The goal of every science is a conceptual model that shows how the pieces of its universe are related. An economist who seeks to become the Copernicus or the Einstein of the international financial system finds the task complicated because the arrangements have changed substantially in the last 100 years, and the pace of change has quickened since the early 1970s.

Relationships among the key components

Before the First World War the system was described as the ‘gold standard.’ Then a change in concept led to a change in name, and the term ‘gold exchange standard’ was applied to the monetary arrangements for the period between the First and Second World Wars – although the changes in the arrangements belied the term. From 1947 to 1971, the term ‘Bretton Woods system’ was applied to exchange market and reserve arrangements. Since 1971, these arrangements are so ad hoc and varied that the most descriptive term has been ‘post-Bretton Woods arrangements’ – which is no more than a statement about an extended interval. These changes in the key arrangements have been more than cosmetic, for the systemic relationships among the key components – the mechanisms for determining exchange rates and for supplying the money that central banks in different countries use in payments with other central banks – also have been revamped.

Changes in the system have usually been precipitated by a crisis over the relative values of different national currencies; the established arrangements for financing payments imbalances were about to break down. Thus the move to the gold exchange standard in the 1920s reflected an anticipated shortage of gold; the new arrangements were
intended to economize on the use of gold in payments – in effect, to reduce the demand for gold. The gold exchange standard failed in the Great Depression of the 1930s because changes in the foreign exchange values of different national currencies were too frequent: individual countries had concluded that maintaining parities for their currencies seemed too costly in terms of their domestic economic objectives. The Bretton Woods system collapsed in 1971 because it was unable to cope with the large payments imbalances partly generated by the US inflation associated with the Vietnam War. The pattern is one of crisis, breakdown, and innovation.

There has been no significant innovation at the global level since the collapse of the Bretton Woods arrangements. At the regional level, however, there has been a remarkable innovation as the member countries of the European Union (EU) – initially 11 of the 15 members – moved to adopt a common currency as a replacement for their national currencies.

The Copernicus of the international financial system must resolve two issues. First a model must be developed of the relationships among the major components of the arrangements: the foreign exchange market in which one national money is traded for other national monies, the monetary and fiscal policies of various countries and especially of the large industrial countries like the United States, Germany, and Japan, and the supply of international monies such as gold and US dollars and German marks. (Thus the US dollar and the German mark do ‘double duty’ as national and international monies.) Then the Copernicus must explain why these relationships change over time, and whether the changes in these relationships follow a pattern or are random. This chapter discusses the relationships among these components, while Chapter 3 reviews the changes in the arrangements over the last 100 years.

**Fitting the pieces: the foreign exchange market**

International transactions have one common element that makes them uniquely different from domestic transactions – one of the participants must deal in a foreign currency. When Americans buy new Mercedes and new Volkswagens, they usually pay US dollars to the dealers who in turn pay US dollars to the German producers; the German firms must then exchange the US dollars for German marks, so they will be able to pay their workers and their suppliers. If instead the German automobile firms want to be paid in German marks, the