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The evolving international monetary system

Jane D'Arista*

The global financial and economic crisis has prompted renewed interest in international monetary reform. The key-currency status of the US dollar has been challenged but discussion of what might be reasonable objectives and institutional structures for a new system has not yet broken new ground. Nevertheless, as interest in the issue begins to include policymakers and non-governmental organisations, new proposals are likely to emerge. To assist the process, this paper provides an overview of how the international monetary system has evolved since the inauguration of the gold standard in the late 1800s to provide a context for some of the reform ideas that emerged during and after the discussions at Bretton Woods and some of the proposals that were offered subsequently. It concludes with an outline of three proposals by the author that are intended to expand the debate.

Key words: International monetary system, Bretton Woods, International reserve assets, Special drawing rights
JEL classifications: F30, F33, F37, F50, F59

1. Introduction

As the world slips once again into crisis, there is renewed discussion of the need to reform the global financial and monetary architecture. During the crises at the end of the 1990s, discussions covered many of the issues that are still being considered today—international policy coordination and surveillance, participation in global governance, financing for development, debt and crisis management. As was true of these issues, little progress was made in dealing with another critical issue, the monetary aspect of problems within the existing international system, even though those problems had been identified and discussed since the 1960s. Official discussions continued to revisit the familiar ground of earlier debates over fixed versus floating exchange rates. Countries that had experienced crises were moving to new ground with proposals centred on adopting another country's currency (dollarisation) or bloc solutions modelled on the euro area's single currency system, while academics and analysts from non-governmental organisations revived calls for new issues of special drawing rights (SDRs).

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Address for correspondence: Political Economy Research Institute (PERI), University of Massachusetts, Amherst, Massachusetts MA 01002, USA; email: jane.darista@snet.net

* Research Associate, Political Economy Research Institute (PERI), University of Massachusetts, Amherst.

The most basic element of the global system is the choice of the means of payment in cross-border transactions. It is an element that has been at the centre of the incremental process that determined international financial and monetary architecture in the past but slipped into non-priority status as a focus for reform after the collapse of the Bretton Woods regime in the early 1970s. President Richard Nixon's decision to end the dollar's convertibility into gold ushered in a new international monetary system in which international payments would be made by private banks in the national currencies of the so-called 'strong' currency countries rather than exchanges of gold by central banks. The value of the currency most used in these transactions—the US dollar—was no longer fixed in relation to gold. After 1973, it was allowed to 'float' with its value determined by changes in the supply and demand for the currency.

Since 1973, the dollar has had its ups and downs: a substantial fall at the end of the 1970s, a large appreciation beginning in 1983, an engineered decline after 1985 and a period of steady strength from 1994 until 2002. In the 1990s, the dollar's dominant role in the global economy was unchallenged. Measures of that dominance included the rising amount of dollar debt owed both to foreign and domestic creditors by borrowers in countries other than the USA, the share of dollar assets in international reserve holdings, the amount of US currency held and exchanged outside the USA by residents of other countries and the impact of changes in US interest rates and the value of the dollar on developments in other economies around the world.

While the key-currency status of the dollar appeared to offer significant advantages for the USA, questions about its sustainability have been raised almost since its inception. Any country that issues the global medium of exchange will experience capital inflows and the resulting investments in its credit instruments will increase the availability of credit and allow its residents to spend more and save less. But the steady stream of capital inflows can only continue if the key currency country is able or willing to run the trade deficits that allow other countries to earn the currency they hold as international reserves. Over time, growing imbalances between the external debt of the key currency country and the surpluses of other countries tend to push the system to breaking point. The ballooning internal debt of the reserve currency country—particularly of its household sector—strains its capacity to import and undermines the value of its currency both literally and in terms of its role in the global economy.

So far, concerns about global payments imbalances have provoked little interest in monetary reform. There has been a widespread assumption that, after this period of economic and financial turmoil has passed, the euro will increase its share in the international monetary system and the current strong-currency regime will continue. But Europe is unlikely to assume the US role of importer of last resort and if no country or region is willing to run the trade deficits that provide the opportunity for other countries to earn the preferred reserve currency, a global system based on national currencies cannot continue. Over the next decade, it will either be replaced by conscious planning or transformed by the effort to adapt to the ever-larger crises that are fuelled by an unstable international monetary regime.

This paper is addressed to those who are likely to be involved in discussing and determining what might be reasonable objectives and institutional structures for a new international monetary system. It assumes that policymakers and members of non-governmental organisations interested in this issue will benefit from a brief—admittedly simplified—overview of past systems and how they have come into being. While there are many outstanding historical analyses of past systems, the focus here is on institutional structures that have had, and are likely to continue to have, dominant roles in shaping international monetary developments. The overview of those developments is intended to provide a context for some of the reform ideas that emerged during and after the discussions at Bretton Woods and some of the proposals that have been offered subsequently that are part of current discussions. It concludes with an outline of three proposals by the author intended to expand the debate on the international monetary aspect of the current crisis in the global system.

2. The historical framwork

2.1 The gold standard

In today's national economies and the current international monetary system, fiat currencies are the norm. With no backing other than the full faith and credit of the governments that issue them, the evolution of today's money began with the introduction and acceptance of paper money in the seventeenth century in the form of receipts for deposits of gold in the Bank of Amsterdam. The growing role of the state and its ability to tax and impose tariffs to provide metallic backing made it possible to instill confidence in issues of bank notes convertible into gold and silver and paper currencies spread across Europe as a more convenient vehicle for payments than coins. Bank notes thus became the standard currency for transactions within national economies in the eighteenth and nineteenth centuries.

One notable exception to what had become the accepted requirements for issuing bank notes occurred during the nineteenth century in the USA. As the Civil War got underway in 1861, the US government suspended the convertibility of bank notes and issued a currency—the greenback—that was not convertible into specie. The greenback's value depended on the law that made it legal tender and required that it be accepted for payment of debts and taxes. While the US reinstated both gold and silver as backing for private bank notes in 1879 (Dam, 1982), it suspended convertibility a second time during the banking crisis in 1933 and gradually lowered the required gold backing for Federal Reserve notes until, in the 1940s, it was removed altogether and the US currency became fiat money.

Nevertheless, the US, like other industrialising countries, continued to use gold and silver to make payments for cross-border trade and investment during the period when it abandoned convertibility. Meanwhile, large discoveries in California (1849) and Australia (1851) resulted in a ten-fold increase in gold production and gold began to crowd out silver as backing for national currencies and as a means of payment in international trade. Led by Germany's sales of silver in 1877, Europe went on a gold standard. The USA, a large producer of silver, called an International Monetary Conference in 1878—the year before it resumed convertibility—in hopes of persuading other countries to return to a bimetallic standard. But with further increases in gold production (in Witswatersrand in the 1890s and Alaska in the 1900s) the USA joined the nations of Europe and passed the Gold Standard Act in March 1900 (Kindleberger, 1984).

The adoption of the Gold Standard was a gradual process. There was no international legal foundation—no treaties, agreements or conferences. Its international acceptance relied on the fact that national laws dealing with convertibility put no constraints on the import and export of gold bullion by either residents or non-residents. Its duration was relatively short—from about 1870 to 1914—and economic historians dismiss the assertion that it was an automatic, self-adjusting system. Kindleberger (1984) questions the monetarist claim that it created an effective world money supply and world prices, the claim of the currency school that 'money' was only bank notes backed by gold—not bank deposits or bills of exchange—and the belief that it involved no role for policy. Dam (1982) argues that the most effective aspect of the gold standard was that the system of fixed exchange rates resulted in no change in parities between the currencies of the USA, the UK, France, Germany and most of the smaller European countries from 1879 to 1914. That success undoubtedly contributed to the extraordinary increase in international trade during that period.

Another view of the gold standard is that it was a 'managed' system. There is general agreement that the Bank of England was the central bank to the world and that London as the financial centre was the principal source of liquidity for the international monetary system (Dam, 1982). Some see it as a period in which the 'sterling standard' prevailed and the central mechanism was the Bank of England's discount rate. This was due to the fact that Britain financed its trade with sterling bills and held no other currencies or non-sterling bills. Other countries financed both their trade with Britain and their third country trade in sterling bills and thus had to hold sterling balances. As a result, changes in the Bank of England's discount rate affected world prices by way of the cost of holding and transporting stocks of goods (Kindleberger, 1984).

But the custom of holding sterling balances in London precipitated a substantial increase in capital flows as well as in trade and, by either attracting or repelling short-term capital flows from the rest of the world, changes in the Bank of England's discount rate also influenced gold movements. As capital flows increased, deficit countries could offset the deflationary effects of losses of reserves on their economies by raising interest rates to attract foreign investment while other countries financed their trade surpluses with capital outflows to prevent inflationary pressures stemming from rising reserve levels. While this was only possible for countries with developed financial markets and the benefits were often only temporary, the use of this policy tool to manage the expansionary and contractionary effects of the gold standard was fairly widespread.

Countries without developed capital markets that lacked financial instruments denominated in their own currencies could not attract capital inflows and tended to experience the so-called 'automatic' effects of the gold standard. Trade deficits had to be financed with outflows of gold and since commodity producers could only buffer price changes determined by developments in the industrialising countries by building up reserves when prices were high, the gold standard resulted in abrupt and often harsh changes in economic conditions in those countries and much default.

In short, for both industrialising and underdeveloped countries, the 'managed' gold standard resulted in some of the same seeming benefits and real problems as the current fiat currency reserve system. It 'worked' in part because of the immense increase in the supply of gold in the period from 1849 through the early 1900s. Nevertheless, as the emphasis on the management of the system suggests, it was actually sterling credit and capital markets in London—not gold—that underpinned the system. In any event, the period from 1970 to 1914 produced a remarkable increase in growth in the industrialising countries by facilitating an expansion in domestic money that resulted in increased spending, trade and investment. The expansion in cross-border trade and investment was unmatched until the 1980s.

2.2 The gold exchange standard

It is probable that the success of the gold standard also depended on a parallel development that emerged out of the mechanisms the industrialising countries used to 'manage' the gold standard—the development of the gold exchange standard. This monetary system differs from the gold standard in that international reserves consist of both gold and convertible currencies so that the system can function with less gold. Another difference is that, because those convertible currencies tend to be invested in interest-bearing financial assets, the gold exchange standard includes a mechanism that allows for growth in world reserves independent of increases in gold production.

The use of a mixture of foreign exchange assets and gold as components of reserve holdings was not just a post-World War I phenomenon. The Scandanavian countries had entered into agreements to use one another's currencies as early as 1885. By 1913, some 15 central banks held about 12% of their reserves in the form of foreign exchange assets (Grubel, 1977).

The mechanisms for settlement of foreign exchange holdings evolved throughout Europe with the development of financial markets and central banks. A government (treasury or central bank) bought and sold foreign exchange in transactions with its own private sector, becoming the creditor by drawing down or building up its own holdings of foreign exchange. This permitted the development of a larger role for the public sector in controlling international payments as these transactions replaced the earlier and less efficient transfers of gold reserves to net out holdings of bills of exchange between private banks in different countries (Grubel, 1977). Thus, the addition of convertible currency assets as components of international reserves constituted a significant revision of the rules of the game in international payments that persisted until the collapse of Bretton Woods in 1971.

Very few countries had returned to the gold standard after World War I. The USA—by then a creditor rather than debtor nation—was a notable exception. Coping with economies damaged by war, rising prices, the movement of gold reserves to the USA and a fall in gold production, European countries sought some means to regain currency convertibility and, in 1922, held a monetary conference in Genoa that recommended the use of foreign exchange reserves to economise on gold. Again, there was no international agreement involved but some countries acted legislatively on this recommendation at the national level and many others simply resumed the practice of buying foreign exchange from their own financial institutions. The Bank of England resumed gold convertibility in 1926 (at the pre-war rate) and was able to persuade some other European countries to do the same. Nevertheless, most industrial countries continued to rely on acquiring holdings of foreign exchange assets to build up their reserves and, by the end of the 1920s, foreign exchange reserves constituted about 42% of total reserves of 25 countries (Grubel, 1977).

The rise in holdings of foreign exchange reserves became a critical channel for the transmission of economic collapse in the 1930s. Inflows to the USA had climbed in the late 1920s with foreign funds attracted by returns on call loans during the stock market boom. Observing the shift in capital flows, John Maynard Keynes (1930) noted this change in the direction of capital flows as a shift from 'transactions circulation' to 'financial circulation'. With the market's collapse, losses by foreign investors affected their own national economies. But the collapse of reserves had an even greater impact. Between 1929 and 1931, foreign exchange reserves fell to 27% of total reserves and fell further to 8% by 1932 (Grubel, 1977).

France played a major role in initiating the extinction of reserves. Having undervalued the franc when it returned to convertibility in 1926, it ran large trade surpluses and amassed huge foreign exchange holdings, mostly in sterling and dollars. With legislators growing concerned about the size of these holdings, a law was passed in 1928 prohibiting further acquisitions of foreign exchange reserves (Grubel, 1977). In 1928 and in 1929 when negotiations on reducing reparations payments by Germany (which France opposed) were underway, France sold its holding of deutschmark assets and forced Germany to suspend convertibility. At the same time, French withdrawals of sterling drove up the Bank of England's discount rate. The credit strain in London resulted in foreign loans being called and contributed to the $120 million drop in call loans in New York in August 1929 (Gisselquist, 1981; Kindleberger, 1984).

As economic conditions deteriorated worldwide, the Bank of France began to convert its existing stock of foreign exchange reserves into gold in 1931. Its sales of sterling set off sales by other countries that were required by law to hold only foreign exchange assets convertible into gold. These countries feared that France's sales would force the UK to suspend convertibility and, after they had precipitated a run on the Bank of England, the UK did, in fact, suspend convertibility on 21 September 1931. Unable to dispose of sterling, many of these countries converted sterling holdings into dollars and, even though the dollar remained convertible, they exchanged dollars for gold (Gisselquist, 1981; Grubel, 1977). From mid-September to the end of October 1931, the Federal Reserve lost $755 million of gold, $350 million taken by France and the rest by Belgium, Switzerland and the Netherlands. The Fed responded by raising the discount rate from 1.5% to 3.5%—a move that is generally viewed as deepening the US depression and that of the rest of the world outside the sterling block (Kindleberger, 1984).

By 1932, global reserves had contracted by one-third. The loss of reserves put severe downward pressure on money stocks and credit in national economies and resulted in a sharp contraction in cross-border trade and investment. In the next several years, the contraction in reserves was offset to some degree by competitive devaluations (including the US dollar in April 1933) that raised the value of gold reserves and permitted some re-expansion of money stocks. But it was more than a decade after the end of World War II before money stocks in Europe returned to previous levels (Gisselquist, 1981; Grubel, 1977).

The great deflationary spiral from 1931 to 1933 effectively ended the multilateral world in which trade and investment had flourished. Germany imposed exchange controls and entered into bilateral trading arrangements that included barter as a way of bypassing the international monetary constraints that had blocked its access to international borrowing. Other European countries retreated into trading blocs enforced by tariffs and quotas.

There was also a substantial dispersal of both economic and political power. The UK retained industrial, military and diplomatic power but its loss of financial power ended its role as hegemon. France acquired financial and military power but its failure to rebuild industrial power prevented it from assuming the dominant role it sought. Germany remained an industrial power but lacked financial, diplomatic and, until later in the 1930s, the military power to assume a leadership role. The USA had acquired great overall financial and economic power but was weak militarily and had little diplomatic strength (Gisselquist, 1981).

As one historian of the period notes, no one nation had sufficient power to enforce its will or to lead. Without mechanisms—or the will—to shape policies by consensus, effective power was most often used as a veto (Kindleberger, 1984). The major nations took positions that would seemingly enable them to control their own destinies (Gisselquist, 1981).

2.3 Bretton Woods: the dollar exchange rate regime

The adoption of an exchange standard that included both gold and foreign exchange by many of the major countries after World War I paved the way for the use of this model after the World War II. The international monetary system set in place at Bretton Woods differed from the gold exchange standard, however, in that, as Joseph Gold noted, it was in practice 'a solar system in which the US dollar was the sun' (Dam, 1982, p. 95). The USA committed to exchange dollars for gold at the rate of $35 an ounce and other currencies were to keep their par values at a given relationship to the dollar. The burden of intervention was to be borne by the non-reserve currency countries. The value of the dollar was fixed but the value of other currencies, determined by the market, could appreciate or depreciate by 2% without the requirement to intervene.

As noted, the dollar had been devalued in 1933 and was no longer convertible domestically. The amount of gold the Federal Reserve was required to hold as backing for Federal Reserve notes had also been reduced and, at the international level, the dollar was only convertible in transactions between central banks or other government agencies, not in transactions with private foreign holders of dollars.

Much has been written about the competing British and American plans for the post-war system and the following is a very superficial account of these plans and the political and economic objectives they embodied. Given its large external debt accrued during the war to the colonies and dominions in the sterling bloc, a major concern for the UK was to protect sterling by gaining access to credit to fund its debt and prevent a run on its gold reserves. Keynes and others in the UK Treasury saw exchange controls as necessary to curb speculative flights and while the USA did not adopt controls, they were permitted in the final agreement and adopted by the UK and other European countries (Dam, 1982).

Keynes' International Clearing Union (ICU) reflected his belief that the key problem in the international system was the lack of liquidity. He saw the need to construct a system that would favour expansion rather than contraction and one that would not restrain domestic policy. In addition, the ICU was structured to avoid creating a system that relied on one or more dominant currencies as reserve assets to minimise governmental influence and prevent a repetition of the collapse of foreign exchange reserves that had occurred in the period 1928–32. It was to be a multilateral system with automatic overdrafts based on the relative size of a country's trade. Foreign exchange reserves were to be concentrated in national central banks with purchases and sales of currencies among central banks only through accounts with the ICU that were to be denominated in 'bancor'. The accounts of both debtors and creditors would be interest-bearing so that the burden of adjustment would fall on both. Creditor countries would make deposits of current account surpluses they did not wish to spend and thus create an additional supply of funds for debtor countries to borrow (Dam, 1982; Gisselquist, 1981; Skidelsky, 2000).

The original US proposal offered by Harry Dexter White was based on the structure of the exchange stabilisation fund the USA had created when it devalued gold in 1933. It proposed to use repurchase agreements to make swaps rather than loans to deficit countries (Boughton, 2006). Like Keynes, White saw the ability to provide liquidity as a major objective of the fund but he was more concerned than Keynes with exchange rate stability. Since US interests were more aligned with investment than with trade, White and others in the US Treasury were unwilling to be lenient about the right to devalue or accept currency fluctuations. He proposed a role for the dollar as the unit of account in the system but, unlike Keynes, designed an active rather than a passive role for the fund. In his view, subscriptions to the fund should be made in transferable securities rather than currencies that would allow it to conduct open market operations (Boughton, 2006).

Neither of these plans was adopted and some of their more important benefits did not survive to be incorporated in the final structure of the monetary system and the

International Monetary Fund (IMF) that was to administer it. For example, a major advantage in the structure of the ICU compared with that of the IMF was that the ICU could use the resources contributed by all surplus country depositors as well as the contributions to its capital base, whereas the contribution of nonconvertible currencies to the Fund has limited its ability to lend and made it overly reliant on US dollar contributions. Another is that both Keynes and White agreed that policy conditions should only apply *ex post*—after a borrower's needs were met—and only if that borrower were unable to take appropriate action or were unable to repay. Their position on conditionality was, in fact, reflected in the initial framework for the IMF. It was only in the 1950s that the Executive Board of the IMF 'introduced the conditional lending that gradually became standard practice' (Boughton, 2006, p. 11).

Also missing from the final agreement was the automaticity and apolitical structure that Keynes envisioned. It is likely that either his overdraft plan or White's swaps would have provided liquidity in a more timely fashion than the IMF's quota-based lending. But another serious loss was White's proposal for subscriptions of transferable securities to provide the framework for countercyclical open market operations. This would have made the International Stabilisation Fund a true lender of last resort—unlike the IMF that depends on contributions of taxpayer funds and, like Keynes's ICU, plays an essentially passive role in international transactions.

The absence of countercyclical mechanisms is the weakest aspect of Keynes' ICU proposal and one that must be addressed by those who would revive it in some form. William R. White (2007) suggests that Keynes had doubts about the efficacy of monetary policy in deep recessions and so recommended (indeed, invented) fiscal policy at the national level as the primary tool for stabilisation. Another possible explanation is that, accustomed as he was to the overdraft mechanism in the British monetary system, Keynes underrated the open market tools that the Federal Reserve had invented to conduct countercyclical operations in the 1920s and that, after being abandoned in 1928, had been revived in the mid-1930s.

2.4 The early years of the Bretton Woods monetary system

As noted, the new system originally envisioned the dollar's role as that of an international unit of account. That function for the dollar required that the dollar/gold exchange rate be fixed and unchangeable. But the absence of rival currencies convertible into gold ensured that the dollar would also emerge as an international medium of exchange used in transactions between third countries and an international store of value for private investment. A larger role for the dollar was inevitable given the reality of US economic power at the end of World War II. The US accounted for 60% of world output, owned 60% of the world's gold reserves, had modest import requirements and was able to produce much of what the rest of the world needed to resume economic growth. Nevertheless, as necessary as this role was at the time, it required the USA to subordinate fiscal and monetary policy to the objective of ensuring exchange rate stability. And, as proved to be the case, it was an objective that the US—or any other country—could not meet over time (Gisselquist, 1981).

In the immediate post-war period, most countries continued to operate under the pre-war rules of the gold exchange standard. Legal restrictions in some countries prohibited holding foreign exchange as reserves unless the foreign currency was convertible into gold. Europe and Japan did not have enough gold to permit convertibility so they could not pay for trade or permit loans in their currencies. Since the dollar was convertible and could be held as a reserve, dollar loans and grants under the Marshall Plan allowed Europe and Japan to build foreign exchange reserves.

Moreover, the establishment of a European Payments Union in 1950 with a $500 million capital grant from the USA alleviated the problem in terms of trade within Europe. Intra-European trade imbalances were settled through extensions of credit rather than exchanges of dollars or gold under a system of quotas or tranches for individual countries (Kindleberger, 1984). The Payments Union ended in 1958 when Europe returned to current account convertibility (as did Japan in 1964) but it had facilitated a more even distribution of reserves, helped rebuild Europe, fostered a sense of community and laid the foundations for the establishment of the European Economic Community in 1957 (Gisselquist, 1981).

Nevertheless, there was real constraint on trade and investment during this period. Without convertibility, private financial institutions could not move funds across borders. All financial flows had to originate in the hegemon's national market and, initially, were largely government-to-government flows. Subsequently, governments began raising funds from private institutions in the US national market, holding dollars as reserves to back the creation of domestic money to be allocated at home. Thus, in the period before 1958, the inability of the major industrial countries to participate in the international monetary system required governments to undertake the role of intermediaries in managing financial flows (Gisselquist, 1981).[1]

2.5 The unravelling of Bretton Woods

With the advent of convertibility in 1958, there was an increase in US private capital flows to Europe and, later, to Japan. But the return flow to the US—public and private—was greater. Dollar reserves had to be invested in US financial assets to earn interest and as earnings on reserves augmented the supply, the amount of investments in US financial assets also grew. Private dollar holdings were also returned to the US and held as working balances with US banks to pay for trade with the US and third countries. Surplus private funds were invested in time deposits or money market assets or Treasury bills. In time, the return flow of dollars to the US provided more credit than its economy could use. The outcome was lower US interest rates, economic expansion and a rising rate of inflation. Excessive inflows also encouraged an even larger volume of capital outflows by US residents that put pressure on the dollar exchange rate. In short, the 'dollar shortage' of the 1950s rapidly became the 'dollar glut' of the 1970s (Gisselquist, 1981)).

The first dollar crisis erupted in 1960 with speculative sales of dollars for other currencies and some official demand for gold in expectation of devaluation. Despite the sudden turmoil the crisis created, the USA would not be willing to devalue for another decade. Its attempts to counter pressure on the dollar included a monetary response known

[1] A variation on this pattern was developed in the 1970s by many developing countries because their currencies were not readily convertible in the private foreign exchange markets that had developed after the collapse of Bretton Woods and could not be used in international transactions. Governments in these countries borrowed dollars and other hard currencies from private financial intermediaries in industrial countries or offshore centres and used the proceeds to allocate or guarantee foreign currency loans to their domestic public enterprises, to build foreign exchange reserves, to make foreign exchange available to private domestic exporters in exchange for domestic currency, and as backing for expansions of domestic credit. It was a pattern that inevitably led to the buildup of external debt.

as 'Operation Twist'[1] in 1961 followed by the inauguration of a series of capital controls as the decade progressed. The first of these, the interest equalisation tax, taxed US residents' holdings of foreign securities issued in the USA to reflect the higher interest foreign issuers would have paid in their own countries (Moffitt, 1983).[2] The effect of the tax was to move dollar issues offshore to the Eurobond market, reduce capital outflows and seemingly reduce pressure on the dollar.

The creation and expansion of the so-called Euromarkets in London and other financial centres was seen as a way to 'manage' the dollar glut. Dollars (and other strong currencies) could be borrowed and loaned outside the US national market for transactions involving both US and non-US residents and would not appear as US transactions on its international balance sheet. What was not understood initially was that those offshore transactions would nevertheless affect the exchange rate for the dollar; that they would change the demand for dollars as effectively as transactions in the national market that involved capital flows and would tend to expand foreign holdings of dollars if other currencies were not used for cross-border transactions.

Overall, US efforts did not succeed in balancing its external accounts.[3] The second run on the dollar occurred in 1967, prompting the Fed to raise interest rates to attract foreign funds and dampen the economy. While capital controls were limiting outflows by banks, they responded to higher rates by bringing in funds from their foreign branches for lending in the USA. But, as rates declined, US banks ignored the voluntary restraint programme and moved funds back to the Euromarket—a move that prompted the next dollar crisis in 1969 and what was called a monetary 'jolt' as the French franc devalued by 10% and speculative flows pushed up the value of the deutschmark by 10%. The countries of the European Economic Community (EEC) responded to the renewed turmoil by imposing capital controls and recommending a revival of the credit system for settling balances under the 1950s Payments Union (Kindleberger, 1984).

As the unsustainability of the dollar/gold exchange rate system became increasingly obvious in the 1960s, Robert Triffin led the way in calling attention to the need for a post-Bretton Woods system. His proposals were an integral part of the discussions that led to the Rio Agreement in 1967, which authorised the IMF to create and issue SDRs. Although he was highly critical of the Rio Agreement, Triffin believed that its central achievement—the creation of new reserve assets to strengthen the balance of payments adjustment mechanism—was a first step in the right direction. Nevertheless, he warned that it would not constitute a viable reform effort if it failed to take a more comprehensive approach in assigning roles to all three components of reserves—gold, foreign exchange and collectively created assets—especially since gold would certainly be demonetised internationally as it had been nationally since the 1930s (Triffin, 1968).

[1] Operation Twist was an attempt to use monetary policy to shift the slope of the yield curve. The Federal Reserve bought long-term securities to depress their yield and raise the yield on short-term securities. The objective was to attract foreign investment into dollars to counter speculative sales but to do so without harming housing and business borrowing in long-term markets. It was a programme initiated by the Treasury, reluctantly accepted by the Fed and not a great success (Gisselquist, 1981).

[2] The 1965 voluntary foreign credit restraint programme was an agreement by US banks to reduce their foreign lending by limiting them to the amount loaned in 1965. The 1968 foreign direct investment programme restrained borrowing in the US by US corporations for overseas investment or transactions with overseas subsidiaries and was not voluntary.

[3] Among the impediments were slow growth in the US relative to other major countries that had rebuilt their industrial bases in the aftermath of the war and become more productive as well as the fiscal drain of the Vietnam War.

Triffin argued that the central flaw in the Bretton Woods Agreement was the conversion problem. As the USA accumulated IOUs, the conversion of these obligations into gold posed a growing threat to the system. But avoiding conversion (as some academics and US officials favoured) threatened to force the rest of the world into the dollar area. In Triffin's view, 'the alternative to the gold standard is not a dollar standard unilaterally run and managed by the United States alone, but a true international standard, calling for concerted decisions and management by all participating countries' (Triffin, 1968, p. 187).

Triffin's created reserve assets were similar to the reserve asset Keynes called 'bancor' in his 1940s proposal. Unlike Keynes, however, Triffin linked the distributions of reserve creation to development finance. But the major industrial countries with the majority of votes in the IMF linked the distribution of SDRs to the size of existing quotas.[1] Triffin complained that this decision was 'as indefensible economically as it [was] morally', especially since two of the richest countries in the world (the USA and the UK) were assigned about one-third of the total (Triffin, 1968, p. 194).

SDRs are valued in relation to a basket of currencies and are the unit of account in which all IMF transactions and obligations are denominated. They can be exchanged for another country's currency at the direction of the Fund or by mutual agreement. They can also be used in swaps, loans and to settle financial obligations among member countries and between members and the Fund.[2] The IMF's Articles of Agreement state the intention of making SDRs the principal reserve asset in the international monetary system and many more recent reform proposals have called for new issues of SDRs. But the fact that new SDRs have not been issued reflects, in part, the initial decision to allocate so large a share to the USA. That decision effectively destroyed the potential of the SDR to assume an important role in the system since its enormous holdings made the USA reluctant to exchange dollars for SDRs offered by other countries and thus to forge the needed link between the reserve asset and the medium of exchange. Moreover, SDRs were designed for a closed system where international liquidity was created, controlled and distributed among and between central banks and the Fund. After 1971, the control and distribution of international liquidity passed to the private sector.

2.6 Monetary collapse

In 1971, the dollar came under pressure from actions by Germany and France and the Bank of England's need to convert $700 million into gold to alleviate pressure on sterling. Foreseeing a run on the dollar, President Nixon closed the gold window in August, ending dollar convertibility. At a meeting of the G10 nations at the Smithsonian Institution in December, the USA announced a devaluation of the dollar to $38 to an ounce of gold, imposed a 10% tariff surcharge on Japanese imports and negotiated upward revaluations of the deutschmark, the yen and the Swiss franc. It also negotiated smaller revaluations of the Belgian franc and the Dutch guilder and even smaller revaluations of the pound, the Italian lira and the Swedish krone—ensuring the success of the negotiations by permitting these currencies to devalue relative to the mark, yen and Swiss franc even as they appreciated

[1] Some argue that monetary turmoil and the increasingly limited supply of gold relative to the growth in foreign exchange reserves was seen as posing a threat to the convertibility of key currencies (notably the dollar and the pound) that could precipitate a contraction of world reserves like that in the period 1928–32; that it was this concern that led to the decision to give the lion's share of SDRs to the USA and other major industrial countries (Gisselquist, 1981).

[2] In the second half of the 1990s, the US frequently used its SDRS to meet its obligations to the IMF when Congress delayed funding new contributions to the Fund.

relative to the dollar. In addition, the G10 agreed that dollar reserves would be held in the USA, not in the Euromarkets, as investments in US Treasury securities (Dam, 1982).

The Smithsonian Agreement was short-lived. Another, much larger run against the dollar took place in February 1973 and prompted $10 billion of intervention by central banks in an attempt to stabilise foreign exchange markets. Exchange markets were closed in March and the USA took unilateral action, devaluing the dollar to $42.50 for an ounce of gold, letting its currency float and, in 1974, ending capital controls. US officials and academics who had argued that the market should set the price of the dollar had prevailed (Dam, 1982).

There were several important byproducts of these years of monetary turmoil. Intervention by major central banks to support the value of the dollar (or prevent the appreciation of their currencies) resulted in a massive increase in foreign exchange reserves in the period 1970–74 (an increase of 65% in 1971 alone) (Dam, 1982). The result was an equally massive increase in international liquidity that ignited ongoing inflation in the USA and other countries throughout the 1970s.

Another outcome was that public sector influence over international monetary developments was substantially eroded as control of the international payments system and balance-of-payments financing shifted from national central banks to transnational private banks. The result was precipitous growth in the external (Euro) markets and a rising volume of cross-border capital flows that dwarfed the volume of trade.

In response to these developments, European economists issued a manifesto on 1 November 1975, calling for monetary union. An EEC study group report issued in 1977 supported the commitment to resolving monetary instability by the leaders of Germany (Helmut Schmidt) and France (Giscard d'Estaing). The next step was the formation of the European Monetary System (EMS) in December 1978 and the introduction of a new unit of account—the ecu—based on a basket of currencies. The EMS provided a set of rules to aid in narrowing fluctuations of national exchange rates and, like the earlier Payments Union, created a system of credit facilities for mutual payments support.

Twenty years elapsed between the introduction of the EMS and the full monetary integration that occurred at the end of the millennium with the adoption of a single currency by a majority of the states in the European Union. As a group of nations heavily involved in and dependent on trade, Europe's objective was to revive the exchange rate stability that it had enjoyed before World War I. The single currency has provided that stability within the euro area but has by no means sheltered it from effects of monetary developments outside its borders. Nevertheless, European nations have avoided taking the lead in calling for reform of the international monetary system. It may be that their reluctance is fear that tampering with the existing system might cause some unravelling of their own hard-won regional arrangement.

3. The context for reform

In a series of articles on the dollar crisis published by *The Times* of London in September 1971, Nicholas Kaldor wrote:

> The persistent large deficits in the United States balance of payments—given the universal role of the dollar as the medium for settling inter-country debts—acted in the same way as a corresponding annual addition to gold output ... So long as countries preferred the benefits of fast growth and increasing competitiveness to the cost of part-financing the United States deficit (or what comes to the same thing, preferred selling more goods even if they received

nothing more than bits of paper in return), and so long as a reasonable level of prosperity in the United States (in terms of employment levels and increases in real income) could be made consistent with the increasing uncompetitiveness of United States goods in relation to European or Japanese goods, there was no reason why any major participant should wish to disturb these arrangements . . .

. . . [But] as the products of American industry are increasingly displaced by others, both in American and foreign markets, maintaining prosperity requires ever-rising budgetary and balance of payments deficits, which makes it steadily less attractive as a method of economic management.

If continued long enough it would involve transforming a nation of creative producers into a community of *rentiers* increasingly living on others, seeking gratification in ever more useless consumption, with all the debilitating effects of the bread and circuses of Imperial Rome . . . (Kaldor, 1971 [1978, pp. 62–4])

It is hard to realise that Kaldor was not describing the US economy of today rather than that of almost 40 years ago—equally hard to realise that what he was describing as happening then continued to deepen slowly over the many years since. To conclude that the USA bought time for a continuation of its role as monetary hegemon leads one to ask why and for whom it did so. But it is likely that the continuation occurred to some extent without conscious design—that these same countries (and others added to the list over the years) also participated in maintaining it for the reason that Kaldor states: that it was a method of economic management that offered them fast growth and increasing competitiveness.

But, as Kaldor argues, it was not sustainable and now, as the US economy loses any semblance of prosperity and the rest of the world joins in the downward spiral of debt and job deflation, another unravelling has begun. Rather than try to predict what might happen—another run on the dollar, a gradual shift into reserves denominated in another currency, or an implosion of the value of dollar reserve holdings that would exacerbate downward pressure on the global economy—this discussion will try to selectively describe some of the reform proposals that have already been offered in the hope of stimulating renewed debate on the need for reform and new reform proposals.

3.1 The proposal for an international commodity reserve currency

Kaldor himself was one of the more important spokesmen for reform in the 1960s and 1970s. In 1964, he, along with A. G. Hart and J. Tinbergen submitted a paper to the United Nations Conference on Trade and Development that proposed a version of a plan for a new world currency that Benjamin Graham had submitted to participants at Bretton Woods in 1944 (Graham, 1944). Graham's initial work in the monetary field (Graham, 1937) offered a plan for a new US domestic currency in the form of receipts issued by a commodity storage facility. The objective of both his domestic plan and the international version was to ensure monetary stability through countercyclical mechanisms, preserve the link between monetary issuance and the real economy, and back currency issues with a class of financial assets that would be less likely to divert monetary resources into speculative activities.[1]

[1] Graham argued that, under his storage plan, rising prices in a boom would increase redemptions of stored commodities that would augment their supply and drive down their price while shrinking the supply of commodity currency. In a downturn, falling prices would encourage producers to store commodities (stabilising their price) while increasing the supply of commodity currency.

While based on the Graham proposal, the international commodity reserve currency proposed by Hart, Kaldor and Tinbergen was structured to move beyond Graham's intent to stabilise the money price level of commodities. It proposed creating a universal reserve medium that could provide stability in real value by monetising a bundle of primary commodities. Its objectives included adapting the world monetary structure to changes in world production and trade and contributing to the stabilisation of prices and trade in primary products.

The Hart, Kaldor and Tinbergen paper offered a critique of the Triffin proposal to have the IMF create a reserve currency. In their view, this would involve a serious surrender of sovereignty since it proposed to set up a supra-national central bank engaged in credit creation and empowered to issue an international paper currency that could not be regulated by fully automatic rules.

The International Commodity Fund (ICF) these three distinguished economists proposed was, like Triffin's plan, based on the assumption of a continuation of the Bretton Woods agreements for settling payments balances between countries through their central banks and maintaining capital controls. Unless these conditions were reinstated, their proposal that only central banks could hold the reserve unit issued by the ICF would limit its use in settling payments imbalances. Like the SDR, a commodity reserve currency issued by an ICF would be marginalised if it is issued in a predominantly privatised system. Nevertheless, if public control of settling payments balances were revived, a commodity reserve system would, as Kaldor (1976) points out, enable national central banks to expand the conduct of open market operations beyond the current limited menu of securities and into commodity markets.

3.2 Proposals for new issues of SDRs

Since Triffin's initial proposal in the 1960s, there have been numerous calls to revive issuance of SDRs.[1] The objective of these proposals is to move beyond the key currency system by creating an international reserve unit under multilateral governance. While new issues of SDRS are obviously looked on with favour as a mechanism for expanding reserves, they would remove the credit-generating attribute of foreign exchange reserves that introduced a procyclical aspect to reserve holdings and exacerbated booms and downturns as discussed above. Moreover, using the SDR as a reserve currency assumes that national central banks will continue to issue national currencies and that reform can be accomplished without the loss of national sovereignty. But while the SDR could be used in transactions among central banks and with the Fund—and, like the ecu created by the EMS, could serve as a unit of account in private transactions—it could not be used to finance transactions with the private sector. Thus, if country A suffered a natural disaster, it could not use its reserves to buy blankets and medical supplies in country B unless country B were willing to exchange country A's SDRs for country B currency.

In an effort to overcome this problem, Joseph Stiglitz proposed creating 'global greenbacks'—real money SDRs as he described them initially (Stiglitz, 2003)—to be granted to developing countries and countries with financial difficulties in order to finance global public goods and free (or supplement) developing countries' reserves by converting the greenbacks into hard currencies to service debts and finance imports. While this proposal

[1] See, for example, earlier proposals offered by the IMF (1987) and in the USA by Lipton (1999), D'Arista (2000), Soros (2002), Wade (2002) and Ocampo (2007–8).

was narrow in its emphasis on dealing with debt and developing countries, his more recent proposals have been broader in scope. In *Making Globalization Work* (Stiglitz, 2006), he describes his global greenbacks system as one in which new reserves could be created every year and would not be given largely to the wealthiest countries. He proposes the creation of a trust fund of conventional hard currencies to enable countries in crisis to exchange their global greenbacks for currencies that can be used to pay private creditors and for imports. But he adds that a more ambitious version of the system 'would allow global greenbacks to be held by individuals, in which case there would be a market price for them and they could be treated like any other hard currency' (Stiglitz, 2006, p. 263).

Unlike other proponents of SDR issues, Stiglitz acknowledges the need to forge a link between a reserve asset not based on national currencies and the currencies used in private international transactions. His proposal improves on the current system for exchanging SDRs for hard currencies in that the pool of hard currencies that would be created would be used at the direction of the IMF rather than the national central banks that issue those currencies. Nevertheless, the trust fund would necessarily rely on contributions from those countries and he does not suggest how the IMF would ensure that their contributions would be sufficient to create a pool large enough to be effective in managing crises.

As for the more ambitious proposal to allow the global greenback to evolve into a transactions currency, Stiglitz is vague on the institutional arrangements that would be required. One assumes that global greenbacks would not be issued directly to individuals or private institutions but might leak into the payments system through sales to private institutions by central banks. They could, of course, also be used to denominate private transactions without actually being exchanged at settlement as was done prior to the inauguration of the European Monetary Union.

These, and perhaps other ways of using a more plentiful supply of SDRs in trade and debt-servicing transactions, might constitute an effective incremental path toward substituting an international unit of account for national currencies as both the primary reserve asset and means of payment in the international system. As discussed below, the SDR has the virtue of already being incorporated into the international monetary system and additional creative proposals on how it could be used in managing the current crisis appear to constitute the most fruitful path toward reform. But as these proposals are developed, they must place restraints on the role of the private financial system in pricing or distributing SDRs or similar reserve assets. Failure to do so would likely expose the reserve asset once again to the perils of speculation. Given the damage done by the process of privatising the international monetary system since the 1970s, the debate on reform must include discussions of the appropriate criteria for determining changes in exchange rates and how those determinations should be made.

3.3 Proposals for alternative solutions

Most criticisms of the current international monetary system have stressed the need to create a reserve asset not based on a national currency. Many note the system's inequities while others argue with Kaldor that it is inherently unsustainable. The extraordinary growth in holdings of dollar reserves over the last decade has reflected rising imbalances in the global economy and suggests that if those imbalances diminish in the wake of the crisis they could lead to a contraction in global reserves like the one that occurred between 1928 and 1932 and would, as then, exacerbate downward pressure on the global economy. Whether or not that threat is real, now is the time to build on increased interest in international monetary reform by encouraging discussion at the national as well as international level and expanding the menu of proposals to be considered. The author's three reform proposals outlined below are offered as part of the effort to enlarge the debate.

3.3.1. Creating a public international investment fund for emerging economies. The spillover effects of the investment of emerging economies' current account surpluses in the USA and other major national and international financial markets assured not only that these poorer countries would be financing the rich but that some portion of those funds would be recycled back to those same creditor economies in the form of foreign acquisition and ownership of their financial assets and productive facilities.[1] This channel for the reflow of these countries' savings does not always reflect investment strategies that are concerned with development. In fact, portfolio and direct investment by foreigners necessarily entails the need for returns to reward the individuals and institutions that have acquired ownership of these assets and tends to encourage and facilitate export strategies that increase the accumulation of external currencies. In view of this aspect of the reserve accumulation process, one of the more pressing issues in dealing with global imbalances is to find ways to recycle these countries' savings back into their own economies in support of development strategies that increase demand and income more equitably and reduce dependence on export-led growth.

With the phenomenal growth in the assets of institutional investors in developed countries in the 1990s, foreign portfolio investment became a more important form of inflows into emerging market countries than bank loans. In most cases, however, inflows into evolving securities markets tended to change prices and exacerbate volatility in secondary markets rather than provide long-term financing for economic expansion, while outflows often triggered or intensified currency crises. Moreover, many developing countries that need long-term financing for infrastructure and other basic components of development strategies do not have markets that can absorb foreign investment flows or the credit standing to attract them. What is needed is a new channel for portfolio investment to provide flows that are stable, in amounts appropriate to the size of a country's economy and directed more toward the goals of development than short-term profits for investors.

Such a channel could be constructed by creating one or more closed-end funds for emerging market investment as a separate institution under the Bretton Woods umbrella.[2] These funds would issue their own liabilities in a variety of national currencies and use the proceeds to pay for stocks and bonds of private enterprises and public agencies denominated in local currencies in a wide spectrum of developing countries. The funds' liabilities would be marketed both to private institutional investors in advanced economies and official investors from emerging economies and they would also qualify as international reserves, guaranteed by a multinational agency and its member countries. Investing the reserves of developing countries in these funds would redirect external savings back into the economies of the countries that own them rather than into the financial markets of strong currency countries. Moreover, their closed-end structure would ensure that long-term funds would be provided and that sales of the funds' liabilities by investors would not force redemptions that would disrupt development projects.

[1] See the discussion of the round-robin character of capital flows in D'Arista and Griffith-Jones (2006).

[2] For a discussion of the benefits of a closed-end fund and other details of its structure, see D'Arista (2000, 2007).

Like proposals for additional issues of SDRs, a major objective of these investment funds is to inaugurate a meaningful shift into a non-national reserve asset and phase out a system in which the choice of financial assets as reserve holdings centres on a few countries whose wealth supports the strength of their currencies. One incentive for developing countries to hold these securities as reserves is that they would provide a multilateral (rather than unilateral) guarantee from industrial countries and, in time, from wealthier emerging economies.

3.3.2 Reforming the international payments system. The above proposal—to use multilateral credit liabilities as reserve assets—is incremental in nature and, while it addresses a critical flaw in the current international monetary system, an equally critical one—the means of payment—would still need to be addressed. Permitting the continuation of a key or strong currency regime for cross-border transactions would perpetuate the export-led growth paradigm by requiring the majority of countries to shape their economies to ensure that they can earn—or borrow—key currencies to engage in external trade and investment. It also requires the key currency country to import more than it exports to meet the demand for its currency and accept the resulting current account deficits and build-up in debt described by Kaldor in 1971. The global economy can only regain balance if every country is able to use its own currency, backed by the wealth created within its own borders, to participate in the global economy.

One way to achieve this objective would be to mine Keynes' Bretton Woods proposal to create a new institutional framework. While Keynes' overall proposal was designed for a very different world, the basic structure in his concept—an international clearing agency (ICA)—could be revised to serve as the institutional platform for a new global payments system that would foster egalitarian interactions and more balanced outcomes.

The new ICA would clear transactions denominated in members' own currencies by crediting and debiting their clearing accounts. These clearing accounts would, in fact, constitute the international reserves of the system, held for the member countries by the ICA and valued using a trade-weighted basket of all members' currencies. Thus, the clearing process would change the ownership of reserves and reinstate the original intent of the Bretton Woods Agreement to maintain public control of international payments. It would also permit exchange rate adjustments over a set period of time in response to changes in reserve levels, preserving the valid role of market forces in shaping currency values through trade and investment flows while ensuring that speculators would no longer dominate the process.

A revised ICA proposal could also reintroduce Harry D. White's Bretton Woods proposal to authorise open market operations by an international agency. It would do so by permitting the new clearing agency to acquire government securities from its member countries to back their reserve holdings. This would give the ICA means to buy or sell these securities to help national authorities correct imbalances and promote stability. In addition, when approved by a super-majority of its member countries, the ICA's money creating powers would also allow it to operate as a true lender-of-last-resort—a role the IMF cannot play given its dependence on taxpayer contributions. In this capacity, the ICA could assist a national central bank in supplying liquidity by buying government securities from residents in the national market and augmenting the country's supply of international reserves.

Membership in the ICA would be open to national central banks of all participating countries and branches of the clearing agency would operate in every major financial centre across the globe. The Agency would be governed by a rotating executive committee that would at all times represent half the world's population and half its total output. Its role in clearing members' payments in their own currencies would ensure that the ICA would not infringe on their sovereignty—as an international central bank that issued a single currency would do. The conduct of national monetary policy and decisions about preferred exchange rate regimes would remain the prerogative of national authorities.

But the ICA's ability to create and extinguish international reserves would give it the power to change the availability of liquidity at the global level. The absence of and need for that power has been increasingly evident throughout the post-Bretton Woods era as crisis after crisis has damaged the global economy and underscored the inadequacy of the current monetary framework. The establishment of an international monetary agency to conduct countercyclical operations was never more needed than it is now.[1]

3.3.3 A new structure for reviving SDR issuance. Establishing the institutional framework for the two proposals outlined above would require international agreements. Obtaining this level of institutional and monetary reform is not totally impossible but it is unlikely given the current focus on dealing with a crisis that has become global in scale. It is more likely that incremental reforms will be offered in discussions involving the G20 and, as noted above, the most likely candidate for changing monetary arrangements is an enhanced role for the SDR.

The focus on the SDR is, perhaps, a realistic assessment of the potential problem that foreign exchange reserves may pose for global recovery. The slowdown in spending by US households and the ensuing drop in imports could narrow the channel for reserve creation if, as is likely, no other country and its currency can create reserves by acting as a global buyer-of-last-resort. As recognition of the flaw in the key currency regime widens, reserve creation through issues of SDRs by the IMF is also gaining wider support.

One version of SDR issuance may be the revival of the substitution account, allowing countries with holdings of dollar reserves to turn them in to the IMF for SDRs. There is concern that the Treasury's borrowing to finance the stimulus could precipitate increases in interest rates that would result in losses on holdings. At the same time, it is feared that the expansion of the money supply due to the Federal Reserve's lending programmes could cause inflation and weaken the dollar's value. A shift into SDRs might help cushion those losses for China and other countries with large holdings of dollar reserves in the short term. Over time, however, the downward pressure on US credit markets from the loss of capital inflows would exacerbate the decline in US imports and erode US markets' *entrepot* function in recycling investment flows back to emerging economies. Given those likely developments, dollar depreciation would be inevitable and substitution accounts would offer only limited protection against the economic consequences of the shrinkage in trade and investment.

The current channel for reserve creation rests on the paradigm of export-led growth and is one that may intensify the effects of the loss in value of reserve holdings. Thus the need for fiscal stimulus programmes in developing and emerging market countries that rely on exports for growth is as great as in advanced economies. But loss in the value of their international reserve holdings could constrain the ability of these countries to expand credit needed to finance stimulus programmes.

[1] For an expanded discussion of the ICA proposal, see D'Arista (2000).

Here, perhaps, issues of SDRs in exchange for the government debt of countries undertaking infrastructure projects and programmes related to health and education could make a real contribution. The IMF would not only act as a buyer for that debt on reasonable terms but would release the foreign exchange reserves needed to fund the programmes by substituting SDRs as backing for domestic credit expansion. The use of foreign exchange reserves for spending would increase demand and contribute to recovery both locally and globally through job creation and increases in imports. Such a programme would also allow the IMF to mop up excess liquidity in the aftermath of recovery by selling back its holdings of government debt and extinguishing the SDR reserve holdings. It would therefore introduce a variation on the countercyclical mechanism that Harry D. White had proposed in the 1940s.

4. Conclusion

As the discussion of the evolution of the international monetary system suggests, it has been a process in which successes and failures of previous stages have prompted and been incorporated into the next stage. The success of the evolving gold exchange standard in the early 1900s led to its adoption in the 1920s as stagnation in gold production created the need for an expansion of reserves to promote growth. But the collapse of foreign exchange reserves in the period 1928–32 led the two major participants in the Bretton Woods discussions to emphasise the need for a system that would promote liquidity. For most of the 60 years since the dollar assumed the role of key currency, the system has not impeded the ability of central banks in countries with well developed financial markets to maintain liquidity and promote growth. But countries without developed financial markets have experienced monetary jolts similar to those they suffered under the gold standard and through World War II.

Now, however, there is a possibility that a monetary collapse could engulf the entire global economy—that a loss in the value of the key currency could precipitate a world-wide shrinkage in credit that would deepen the financial and economic crisis already underway. The unsustainable aspects of the key currency regime to which Kaldor called attention in 1971 are finally forcing the system to unravel. The successful economic performance of the USA that was the real backing for the dollar has eroded at the same time that growing US dependence on foreign savings for that performance has increased its vulnerability. Their current focus on stimulus programmes and financial regulation suggests that the G20 may attempt to solve the crisis without addressing the monetary aspect that is exacerbating the problem. If so, one must hope that other governmental and non-governmental groups will exert pressure to take up the discussion at a level that can realise the needed reforms.

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