The Evolving Global Financial System

Richard Vedder

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Seamstresses in Mexico sew clothes for the U.S. market.

During the late 19th and early 20th centuries, there was little coordination of international finances. That changed substantially after World War II, and the change is continuing today.

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The prosperity of the world has been immeasurably enhanced by the growth in international economic relations — trading in goods and services, and the migration of labor, capital, and ideas across the planet. The principle of comparative advantage suggests that the wealth of nations is enhanced by each country specializing in those economic activities for which it has low opportunity costs. Yet all this economic activity must be financed, and the stability of the world financial system is critical to the continued growth in world trade. This is complicated by the fact that most nations have their own currency, and that the rules and regulations governing financial transactions vary widely between countries.

During the late 19th and early 20th centuries, there was little coordination of international finances. The world's financial capital was London, and most major trading nations were on the gold standard, meaning financial obligations were settled in currencies redeemable in gold. If a nation used its currencies excessively to buy imports or invest overseas, it lost gold reserves, forcing it to restrict money supply and credit, usually causing deflation. This made the country's exports more attractive and imports less desirable, thereby correcting the balance-of-payment imbalance problem. Many scholars believe the system worked reasonably well between 1871 and 1914.

World War I involved vastly larger international capital flows than ever before, as European nations such as Britain and Germany went deeply in debt, borrowing heavily from other nations, especially the United States. The Versailles Treaty (1919) provided for punitive reparation charges against Germany, which then engaged in hyperinflationary policies that severely damaged that nation economically. An attempt to restore the gold standard in the 1920s was short-lived: Britain left the full gold standard permanently in 1931, as did the United States two years later.

The Great Depression of the 1930s resulted partially from sharply declining international trade caused, in part, by high tariffs. Beginning in 1934, however, nations started to reduce ruinous trade barriers, led by the Reciprocal Trade Agreements Act in the United States. However, return to normalcy in international finance was shattered by the outbreak of World War II in 1939, the most costly war ever fought, which disrupted world trade and led to international cooperative arrangements to facilitate economic stability and growth.

New International Institutions

A large number of major developments between 1944 and 1960 profoundly altered the nature of the international financial system. Concerned about huge deficiencies of hard currencies to pay for goods, services, and the reconstruction of war-torn economies, Britain's John Maynard Keynes and the United States' Harry Dexter White successfully proposed a new international financial order at the Bretton Woods Conference in 1944. The International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank) were created.

The IMF would help nations with balance-of-payments problems and with difficulties maintaining reserves consistent with agreed upon fixed exchange rates defined in terms of gold. While the fixed-rate system broke down after 1971, the IMF continues with expanded responsibilities. For example, it has played a key role in averting or reducing national and regional financial crises, serving as a lender of last resort to nations in fiscal stress. The World Bank originally provided loans to war-torn countries to finance reconstruction, although by the 1950s the bank had moved to broader lending to finance new development projects. Although both the IMF and World Bank are headquartered in Washington, D.C. (given America's prominence as a global financial power), these organizations are truly international in orientation and control.

The most important international organization, the United Nations, began in San Francisco in 1945. While not focusing primarily on economic and financial issues,

The European Central Bank in Frankfort, Germany.

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Workers walk near a container ship in Tianjin Port, China, March 2009.

those issues have been important to U.N. agencies such as UNCTAD (U.N. Conference on Trade and Development) and UNESCO (U.N. Economic, Social, and Cultural Organization). The principle of international assistance to meet financial strains received a prominent boost with the Economic Recovery Program (Marshall Plan) of the United States (1948-1952), which provided aid to many European nations. The Marshall Plan promoted international cooperation among the recipients of its more than $12 billion in economic assistance in the form of loans. The Cold War after 1945 led to new forms of political and economic regional cooperation as a by-product of the creation of two military alliances, NATO (North Atlantic Treaty Organization) and the Warsaw Pact of nations allied with the Soviet Union.

More direct forms of financial cooperation began, leading to the creation of a system of international financial arrangements. In 1947, the General Agreement on Tariffs and Trade (GATT) began, which provided a framework for a series of negotiations (such as the Kennedy Round and the Uruguay Round) that over the next half century led to dramatic reductions in barriers to international trade, especially in goods and services.

World Economic and Financial Integration

The financial stress of World War II contributed to the hastening of an abrupt decline in colonialism, as literally dozens of new nations emerged. Most dramatic, perhaps, was India's independence in 1947, but large parts of Asia and Africa also became independent nations in the next two decades. This greatly accelerated the need for international financial organizations such as the IMF and World Bank. Each new nation typically had to establish a currency that would gain widespread international acceptance, needed to borrow considerable sums of money from foreign nations despite uncertain abilities to repay loans, and often had to learn to live within the rule of law and the discipline imposed by market conditions. Organizations such as the IMF and the World Bank became increasingly important in facilitating these factors.

The move toward world economic/financial integration was advanced by important new institutions, especially in Europe. A European Payments Union was developed in 1950 to facilitate ways of dealing with the dollar shortage that made international payments difficult. The Organization for Economic Cooperation and Development (OECD) began to collect uniform economic information on major industrial countries, ultimately including nations in Asia and Latin America as well as Europe and North America. Most important was the Treaty of Rome, signed in 1957, creating the European Economic Community (Common Market), which has grown from a six-nation customs union in 1958 to a 27-nation group that has integrated much of its economic structure into today's European Union, including a common currency covering over half the area (the euro) and an EU central bank.

The European effort has been duplicated elsewhere on a much smaller scale, with Asian, African, and Latin American nations moving to integrate their economies more regionally. The Asian Development Bank, for example, is an institution of about 40 nations designed to further the creation and free flow of capital in one important region of the world (making over $10 billion in loans in 2008), while the North American Free Trade Agreement (NAFTA) of 1994 extended the customs union approach to the Americas.

Four further extensions of the world financial system are important. In 1995, the World Trade Organization (WTO) replaced the GATT, and it was given wide authority to

Foreign currency notes are displayed in a commercial area of Karachi, Pakistan, October 2008.

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enforce international standards relating to trade and cross-border financial dealings. The Group of Seven (G-7) was originally a meeting of the finance ministers of seven leading industrial nations, but it has expanded numerically, now encompassing 20 nations (the G-20) that meet regularly to agree on policies governing international economic and financial arrangements. Other, nongovernmental sponsored conferences, especially in Davos, Switzerland, bring together corporate and financial leaders, often sowing seeds for later policy reforms. Finally, a number of multilateral tax treaties have tried to standardize to some extent tax treatment for those engaged in international activities; recently, small tax-haven nations have agreed to modify bank secrecy provisions to deal with tax evasion.

Coordination Is Key

The evolving global financial system has been both a cause and a consequence of the rapid growth in globalization. For most nations, international trade comprises a larger portion of output than a generation or two ago. International capital flows have grown extraordinarily.

Beyond that, institutions such as the IMF and World Bank have been critical both in terms of financing long-term development needs and stabilizing shaky financial systems. Two noteworthy examples are the financial crises of 1998 beginning in Asia but ultimately spreading beyond, especially to Russia, and the 2008 worldwide crisis that has caused significant stress to financial institutions and economies worldwide. In both instances, the IMF and World Bank made important financial infusions in stressed countries such as Thailand and Russia. The development arm of the World Bank makes “soft” loans of around $10 billion annually, for example. Additionally, large-nation central bankers and finance ministers have met and coordinated the provision of credit to ease panic and the potential collapse of major banks, insurance companies, and other financial institutions.

As international economic and financial interaction grows, the need for coordinated rules of behavior becomes greater than ever — uniform accounting rules, international standards of permissible conduct, provision for emergency loans, and the like. No doubt existing institutions will continue to evolve, perhaps into a new umbrella organization encompassing all facets of financial regulation. ■

The opinions expressed in this article do not necessarily reflect the views or policies of the U.S. government.