

Understanding the Evolution of Macroeconomic Thinking since 1717:

An International Monetary System Perspective*

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Abstract:

This paper proposes a way to understand the evolution of macroeconomic thinking. The macroeconomic thinking, not necessarily synonymous with macroeconomics, has been dealing with the questions of money and business cycles. Money and business cycles, in turn, have been closely connected with the international monetary arrangements such as the Gold Standard, the Bimetallic Standard, the Bretton Woods system, and the Flexible Exchange Rate. I shall argue that the evolution of macroeconomic thinking is best understood as the responses of economists to, and their interaction with, the changing monetary and exchange rate regimes. The theoretical foundation of the paper is rather simple: the so-called trilemma, or “irreconcilable or impossible trinity.” A policymaker cannot simultaneously choose a fixed exchange rate, free mobility of capital, and domestic price stability via independent monetary policy. Facing this constraint, the policymaker can, at most, choose two from among these three goals. Therefore, further questions emerge: which goal or goals should be given priority from among these three, and what is the exact tool or mechanism that can ensure the achievement of preset policy goals. The answer to the first question determines the nature of international monetary arrangements, which, in turn, are shaped by political and economic factors. With respect to the second issue, institutions, or what we might call the institutional or social governance technology, play a crucial role. Throughout history, concerns over “unrestrained inflation” have been widespread, since there have always been strong incentives for a government to raise seigniorage by over-issuing money. The choice of international monetary arrangements depends on the availability, credibility, and effectiveness of a specific social governance technology that acts as a constraint upon policymakers, which, in turn, depend on the specific political and economic structure.

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