The Rules of the Game: International Money in Historical Perspective

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Purpose

- Clarify the ‘rules of the game’ under successive ‘international monetary orders’
- Notion of ‘international monetary order’ was introduced by Mundell (1972)
- Can be seen of essential principles of coherent international monetary arrangements underlying actual arrangements

An *order*, as distinct from a system, represents the framework and setting in which the system operates. It is a framework of laws, conventions, regulations, and mores that establish the setting of the system and the understanding of the environment by the participants in it. A monetary order is to a monetary system somewhat like a constitution is to a political or electoral system. We can think of the monetary system as the *modus operandi* of the monetary order. (Robert Mundell 1972, p. 92)

McKinnon’s seven monetary orders

1. *The International Gold Standard, 1879–1913*
2. *The Bretton Woods Agreement in 1945: The Spirit of the Treaty*
3. *The Fixed-Rate Dollar Standard, 1950–1970*
4. *The Floating-Rate Dollar Standard, 1973–1984*
5. *The Plaza-Louvre Intervention Accords for the Dollar Exchange Rate, 1985–1992*
6. *The European Monetary System in 1979: The Spirit of the Treaty*
7. *The European Monetary System as a Greater Deutsche Mark Area, 1979–1992*

The Gold Standard

Rule Box 1

THE INTERNATIONAL GOLD STANDARD, 1879–1913

All Countries

I. Fix an official gold price or “mint parity,” and convert freely between domestic money and gold at that price.

II. Do not restrict the export or import of gold by private citizens, nor impose any other exchange restrictions on current or capital account transacting.

III. Back national banknotes and coinage with earmarked gold reserves, and condition long-run growth in deposit money on availability of general gold reserves.

IV. In short-run liquidity crises from an international gold drain, have the central bank lend freely to domestic banks at higher interest rates (Bagehot’s Rule).

V. If Rule I is temporarily suspended, restore convertibility at traditional mint parity as soon as practicable—if necessary by deflating the domestic economy.

VI. Allow the common price level (nominal anchor) to be endogenously determined by the worldwide demand for, and supply of, gold.

The Bretton Woods system than never saw the light

Rule Box 2

THE BRETTON WOODS AGREEMENT IN 1945: THE SPIRIT OF THE TREATY

All Countries

I. Fix a foreign par value for the domestic currency by using gold, or a currency tied to gold, as the numeraire; otherwise demonetize gold in all private transacting.

II. In the short run, keep the exchange rate within one percent of its par value; but leave its long-run par value unilaterally adjustable if the International Monetary Fund (IMF) concurs.

III. Free currency convertibility for current-account payments; use capital controls to dampen currency speculation.

IV. Use national monies symmetrically in foreign transacting, including dealings with the IMF.

V. Buffer short-run payments imbalances by drawing on official exchange reserves and IMF credits; sterilize the domestic monetary impact of exchange-market interventions.

VI. National macroeconomic autonomy: each member government to pursue its own price level and employment objectives unconstrained by a common nominal anchor or price rule.

The actual Bretton Woods system

Rule Box 3

THE FIXED-RATE DOLLAR STANDARD, 1950–1970

Industrial Countries Other Than the United States

I. Fix a par value for the national currency with the U.S. dollar as the numeraire, and keep exchange rate within one percent of this par value indefinitely.

II. Free currency convertibility for current-account payments; use capital controls to insulate domestic financial markets, but begin liberalization.

III. Use the dollar as the intervention currency, and keep active official exchange reserves in U.S. Treasury Bonds.

IV. Subordinate long-run growth in the domestic money supply to the fixed exchange rate and to the prevailing rate of price inflation (in tradable goods) in the United States.

V. Offset substantial short-run losses in exchange reserves by having the central bank purchase domestic assets to partially restore the liquidity of domestic banks and the money supply (Bagehot's Rule).

VI. Limit current account imbalances by adjusting national fiscal policy (government net saving) to offset any divergences between private saving and investment.

The United States

VII. Remain passive in the foreign exchanges: practice free trade with neither a balance-of-payments nor an exchange-rate target. Do not hold significant official reserves of foreign exchange.

VIII. Keep U.S. capital markets open to foreign governments and private residents as borrowers or depositors.

IX. Maintain position as a net international creditor (in dollar-denominated assets) and limit fiscal deficits.

X. Anchor the dollar (world) price level for tradable goods by an independently chosen American monetary policy.

Floating exchange rates 1973-84

Rule Box 4

THE FLOATING-RATE DOLLAR STANDARD, 1973–1984

Industrial Countries other than the United States

I. Smooth near-term fluctuations in dollar exchange rate without committing to a par value or to long-term exchange stability.

II. Free currency convertibility for current payments, while eventually eliminating remaining restrictions on capital account.

III. Use the dollar as the intervention currency (except for some transactions to stabilize intra-European exchange rates), and keep official exchange reserves mainly in U.S. Treasury bonds.

IV. Partially adjust short-run growth in the national money supply to support major exchange interventions: reduce when the national money is weak against the dollar and expand when it is strong.

V. Set long-run growth in the national price level and money supply independently of the United States, and allow corresponding secular adjustments in dollar exchange rate.

The United States

VI. Remain passive in the foreign exchanges: free trade with neither a balance of payments nor exchange rate target. Do not hold significant official reserves of foreign exchange.

VII. Keep U.S. capital markets open to foreign governments and private residents as borrowers or depositors.

VIII. Pursue monetary policies independent of the foreign exchange value of the dollar and of the rate of money growth in other industrial countries—without trying to anchor any common price level.

Floating exchange rates among advanced countries 1990-2010

- Unrestricted current and financial account convertibility
- Generalised central bank independence. Each central bank to target domestic price stability and ensure predictability of monetary policy
- Central banks to intervene on exchange markets in case of market disruption or severe misalignments only, preferably in a concerted way and in agreement with governments
- In the event of financial stress, central banks to act as lenders of last resort through providing unlimited liquidity to the financial system. Swap agreements to make central banks able to provide liquidity in foreign currency
- Coordinate budgetary and monetary policies in case of severe inflationary or deflationary shocks, otherwise consult within G7 on policy priorities
- (Use G7 and IMF as vehicle to exercise joint leadership in crisis management)

The Bretton Woods 2 system between the US and (Asian) developing economies

Developing economies

- Peg the currency on the US dollar or manage exchange rate so that fluctuations of dollar exchange rate remain limited
- Free current account convertibility but capital controls or intervention to offset exchange-rate impact of capital inflows
- Ensure that domestic policy and exchange rate level are consistent with external surplus, invest reserves in US T-Bonds

United States

- Act as buyer of last resort through keeping domestic market open and ensuring high level of demand
- Ensure monetary policy is geared towards stability within the wider dollar zone
- Provide liquidity assistance in case of sudden stops, either directly or through the IMF