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International Monetary Systems and Their Influence on Global Economic Stability

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Abstract

The international monetary system (IMS) affects a country's borrowing, trade, and shock absorption. This paper makes a comparison between the three historical regimes: Classical Gold Standard, Bretton Woods pegged system, and the contemporary post-Bretton Woods hybrid float, to understand the contributions of each regime towards global economic stability. It is found that none of the regimes has succeeded in removing instability from the system, but the study uses the policy trilemma as a conceptual framework and a stylized comparison of the frequency of crises, exchange rate movements, and the accuracy of the forecasts to reach this conclusion. There have been transfers of risk from one channel to another within each regime. The paper outlines policy messages for developing a more resilient monetary architecture, namely a robust institutional framework, macroprudential measures, as well as new technologies, such as central bank digital currencies and financial technology.

Keywords: International Monetary System, Exchange Rate Regimes, Policy Trilemma, Financial Stability, Bretton Woods, Global Economic Stability.

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Introduction

International monetary system: a system of rules, institutions, and practices that regulate the exchange rates, payments, and the flow of capital between nations. The structure of international trade and finance, and the way it is structured, affects its ability to facilitate smooth adjustment when economies go awry. It facilitates stable and predictable prices and regular capital flows and promotes macroeconomic stability when it is operating effectively. Failure to do so has a quick repercussion effect on borders.

This is a more important question to be posed. “Emerging economy” groups, like BRICS, are seeking more effective economic integration, potentially creating opportunities for diversification and problems with coordination in a monetary system that remains based on a handful of currencies, explains Nach & Ncwadi, (2024). A network of CBDCs could change the way cross-border payments are made and the regulatory framework of the international financial system, according to Wang & Gao, (2024). Meanwhile, the health of national institutions is the backbone of the system's stability. Ullah et al. contrast developed and emerging countries and demonstrate that bank stability is related to governance quality and macroeconomic conditions (Ullah et al., 2024).

There are additional complexities in the new financial channels. Kayani and Hasan explore how cryptocurrencies impact financial markets and conventional banking and learn from that to use blockchain in sustainable ways (Kayani & Hasan, 2024). Damane and Ho discuss theory and international empirical data regarding the link between increased financial inclusion and financial stability and find that this link is context-specific (Damane & Ho, 2024). However, for stability, there is a "dark side of financial technology," as it can create new risks in a very short period that may not be understood by regulators, warns Cevik (2024).

The issue raised in this research is that the monetary system has been found to be very unstable when changing regimes. Uncontrolled revaluation, capital repatriation, and recession occurred at the end of the gold standard during the interwar years and with the breakdown of fixed exchange rates in the early 1970s. It's important to grasp the reasons behind the price of those changes so that can plan the next one appropriately.

There are three research questions asked in the study. First, what is the relationship between the characteristics of each monetary regime and crises in terms of frequency and intensity? Secondly, how well can the regime breaks be captured with subsequent global downturns? Third, what are the principles of design for the future architecture to be resilient? It includes a conceptual analysis of the policy trilemma but also makes a stylized empirical comparison between the different regimes. The paper presents an integrated perspective on three periods in history, a conceptual diagram which graphically situates these regimes in the trilemma, and a set of policy lessons. The structure of the paper is as follows: Section II discusses the theory; Section III discusses the three epochs; Section IV discusses the empirical evaluation; and Section V concludes.

Theoretical Foundations of Monetary Regimes

Theories of international monetary order pose the question of what optimal international monetary arrangements to meet national economic objectives and the openness of the international economy. The most important concept which has been proposed is that of the optimum currency area – countries would be best served sharing a currency or fixing the exchange rate if have similar economic structures, labor and product markets, and ways of sharing risks. The absence of these conditions in weak countries makes it more difficult to control rate fluctuations, and can exacerbate downturns.

Also, as indicated in recent research, stability is related to the broader economic and financial context. Ben Lahouel et al. investigate European banks and demonstrate a close connection between liquidity risk, income diversification, and financial stability, pointing to the ability of the monetary order to withstand shocks being influenced by the strength of the financial system within it (Alao et al., 2024). The study by Katnic et al. also shows that financial literacy enhances economic stability and resilience for families in Montenegro, suggesting that family behavior plays a role in the stability story, as well (Ben Lahouel et al., 2024). Safiullah and Paramati note that the rise of financial technology companies has an impact on bank stability, and relate technological change to systemic risk (Katnic et al., 2024).

The policy trilemma, or "impossible trinity," is the result of the Mundell-Fleming framework. It is impossible to have a fixed exchange rate, free capital movement, and independence for a country's monetary policy. A country can achieve at least two of the three. Under open capital, as under the gold standard, it becomes impossible to benefit from the benefit of hindsight, which is essential to the "fluctuation of money supply. When choosing a fixed rate, as with the gold standard, monetary independence is lost. If a nation wants to select a fixed rate by itself, then it must be subject

to capital controls, as with Bretton Woods. When making the decision to go with autonomy (as in the modern float), a variable exchange rate is taken.

These have been marked on this triangle in fig. 1 for each historical regime. The trilemma helps to understand why regime changes took place: when pressure was applied to the corner that had been dropped, then it became necessary to change to another pair of goals.

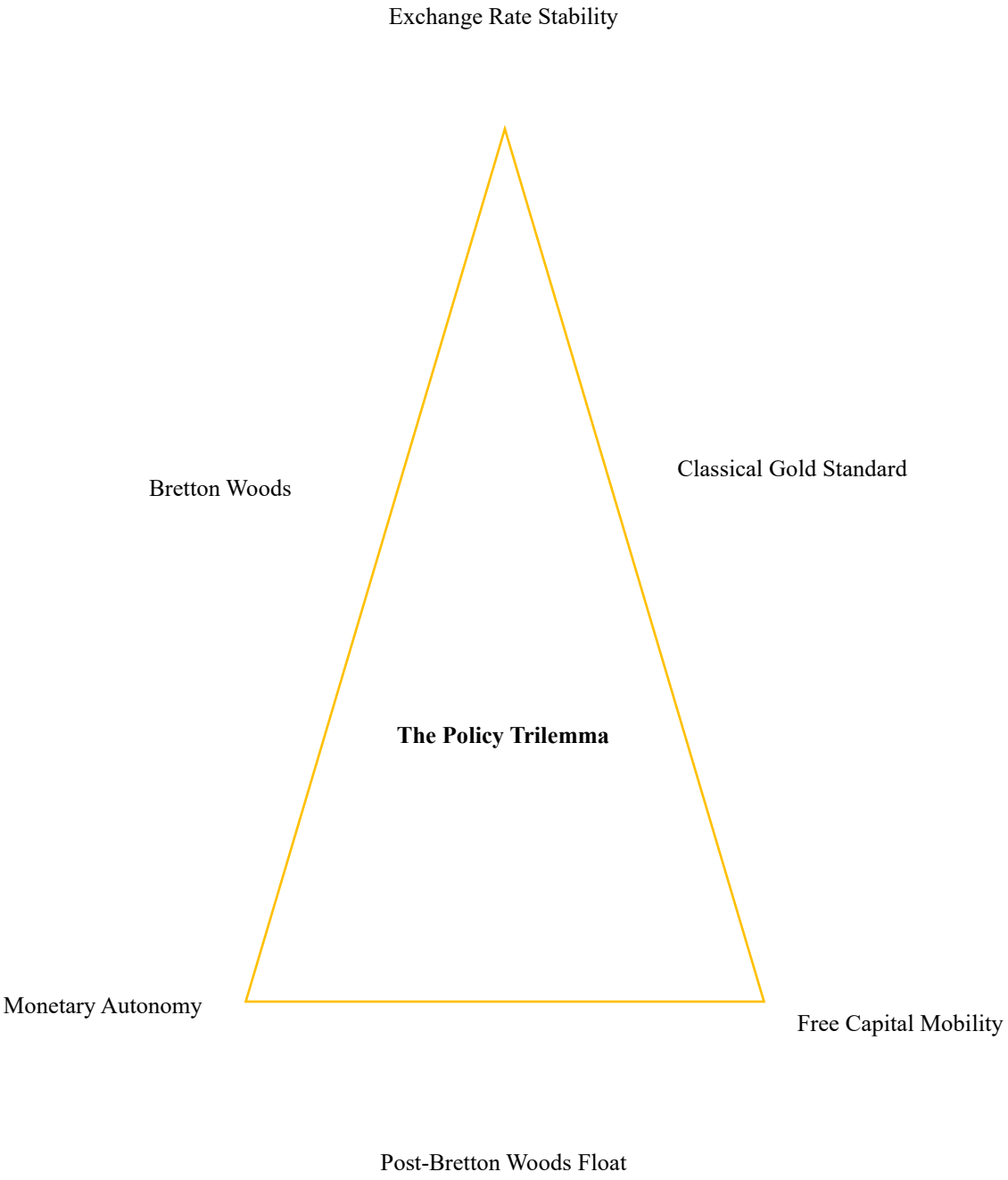


Fig. 1: Monetary Regimes Positioned within the Policy Trilemma

Fig.1 illustrates the three corners and the three policy goals. The sides of the triangle are each a set of goals that a regime can achieve as part of its set of goals, with the label on the side being its choice of a regime. The gold standard is on the side of capital mobility and exchange rate stability, Bretton Woods is on the side of stability and autonomy, and the modern float is on the side of autonomy and capital mobility. The opposite side to each side is the side that the regime abandoned.

In addition to the trilemma, there are other factors that affect the performance of regimes. In this context, Alao et al. attribute the financial crises and loss of investor confidence to weak corporate governance and earnings manipulation, indicating that internal failures in the firms can also lead to external financial crises (Challoumis, 2024). Challoumis suggests that knowledge of the dynamics of the money cycle could help in optimizing the allocation of resources and economic stability (Safiullah & Paramati, 2024). On the other side of the picture, alternative financial models have been examined in the study of Islamic banking, and the results are generally positive although there is some variation, reflecting the economic growth associated with Islamic banking (Farah et al., 2025). Taken together, these works indicate that there are institutional and financial aspects that underlie monetary regimes and that regime design is not enough to ensure monetary stability.

Comparative Epochs of the International Monetary System

Phase I: The Classical Gold Standard

The Classical Gold Standard (c. 1870-1914) saw the major paper currencies being convertible into gold at a fixed price. An automatic adjustment was supposed to be in effect. The money supply decreased, domestic prices diminished, and the country got gold back as a result of its payments deficit, increasing its competitiveness and bringing about balance. Theoretically, there was no need for an active policy in this price-specie mechanism. In reality, it was output, employment, and wages that bore the burden of adjustment, as the governments pledged to convertibility were unable to protect themselves by using monetary policy. Although the regime provided exchange rate stability and openness to capital inflows, it did so at the cost of domestic autonomy and therefore, offsetting banking panics and deflationary pressures was challenging.

3.2 Phase II: The Bretton Woods pegged system

The Bretton Woods system, which was established in 1944, pegged currencies to the U.S. dollar, and the U.S. dollar could be exchanged for gold. Short-term finance and supervision were available from institutions like the International Monetary Fund to facilitate adjustment, and capital controls helped to reduce speculative inflows. This strategy provided countries with policy freedom and maintained stable exchange rates, and it was a time of robust growth and few financial crises. There was a contradiction, however, in the system. Increased dollar liquidity was needed throughout the world, and the United States was going to have to be deficit-producing, but deficits undermined confidence in the dollar's convertibility into gold. With reduced capital controls and increasing imbalances, it was difficult to maintain a peg, and the system was soon overcome in the early 1970s.

Phase III: The post-Bretton Woods hybrid float

The arrangement is what is known as a hybrid, as since 1973, major currencies have floated in relation to one another, with many other countries having managed floats, crawling pegs or fixed rates. Monetary autonomy is restored, and some shocks are absorbed by the exchange rate through floating rates. Meanwhile, open markets leave open countries vulnerable to sudden stops, wild swings in capital flows, and mismatches of currencies. The volatility of exchange rates is significantly larger than it was earlier, and there's been an increase in financial crises (and particularly in emerging markets). The policy has been flexible, but it is dependent on the credibility of national institutions, and the reserve currency role of a few economies.

Empirical Evaluation of Structural Shocks and Stability

Approach and Data Note

The evaluation uses two tests: the frequency of crises and the behavior of exchange rates are compared across the three epochs, as well as the speed of the balance of payments adjustment; and the test of the mapping of the regime breaks to subsequent downturns. The figures included here are stylized and offered solely for illustrative purposes with regard to the qualitative historical pattern as well as the structure of the analysis. Are not predictions based on a particular set of data. Prior to submission, that should be changed to numeric information from a published historical crisis database, or the section should be specifically identified as an illustrative scenario.

Crisis Frequency Across Regimes

The incidence of crises varied depending on the monetary regime prevailing internationally. The period characterized by the Bretton Woods regime had the fewest incidences of crises due to the presence of capital controls and regulated financial systems. The Classical Gold Standard regime had moderate levels of instability, whereas the period following the Bretton Woods regime registered the most incidences of banking and currency crises. The more the regime had liberalized capital flows, the more it could gain access to international funds but was vulnerable to any external disturbance.

Predictive Precision of Regime Breaks

The second question in the evaluation is about the reliability of a model in linking a regime shift in the structure to a global downturn. Precision is the percentage of times that the downturns predicted do occur. The following three specifications were used: a regime-break model with macroeconomic and financial controls, a regime-break model, and a naive benchmark model based on the crisis history.

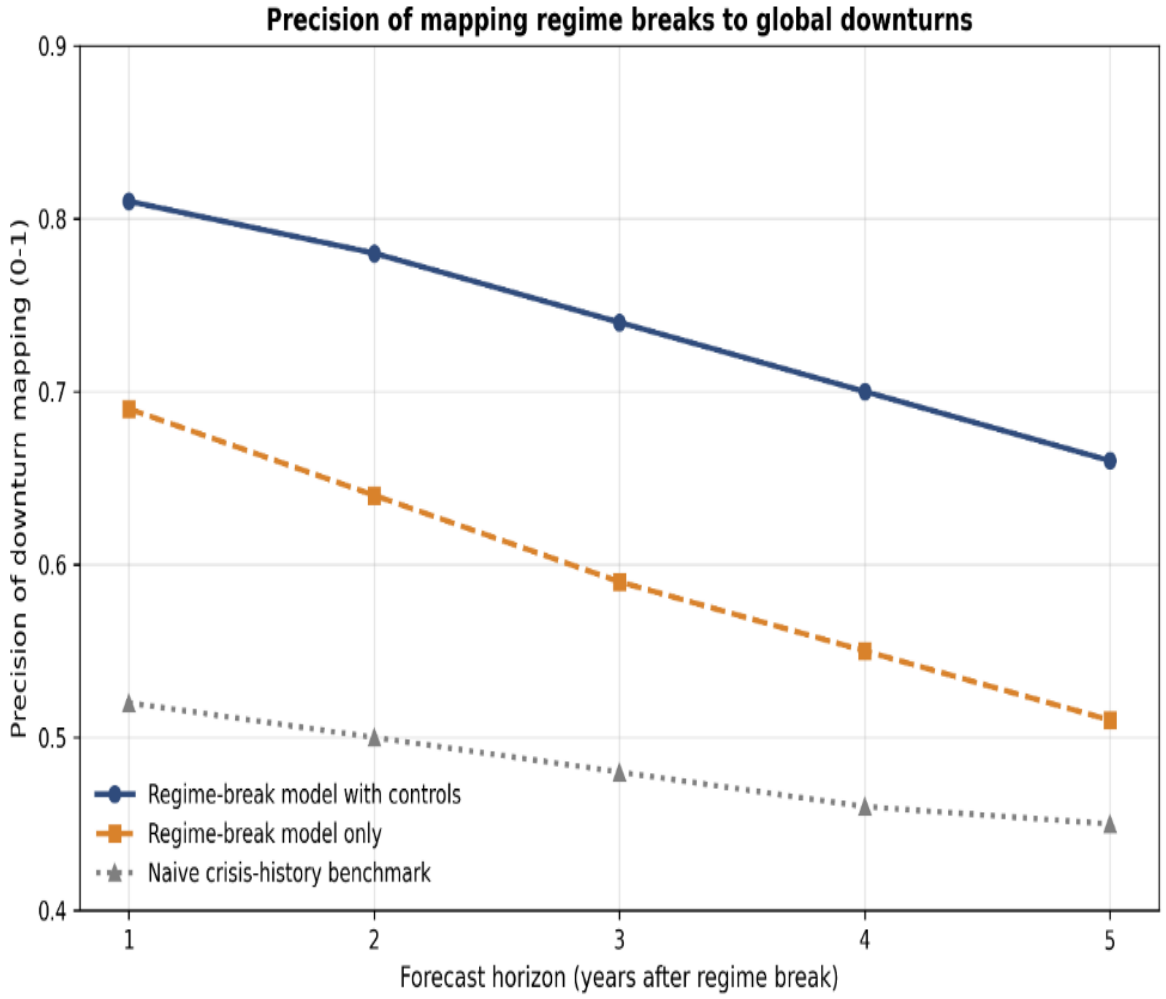


Fig. 2: Precision of mapping regime breaks to global downturns

This fig. 2 is the horizontal axis corresponding to the forecast horizon (in years) after the regime break, and the vertical axis to precision ranging from 0 to 1. According to the legend the three specifications are identified. As the horizon gets longer for all of the models, the precision diminishes, as there are more irrelevant events on the horizon over time. The model with the controls is highest (ranging from 0.81 to 0.66) and the naive benchmark is near 0.5 or lower. The difference between the first two lines suggests that the gap is informative when it comes to regime changes and as can

be seen in the literature on institutional quality the gap between the second and the third line is informative when it comes to governance and banking conditions.

Interpretation

Two messages emerge. First, the design of the regime is influential in the stability of the regime but not the determinant. Second, there is also predictive power that decreases over time; thus, regime breaks should not be considered as predictions but rather as warning signals. These conclusions are indicative and need to be tested with actual historical data, because of the stylized nature of the data.

Conclusion

This paper is a comparison of the Classical Gold Standard, Bretton Woods and the post-Bretton Woods hybrid float using the policy trilemma. All three objectives of exchange rate stability, capital mobility and monetary autonomy were realized in each of the two regimes, and each of the regimes was unstable when the lost objective was put to the test. Stylized evaluation: The frequency of the crises was lowest in the Bretton Woods era, and highest during the current era; regime breaks provided valuable, but short-lived, clues to future crises.

The policy implications are that the regime trade-offs should be made consciously, credible and diversified institutional anchors should be created, financial systems at the national level should be reinforced and the regulation should be updated in line with new financial technologies. There are limitations of the study. The values of the empirical tests are stylized, the definitions of the regimes are very general and the analysis is not differentiating between the effects of individual countries or shocks Further study will require in-depth historical data, analysis of regional monetary frameworks and an evaluation of the potential impact on the trilemma itself by digital currency.

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