MONETARY THEORY AND BRETTON WOODS

Over the twentieth century, monetary theory played a crucial role in the evolution of the international monetary system. The severe shocks and monetary gyrations of the interwar years interacted with theoretical developments that superseded the rigid rules of commodity standards and led to the full-fledged conception of monetary policy. The definitive demise of the gold standard then paved the way for monetary reconstruction. Monetary theory was a decisive factor in the design of the reform proposals, in the Bretton Woods negotiations, and in forging the new monetary order. The Bretton Woods system – successful but nevertheless short-lived – suffered from latent inconsistencies, both analytical and institutional, that fatally undermined the foundations of the postwar monetary architecture and brought about the epochal transition from commodity money to fiat money.

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PREFACE

Monetary theory has an obvious and recognized role in analyzing monetary systems; it has also been crucial in determining the evolution of those systems. The fulfillment of the issuing function by government, since the early days of coined money, required at least a rudimentary knowledge of the workings of a monetary economy: The state of the art has always influenced the essential features of the monetary mechanism.

The international monetary system introduced at the end of the Second World War is a prime instance of the impact of theory on the institutional framework. The Bretton Woods construction was designed at the drawing board and approved by a formal agreement, and as a consequence the theoretical paradigm was paramount in shaping the new international monetary order. Furthermore, the demise of the short-lived Bretton Woods experience did not just put an end to the postwar monetary reconstruction, but it brought about the generalized diffusion of fiat money, an epoch-making change after 2,500 years of commodity money. These points are closely interrelated, for in the aftermath of the First World War institutions were increasingly influenced by monetary theory, itself developing in response to disruptive shocks. The difficulties of restoring the gold standard stimulated a wide-ranging debate, fueled by the conspicuous imbalances in the major economies and the vicissitudes of the international monetary system. Britain's return to gold in 1925 was followed by most countries, but it proved

to be ephemeral. The properties underlying the success of the gold standard had, in fact, been damaged irremediably; the loss of credibility could not be offset by enhanced cooperation because of the altered approach to the monetary mechanism. Then, in the 1930s, the gold standard collapsed, prompting the quest for international monetary reform.

The many factors at work interacted with diverse intensity and timing. Theoretical views of the international monetary system were intertwined with institutional changes, and both were highly diversified. Economists and policymakers displayed a range of positions, while economic developments and changes in monetary arrangements followed different paths in different countries. In the interwar years, the dynamics of these forces were unevenly paced, throwing the international monetary system into disarray. A study of these contrasting elements is therefore essential to an understanding of the origins of the postwar monetary reconstruction, the design of the Bretton Woods architecture, and the latent weaknesses that caused its eventual downfall.

The international monetary order established at Bretton Woods can be viewed as the final stage in the transition from commodity money to fiat money, setting the monetary system on a new foundation. A watershed in monetary history, it was the outcome of a gradual process that spanned the half century after World War I and was propelled by several factors, including, decisively, the theory of money. This work thus focuses on the history of ideas rather than on the history of events, for which it mainly relies on the secondary literature. The theoretical perspective on this critical phase of monetary history has remained largely unexplored, an omission that limits our understanding of the evolution of the international monetary system. This book is an attempt to fill this gap.

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The views expressed in this book are the author's own and not necessarily those of the Bank of Italy.

Though everything that follows appears in its current form for the first time in this volume, I have published a number of articles on particular topics since the mid-1990s, and relevant material drawn from them has been incorporated herein, with kind permission of the copyright holders, who are herewith acknowledged: Duke University Press for the articles "On the Effectiveness of Changes in Money Supply: The Puzzle of Mill's View," *History of Political Economy* 28, Fall 1996, and "Keynes's Revindication of Classical Monetary Theory," *History of Political Economy* 35, Fall 2003; Springer Science and Business Media for the article "Currency Areas and Equilibrium," *Open Economies Review* 8, January 1997; Elsevier for the article "Hume's Specie-Flow Mechanism and Classical Monetary Theory: An Alternative Interpretation," *Journal of International Economics* 45, June 1998; Blackwell Publishing for the article "Expectations and Monetary Policy: A Historical Perspective," *Manchester School 66*, September 1998; Emerald Group Publishing for the articles "Providing for the Optimum Quantity of Money," *Journal of Economic Studies* 25, no. 6, 1998, "Competitive Money Supply: The International Monetary System in Perspective," *Journal of Economic Studies* 26, no. 3, 1999, and "Defining Fundamental Disequilibrium: Keynes's

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