early-May, the discount house was unable to honor its financial commitments that were roughly equivalent to a billion pounds sterling in today's prices. All market transactions were suspended and the financial system seized up in totality. To alleviate the imminent cascade of illiquidity and insolvency across market players, the Bank of England, for the first time in its illustrious history, drastically opened its liquidity spigots.[ii] In time, calm returned to the markets and the financial system returned to its habit of price discovery and funding – minus, of course, Overend, Gurney.

Though long since forgotten by most, the Overend, Gurney panic of 1866 was a formative moment in the history of modern central banking. Although fractional reserve banking[iii] had already become a staple practice at the time, it would take only a crisis to grasp the virtue of crisis lending on an ample scale, against good collateral, and at high rates – lender of last resort (LOLR) operations, effectively, that only a bank with monopoly on note-issuing powers was capable of extending. The Bank of England's lender of last resort operations, born in the panic that undid Overend, effectively helped arrest a contagion of illiquidity from cascading across and impairing the solvency of the British financial system. LOLR operations have since become an essential defibrillator in the financial arsenal of central bankers worldwide.

In the long run, more portentous than the panic's central banking implications were its ramifications for the international monetary system. Because international trade finance-related discounting activities linked to Britain's global trading interests had served as the building block for the development of London's money market, a large share of foreign bills of exchange were held by these discount houses. In accepting these foreign trade-originated instruments as good collateral in exchange for the ample funding that stabilized local and global financial markets, the Bank of England lender-of-last-resort operations helped cement sterling's status as the preeminent international reserve currency of its time.[iv]

On an ominous note though, the Overend, Gurney panic also provided the first significant shot across the bow of the emerging international monetary standard of its time --- the gold standard, and which was to foreshadow the metal's ultimate demise as an accepted reserve asset within the international monetary system 105 years later when U.S. President Richard Nixon formally shuttered the gold window. The gold standard operated on the uncomplicated principle of convertibility. That gold was money was a truism that all central bankers were resolved to defend, and their single-minded capacity to redeem this pledge by allowing gold to flow freely overseas to adjust imbalances in trade was the measure of their (and their country's) respectability. The international trading order and the international monetary order were joined at the hip. Gold was the anchor of this system; automatic and unimpeded convertibility of deposits to currency and currency to gold on call its adjustment mechanism; and maintenance of adequate gold reserves in central bank vaults to defend convertibility its key confidence channel. In this regard, forcing the domestic money supply to contract so as to squarely place the burden on domestic price and wage adjustment to extinguish prevailing trade deficits —- and vice-versa --- was the established norm. Simply stated, domestic monetary contraction as opposed to exchange rate devaluation, which was ruled out in its entirety, was the established norm of adjustment (Frieden, 2006).

https://digitalcommons.kennesaw.edu/jekem/vol3/iss1/18
DOI: 10.7885/1946-651X.1050

The Bank of England's liquidity support during the Overend, Gurney panic upended the principles that buttressed this norm –- its domestic lender of last resort operations standing in polar contrast to its international obligation as guardian of the gold standard. Gold outflow, in the gold standard model, was supposed to be balanced by a contraction in the money supply; to stay the panic as increasingly nervous depositors and investors sought to cash out in gold and exit the market, the Bank of England *increased*, not decreased, its availability of credit to the market. If conducted on an expansive scale, such LOLR operations, at a time when the Bank's gold reserves were shrinking, would call into question its commitment to maintaining the assured convertibility of gold for international transactions. That, in turn, could debilitate confidence in sterling, invite a run on the currency, and presage both its forced devaluation as well as the dissolution of the prevailing monetary order. Indeed, at the peak of Panic of 1866, convertibility *was* briefly suspended (Eichengreen, 2008).

Although the deep pockets - or rather vaults – of the Bank of England did help tide over the crisis, the irreparable contradiction between the domestic and international objectives of monetary policy in a reserve currency-issuing state, whose par value was fixed irreversibly, would not be avoided. In one form or the other, it would be the fundamental cause of the breakdowns of the gold standard as well as subsequent international monetary orderings for the next one hundred years. When the Gold Standard's demise did come however, its proximate cause was the conflagration unleashed by the Great War which forced most governments to suspend convertibility, as well as forbid the outflow of gold so as to amass precious metal that could fund their colossal military requirements. With the adjustment mechanism entirely broken and the U.S. dollar still only at an incipient stage of internationalization, and hence unable to perform the role of substitute reserve currency, the system collapsed on itself in a heap.

***Gold-Exchange Standard*: Fiscal Objectives Overrides International Monetary Obligations**

If the functioning of the gold standard was anchored by gold (history's oldest form of money), and its adjustment mechanism – convertibility – tied to the principle of automaticity, neither held fully true in the case of the *gold-exchange* standard that prevailed subsequently during the inter-war period. By the mid-1920s, more than three-dozen countries constituting the core of the international economy, both at the center and the periphery which were joined together by trade, had once again pegged their currencies to gold; the free flow of gold to adjust imbalances was restored and citizens and investors were freely allowed to convert domestic currency into fixed quantities of gold. Maintaining adequate gold reserves in central bank vaults to defend convertibility, again, was the key confidence channel by which the system sustained itself.

Conscious of the systemic dislocations wrought by the war-time gold export prohibitions, as well as the prevailing shortages in gold production worldwide, central banks deliberately sought to stretch their gold reserves further. The *gold-exchange standard* was the mechanism with central bankers supplementing the gold in their vaults with stocks of foreign exchange. Some of this was based on statute; others did so of their own initiative. None of this was particularly original. Interest bearing deposit claims had been held as reserves, substitutable for gold, ever since gold was first held as a reserve asset in central bank vaults in the early 19th century. What was new though was the scale of the accumulation in paper - in this case foreign exchange – as a supplementary reserve asset; central banks increasingly constructing an edifice of liabilities on a narrowing foundation of monetary gold.

Although, on an individual basis, the decision to augment and stabilize the existing supply of gold reserves in an anticipated period of gold shortage was rational, its consequences, at a systemic level, turned out to be the opposite. Scarcity of gold availability meant that equilibrium interest rates needed to be higher than would normally be the case, so as to attract the flow of gold. This had a contractionary effect on domestic economic policy. Further, differences in the ratio of monetary gold within various countries' reserve holdings were an invitation to speculators to seek out opportunities to bid up the interest rate to potentially unsustainable levels in countries that chose to hold a larger fraction of their reserves in foreign exchange, as opposed to gold. The nexus of the two was destabilizing, economically and financially, as the drain of gold overseas and seeming inability to defend the currency par value invited further speculative attacks. International economic conference diplomacy, as a possible mechanism to smooth out variations in monetary gold ratios and dissuade speculative arbitrage, was at a very embryonic stage of development to succeed.

Furthermore, the international system's largest economy, and chief accumulator of gold – the United States, displayed neither the inclination nor the will to support coordinated management of the international monetary order (Eichengreen & Flandreau, 2010). The most important international economic conference of its day, the Genoa Conference of 1922, aimed at fostering a basic framework of cooperation to harmonize domestic price levels with exchange rate par values, drifted into irrelevance following the United States' cold-shouldering. Even as its gold reserves tripled during the war years on the back of export surpluses, such that by the mid-1920's fully almost half of the world's gold supply sat in its vaults, Washington – like Beijing today – preferred to export capital, *and deflation*, than facilitate an orderly adjustment of imbalances within the international economic and monetary order. Had fiscal and monetary policy actions been coordinated system-wide to simultaneously reflate illiquid domestic banking systems, the collapse of financial dis-intermediation leading to capital flight from economies perceived to be insufficiently anchored to gold could have been avoided. Ironically, it would be an act of monetary unilateralism by the system's fading hegemon of the time – the Bank of England's decision to abandon the gold standard in September 1931 with an eye to stabilizing its banking system – that would set the monetary dominos rolling, such that by 1933 the U.S. itself was forced to abandon gold convertibility. The last remaining members of the west European "gold bloc" – France, Netherlands, Switzerland and Belgium – followed in 1935 and 1936.

https://digitalcommons.kennesaw.edu/jekem/vol3/iss1/18
DOI: 10.7885/1946-651X.1050

When the system did collapse however in the 1930s, fundamentally it was because of upheavals in the structure and complexity of modern capitalist economies – and not just due to the unsatisfactory design of the international monetary system (gold exchange standard) of the day. Classical orthodox economics of the pre-1914 variant had held that industrial capitalist economies were naturally self-correcting – that by way of the invisible hand, wages and prices would automatically adjust to eliminate temporary spikes in unemployment or surpluses/shortages in product markets. Full convertibility leading to adjustment of imbalances in the international balance of payment system was essentially the channel to transmit such self-correcting dynamics globally. By the early decades of the 20th century, however, a variety of factors related to the new organization of modern industrial society had conspired to throw sand into the economy's self-correcting gearbox, such that domestic wages and prices no longer adjusted automatically – or even fully - to keep employment and the business cycle stable. Arising from universal male suffrage, trade unions and parliamentary labor parties had accumulated sufficient political power to affect wage determinations; monopolistic corporations and their anti-competitive market practices had enabled them to exercise sufficient control over economy-wide prices. The complexity of industrial production meantime had generated demands for a workforce skill-set that could no longer be discharged at the first hint of a downturn (Frieden, 2006). All of these dynamics would cumulate and find unfortunate expression during the Great Depression when even zero interest rates were deemed insufficiently inviting to entrepreneurs to stimulate their animal spirits. Even with 22% labor force unemployment in the U.S. economy, real wages in notable industrial sectors remained *higher* in 1934 than 1929 (Frieden, 2006). Clearly, there had been a breakdown somewhere within the self-correcting properties of modern industrial capitalism.[v]

Alongside the collapse of industrial economies, and its takedown of the gold-exchange standard, in the 1930s was the collapse of the classical capitalist economic order. Its replacement by fiscally interventionist governments would have profound consequences, including the failure to throw up an adequate number of international reserve currency-linked assets to anchor new orderings. It would take time to surface this failure, and is only now beginning to be grasped in the context of the economic turmoil unleashed by the recent Global Financial Crisis of 2008.

The Bretton Woods *Gold-Dollar Standard*: Undone by Triffin's Dilemma

The conventions of the gold standard had required free convertibility of domestic currency into gold dictating, in turn, that domestic prices and wages mechanically adjust to preserve the gold value of the currency. The gold-exchange standard operated essentially on these same principles, although on a narrower base of gold reserves which was supplemented with foreign exchange reserves. A significant discovery that governments were quick to grasp by way of the failings of the interwar monetary order was that merely restoring the conventions of the gold standard would not suffice in an emerging era of speculative capital surges. The system rested on a procrustean bed of confidence. Once stability of currency parities was subordinated to more pressing domestic policy objectives and, concomitantly, once automaticity of convertibility could no longer be taken for granted, any subsequent edition of the gold standard would inevitably lack sufficient credibility in the face of cross-border flows. For a system which operated, fundamentally, on the basis of confidence and trust, such a shortcoming was fatal.

Yet full reversion to the gold standard was also equally untenable. Fractional reserve banking was a permanent reality of financial life; further, the liquidity requirements of a modern economy also necessitated that supply of money be delinked from an asset that was in diminishing relative supply. Yet the monetary order also required a golden anchoring. To square this circle, the Bretton Woods architects ingeniously chose to permanently peg the U.S. dollar to gold at the rate of $35 an ounce, while allowing all other currencies, significant or otherwise, to be linked to the dollar and fluctuate in value against it. Akin to the Atlas of yore, the dollar – being as good as gold - would veritably hold up the monetary world and be the key international reserve currency under all plausible scenarios.

With the riddle of the monetary anchor solved attention turned to devising the ordering's adjustment mechanisms. A fundamental lesson of the interwar period had been that capital flows, particularly those of a speculative variant, could aggravate rather than relieve pressures on central banks – indeed, the less durable the presumed monetary anchor, the more flexible the needed mechanisms of adjustment. Two forms of safeguards were endowed in this regard by the Bretton Woods framers: (a) capital controls at the border would be allowable – in fact encouraged – to stanch undesirable capital movements; and (b) a multilateral body – the International Monetary Fund – would be established which would nominally monitor global currencies, advise individual countries on desirable adjustments to their currency values, and provide contingent financing to tide over temporary balance of payments crises.

Inter-governmental cooperation would lend additional ballast to the system. The Tripartite Agreement of 1936 between the U.S., France and Great Britain which traded mutual exchange rate stability for trade openness, and also helped in the process exorcise some of the bitter memories of the 1922 Genoa Conference, was envisaged as a useful prototype for international monetary cooperation, going forward (Boughton, 2004; Frieden, 2006). Unfortunately from the get-go, however, the standing of the IMF was neutered by the U.S. Treasury Department such that it would only assume an emergent role from the 1960s onwards – and mostly with regard to economic emergencies in countries at the periphery of the monetary system. Nevertheless, in the final analysis, both anchor and adjustment mechanism appeared to be elegantly designed. The Bretton Woods Gold-Dollar standard was born.

Those expectations turned out to be deceptive. The Bretton Woods architects had sought to square the dilemma of designing a system capable of generating plentiful liquidity, yet contemporaneously also anchored in gold by pegging the dollar's value to gold while letting other currencies float vis-à-vis the dollar within manageable limits. Deeper reflection would have suggested that this would be impossible in reality. The Belgian economist Robert

https://digitalcommons.kennesaw.edu/jekem/vol3/iss1/18
DOI: 10.7885/1946-651X.1050

Triffin would, by the late-1940s itself, expose the system's inherent contradiction (Triffin, 1947) which forces in the international economy would thereafter expose more ruthlessly down the line: that a system which rested on the commitment of its monetary hegemon, as Eichengreen has succinctly observed, "to provide two reserve assets, gold and dollars, both at a fixed price, but where the supply of one was elastic while the other was not" was neither credible nor tenable in the long-term (Eichengreen, 2011). The United States would need to run balance of payments deficits to furnish liquidity to the global economy, yet at the same time also preserve confidence in the dollar as a store of value that was convertible to gold on call -- a confidence that would be eroded itself in the first place by its persistent and ever-growing external deficits. A delicate balance between liquidity supply, external deficits, and dollar resoluteness would have to be woven – a balance which unsurprisingly failed to be reconciled as European and Japanese Marshall and Dodge Pan-aided economic recoveries, and attendant trade surpluses, drove a battering ram through the fabric of the overly-clever gold-dollar standard.

In the late-1940s, the United States had held two-thirds of the international system's monetary reserves. By 1960, its monetary liabilities to foreigners exceeded its gold reserves; by 1963, it exceeded those to monetary authorities worldwide (Eichengreen, 2011). Speculation against the unsustainable build-up of official American government liabilities on an ever-narrowing reserve base of gold hastened matters to its point of inevitability, leading to the snapping of the gold-dollar peg. On August 15, 1971, the automatic conversion of dollars to gold – the "gold window" – was suspended and tariff surcharges were instituted; momentously, thereafter, the dollar's golden fetters were done away with permanently and the dollar was de-linked from gold altogether. One hundred and five years after the Overend, Gurney panic had fired the first monetary shot across the bow of the gold standard as a durable reserve anchor for international monetary and balance of payments adjustment, gold was unceremoniously dumped for good as an official reserve asset. It was left to the IMF to legally eliminate gold's special role in the official payments system by way the Second Amendment to its Articles of Agreement in 1978.

Like past international monetary orderings, the irreparable contradiction between the domestic and international objectives of economic and monetary policy in a reserve currency-issuing state could not be escaped. Ever since the international economic system had drifted away from its classical moorings, the link to gold had a tendency, over time, to breed overvaluation in the exchange rate of its dominant reserve currency-issuing state. As new economically rising nations chipped away at the reserve currency-issuing state's international economic and trade dominance, the contradictions would inevitably be resolved by speculative attacks leading to the collapse of the ordering altogether. Official capital controls could, at best, delay but not disrupt this inexorable march. The outbreaks of World War I and World War II had served somewhat to mask this contradiction. In 1971, it was nakedly visible for all to see. The solution to this century-old dilemma turned out to be as logical as it was terse: *de-link the system's monetary anchor, or anchors, from any denomination to metal*. Henceforth, all systemically important currencies were to freely float against each other. Whether the system's adjustment mechanisms was capable of rising to the occasion to compensate for this lack of structural central tethering remained to be seen. Further, its ability to adjust and accommodate rising economic nations, that are at once its most dynamic trading powers and yet at the same time neither wholly convinced or committed to a free floating currency and convertibility regime, also remains to be seen.

The *Global Paper Standard* and its Challenge: Accommodating the Rise of the BRICS

The Second Amendment to the Articles of Agreement of the International Monetary Fund which eliminated the special role of gold also legalized the prerogative of countries to float their national currencies. In doing so, it was simply bowing to reality. The Smithsonian Agreement of December 1971 had allowed the dollar to be devalued by a modest percentage. European currencies and the Japanese yen meantime were revalued upwards and their bands for fluctuation widened marginally (Sachs, 1986). Although Triffin's ghost had not yet been banished, the U.S. had insisted and retained the prerogative of keeping the 'gold window' closed. In early-1973, the gold value of the dollar was once again realigned from \$38.02 to \$42.22. Even that proving to be too little too late, in March 1973, the system was abandoned altogether and the major global currencies released to their free floating destinies. Henceforth, Triffin's Dilemma, it was thought, would be permanently exorcised. In the new *global paper standard*, a world of floating yet managed exchange rates operating alongside a world of convertible yet suasible capital flows would establish a new 'golden mean', dynamically eradicating imbalances within.

The reality has proven far otherwise. Capital flows have been anything but pliable, its tsunami-like effect exacting terrible punishment on exposed banking, capital and other asset markets in developing and developed countries alike over the past three decades. Terrified, meantime, of ceding exchange rate stability or domestic monetary policy independence, BRICS and emerging market actors have opted to impose varyingly stringent capital control restrictions - even as they have collectively accumulated trade surpluses and a war-chest worth of reserve holdings. This in turn has repressed the natural adjustment mechanisms within the external order, leading to the development of sharp global economic imbalances as well as a paucity in the development of attractive reserve assets globally. Meantime, the U.S. dollar remains disproportionately the primary provider of benchmark risk-free assets worldwide and the key international reserve currency, even as its economic prowess drains a fair share of its previous luster. Far from establishing a new 'golden mean', the global paper standard appears to suffer from the worst of both worlds – a de facto anchor currency of increasingly uncertain worth and an adjustment mechanism that is frustrated in its means to redress imbalances within. Worse – and in no small irony which Triffin would instantly recognize - the primary reserve currency issuer within the system runs a balance of payments deficit to furnish liquidity to the global economy, yet at the same time strives to preserve confidence in its currency as a store of value - a confidence eroded daily by its persistent and large external deficits in the first place itself!

https://digitalcommons.kennesaw.edu/jekem/vol3/iss1/18
DOI: 10.7885/1946-651X.1050

Given this fraught state of affairs of the present-day monetary system, and the looming challenge on the horizon ahead of designing a viable 21st century order that is accommodative of the rise of China and the BRICS powers as full stakeholders within, the key lessons of the history of the modern international monetary system and the origins of order and disorder therein, bears recapitulating. Perhaps the single most important takeaway to emerge from the system's century and a half history is that a fundamental trade-off – and tension – has always persisted between its anchoring mechanism and the mechanism for adjusting imbalances within. Ever since the international monetary system's moorings drifted from its anchoring to gold and the assured automaticity of convertibility, the adjustment mechanism to regulate intra-systemic imbalances, be it floating exchange rates, capital controls, coordinated international intervention, or a combination thereof, has had to be progressively scaled upwards to account for the contingent nature of the tie to gold. Attempts to weave this balance have typically tended to break down over time, however, as structural shifts associated with modern capitalism have overwhelmed the founding design of each monetary order.

Looking ahead, a 21st century international monetary order that is entirely de-anchored from gold and rests merely on the full faith and credit of its fiat money trustees, will necessitate that its mechanisms of international coordination and adjustment to restore balance be ratcheted-upwards equivalently.

International monetary orders are not seamlessly self-equilibrating; further, there is no assurance that a stable and natural balance will obtain, or that efforts to this end will succeed. Leaving its fundamental structural tensions (semi-liberalized financial and exchange rate regimes in a universe of fully-liberalized and quicksilver capital flows; basic long-term irreconcilability of the United States' international debtor status with its principal reserve currency-issuer status; viability of a dollar-dominated monetary system in a progressively China, Asia and BRICS-dominated global economic and trading order) unaddressed will invite its failure with potentially cataclysmic consequences.

A second lesson that emerges is that the days of gold (or metal or hard commodity) as the principal fractional anchor of the system have, for better or worse, come and gone for good. It is not likely to return. The essential perversion of gold was this: via its fixed link to the exchange value of the dominant reserve-currency issuer of the day, it bred progressive overvaluation in that exchange rate and transmitted misalignments to secondary currency values within the system. Over time, as that overvaluation became unsustainable, the ordering would collapse.

The lesson, going forward, is that any monetary order erected upon a foundation that permanently binds the value of its principal anchor or reserve currency/currencies into perpetuity, is also likely to be inherently unsustainable. Conversely though, the statutory fractional backing of currency by gold up until the shuttering of the 'gold window' in the rarly-1970s, did exercise a weight on the shoulders of reserve currency-issuing states to maintain a delicate balance between liquidity supply, external deficits and maintaining the currency's essential attribute as a store of value. Unchained from this responsibility since, the potentially idiosyncratic issuance of liquidity by the primary reserve currency issuer in aid of domestic economic policy objectives, leading to transmission of inflationary pressures to the global monetary system, constitutes a serious structural hazard.

Third, demands of national economic and financial stabilization have, from the mid-19th century onwards, persistently trumped the sovereign obligations to the international monetary system. Lender-of-last-resort monetary intervention in the Overend, Gurney panic of 1866 was the logical response to exigencies generated by fractional reserve banking; large-scale fiscal and capital market intervention, both at the production and consumption end of the domestic economy, in the wake of the Great Depression and subsequently has been a commonsensical response to the demands of modern industrial capitalism. Both have fundamentally repressed and altered the adjustment mechanisms within the international monetary system. Where the competing demands of currency stability and full employment clash, the outcome will necessarily accrue to the latter's favor.

Looking ahead, with many semi-liberalized BRICS and emerging market nations increasingly becoming integral players in an international monetary order characterized by integrated markets for currency and capital, building flexibility and capacity within the system's regulatory mechanisms to accommodate their economic and financial liberalization trajectories, and rise, are paramount. Full currency convertibility, correspondingly, to avoid frustrating the monetary system's essential adjustment mechanisms, is the reciprocal imperative at the rising powers' end ---- currency internationalization being a necessary but insufficient reform. China's policy of pegging its exchange rate so that the renminbi rises only slowly in nominal terms has resulted in: an undervalued exchange rate; rise in its foreign exchange reserves; and rise in domestic liquidity.

Fourth, footloose capital flows in the absence of an anchoring or regulatory mechanism within the international system can be destabilizing to the extreme. Pre-1914, currency values did not adjust; domestic prices and wages did. Post-1914, as the stability of par value was subordinated to the politics of domestic economic policymaking, confidence in the assured convertibility of currency correspondingly diminished, giving rise to destabilizing capital flows. In this regard, a 21st century international monetary order based on floating exchange rates and unlimited capital flows, yet bereft of credible anchoring and lacking a robust architecture of international cooperation and intervention, simply will not endure. Such a system entailing a regime of free floating exchanges rates and automatic capital account convertibility did appear briefly in the immediate aftermath of World War I. Although anchored in the gold standard, it soon succumbed thereafter to the volatility of international capital movements and lack of coordinated inter-governmental support in that era of political and economic dislocation (Eichengreen, 2008).

That a similar fate does not befall a 21st century ordering will require that governments, one way or the other, either swallow the bitter pill of socializing capital losses multilaterally or

https://digitalcommons.kennesaw.edu/jekem/vol3/iss1/18
DOI: 10.7885/1946-651X.1050

alternatively, by way of orderly insolvency processes, privatize the allocation of risk to the vendors of capital accordingly. For emerging market economies, meantime, embedding their capital account liberalization programs within a broader inter-governmental institutional framework that privatizes the allocation of such risk merits consideration.

Finally, each international monetary ordering's chief hegemonic constituent has been the author of that system's durability and success, as well as the villain of its ultimate undoing. On its way up the ladder of success, the emerging hegemon's exchange rate undervaluation and trade surpluses have not been commensurately balanced with a willingness to assume stakeholder responsibilities. In fact, it has been the primary channel for transmitting deflationary forces to the global economy. On its way down the path of relative decline, its exchange rate overvaluation and trade deficits have failed to instill confidence in its currency as a store of value as well as crowded out other potential reserve currency aspirants as it has sought to perpetuate the low, long-term, fixed rate borrowing costs denominated in its own currency. Monetary unilateralism typically has been its instrument of choice, resorting to inflation-adjusted or outright depreciation of its currency in a pyrrhic attempt to transcend its declinist predicament.

Dynamic productivity gains in its booming economy which effected a real undervaluation of the dollar – tied as it was at par to gold during the gold standard – ensured that the United States amassed significant stocks of scarce gold during the 1920s. Yet, unwilling to deviate from (high) interest rate setting that was geared purely to its domestic economy nor willing to countenance any derogation of the gold standard to a gold-exchange standard (as Genoa Conference attendees had preferred), Washington exported deflation and induced financial fragility abroad. China's fidelity to it administered deposit rates, undervalued currency, and mammoth reserve holdings, even at the expense of generating imbalances and financial fragility abroad, are in many respects only a modern-day mirror image of the past. In this regard, it may be cogent to revisit the 'scarce-currency clause' at Bretton Woods (Eichengreen 2008) – that sought to penalize chronic balance of payments surpluses.

Neither Great Britain nor the United States possessed, nor does China today possess, a monopoly on perpetual balance of payments surpluses. Yet the long lags and the perverse incentive structure of the modern international monetary system that induces rising powers to export capital and deflation, and aging incumbent reserve currency-issuing powers to export inflation – even as it chains the system's incremental liquidity requirements to its depreciating currency, requires methodical review.

Conclusion

Ever since the origins of the modern international monetary system, dating back to the mid-part of the 19th century, moments of deep-seated crises in the global economy have typically been occasions for introspection and change in the system's ordering. The upheaval in the wake of Global Financial Crisis in 2008 has been no different. Discussion and debate related to reform of the international monetary system's architecture has been a prominent theme in the years since, flagged-off as early as April 2009 by G-20 leaders at their inaugural summit meeting in London. In February 2011, a panel of veteran financial and central banking experts and practitioners issued their blueprint for reform of the systemic architecture, timing its release to coincide with the G-20 French presidency's finance and central bank governors meeting (Palais-Royal Initiative, 2011). World Bank president Robert Zoelleck (Zoelleck, 2011) as well as staff at the International Monetary Fund (Lago, Duttagupta and Goyal, 2011), separately, have weighed in with their opinions too. Clearly, debate on the future of the international monetary system has been joined, although it still remains at a preliminary stage.

Substantial issues are on the table: institutional and governance reform; expansion of emergency financing facilities; stable mechanisms for global liquidity creation; capital account convertibility and choice of exchange rate regime in major emerging markets; managing and winding down global economic imbalances; decisions linked to type, attractiveness and issuance of existing and prospective global reserve assets. The presence and participation of the BRICS economies for the first time within the inner sanctum of the international monetary system-related decision-making have added a notable twist to this mix. During the past decade, the BRICS added $8 trillion to global gross domestic product, equivalent to the tune of almost 80 per cent contributed by G-7 nations. During this decade, their contribution is anticipated to be in the order of $12 trillion, double of the U.S. and the Euro-zone combined (Prasad and Ding, 2011; World Bank, 2011). Give this heft and contribution to the global economy, their role and voice in the international monetary and economic system are only expected to amplify.

Accommodating the BRICS economies with the international monetary order is unlikely to be a seamless exercise. The history of systems past suggests that transition in international monetary leadership is neither self-executing nor stable. Adapting to hegemonic leadership transition among close cultural cousins who shared a common understanding of the principles on which the international monetary system rested, itself was an unstable affair. Adjusting to leadership cohabitation between peer competitors who share little of the political, cultural, historical and strategic proximities, and also disagree on the fundamental structural mechanics of the system's functioning, ranging from capital account convertibility to choice of exchange rate regimes, are likely to be all-the-more demanding. Yet perpetual dependence on a unipolar monetary system in an age of economic multi-polarity is equally untenable. Although the dollar continues to play its reserve currency role – as it has for the past six decades, the strain on its shoulders is palpable. Sharing the burden of global reserve asset management is likely to be the foremost order of business within the international monetary system in the years and decade ahead. Ultimately, an ordering based on a diversified set of fully convertible currencies that float against each other and facilitate adjustments within, while generating balances overall, is expected to be the norm. Getting to this point is however neither assured nor inevitable. The history of the failure of past international monetary orderings has been as much one of conception as it has been of a lack of deliberation. If haste is to be made, it ought to be made slowly.

DOI: 10.7885/1946-651X.1050

---

[i] Since the collapse of the Breton Woods gold-dollar fixed exchange rate regime, global reserve holdings as a share of gross domestic product have expanded fourfold, from 3.5 per cent of global GDP in 1974-78 to 14.5 per cent in 2010 (World Bank, 2010)
[ii] Monopoly on exclusive note-issuing powers by the Bank of England was established only as late as 1844 via the Bank Charter Act, passed by the Peel government.
[iii] Fractional reserve banking refers to banking whereby available funds held in the form of cash and liquid securities by a bank is only a fraction of the quantity of deposits taken. As such, they can be prone to bank runs.
[iv] The Federal Reserve's swap arrangements with four central banks providing a dollar – and de facto global lender of last resort- backstop in the immediate aftermath of the recent Global Financial Crisis, holds loose comparisons with the Bank of England's liquidity operation in May 1866.
[v] Keynes had been among the earliest to detect this phenomenon. Rather than wait passively and hope for the economy to adjust, he argued that government should proactively intervene by borrowing and spending heavily to stabilize wages and prices. Stimulating demand and altering private sector expectations was the key to reviving the economy.

References

Boughton, James M. (2004), The IMF and the Force of History: Ten Events and Ten Ideas that have Shaped the Institution, Washington, D.C. *IMF Working Paper*.

Eichengreen, Barry J. (2011), *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System*, New York, Oxford University Press.
___________ (2008), *Globalizing Capital: A History of the International Monetary System*, 2nd Edition, Princeton, Princeton University Press.

Eichengreen, Barry J., & Flandreau, M. (2010), The Federal Reserve, the Bank of England and the Rise of the Dollar as an International Currency, 1914-1939, *Bank of International Settlements (BIS) Working Paper*.

Flandreau Marc, & Ugolini, S. (2011), Where It All Began: Lending of last resort and the Bank of England during the Overend-Gurney panic of 1866, *Norges Bank Working Paper*.

Frieden, Jeffry A. (2006), *Global Capitalism*, New York, W. W. Norton & Company, Inc.

Lago, Isabelle Mateos y, Duttagupta R, & Goyal Rishi (2009), The Debate on the International Monetary System, Washington, D.C. *IMF Staff Position Note*.
Lehrman, Lewis E (2011), The Nixon Shock Heard 'Round the World', *The Wall Street Journal*

Palais-Royal Initiative (2011), *Reform of the International Monetary System: A Cooperative Approach for the Twenty First Century*, Paris.

Prasad, E, & Ding, M. (2011), Debt Burden in Advanced Economies now a Global Threat, *The Financial Times.*

Sachs, Jeffrey (1986), The Uneasy Case for Greater Exchange Rate Coordination, *The American Economic Review*, 76(2).

Triffin, Robert (1947), National Central Banking and the International Economy, *Postwar Economic Studies 7*

World Bank (2011), Multipolarity: The New Global Economy, *Global Development Horizons*, Washington, D.C.

Zoellick, Robert (2011), A Monetary Regime for a Multipolar World, *The Financial Times,*

DOI: 10.7885/1946-651X.1050