The International Monetary System
The Exchange Rate System

The international monetary system can be defined as the institutional framework within which international payments are made, movements of capital are accommodated, and exchange rates among currencies are determined.

The international monetary system has been through several distinct stages of evolution:
(1) Bimetallism: Prior to 1875
(2) Classical Gold Standard: 1875-1914 (World War I)
(3) Interwar Period: 1915-1944 (World War II)
(4) Bretton Woods System: 1944-1971
(5) Flexible/Floating Exchange Rate System: Since 1971
(6) Managed Float System: Since 1973 (Jamaica Agreement)

Bimetallism: Prior to 1875
A double standard of coinage in both gold and silver that was used as international means of payment with exchange rates among currencies determined by either their gold or silver content of their coins. Official gold/silver price ratio was 15.5. Bimetallism was used in Britain till 1816, in U.S. till 1873, and in France till 1878. China, India, Germany, and The Netherlands were on the silver standard.

Classical Gold Standard: 1875-1914
Columbus once said, “Gold constitutes treasure, and he who possesses it has all he needs in this world.” Mankind’s fondness for gold as storage of wealth and means of exchange dates back to antiquity and was shared by diverse civilizations. During the classical gold standard system, most major countries agreed that, (1) gold alone would be assured of unrestricted coinage, (2) there would be two-way convertibility between gold and national currencies at a stable ratio, and (3) gold would be freely exported and imported. This implied that domestic money stock should rise and fall as gold flows in and out of the country, i.e., international imbalances of payment (overall balance of BOP) will be corrected automatically --price-specie-flow mechanism. Shortcomings: (1) natural scarcity of gold, (2) cyclicality, and (3) abiding by the rules of the game.

Interwar Period; 1915-1944
- WWI ended the classical gold standard as major countries suspended redemption of banknotes in gold and imposed embargoes on gold exports.
- The U.S., which replaced Britain as the dominant financial power, spearheaded efforts to restore the gold standard.
- The gold standard of the late 1920s was a façade as major countries gave priority to stabilization (short-term economic policies) of domestic economies by matching inflows and outflows of gold respectively with reductions and increases in domestic money and credit.
- No coherent international monetary system prevailed with detrimental effects on international trade and investment.
Bretton Woods System (the par value system): 1944-1971

- Representatives of 44 nations signed the Articles of Agreement of the International Monetary Fund (IMF --with European Managing Director), which constitutes the core of the Bretton Woods System.

- Each member country established a par value for its currency in relation to the U.S. dollar, which in turn was pegged (convertible) to gold at $35/oz.

- Each country was responsible for maintaining its exchange rate --via Central Bank intervention-- within +/- 1% of the adopted par value. However, a member country with a fundamental disequilibrium may be allowed to change its par value.

- The U.S. dollar was the only reserve currency that was fully convertible to gold.

- To satisfy the growing need for international reserves, the U.S. ran BOP deficits continuously in the 50s and 60s (Vietnam War) --causing the eventual downfall of the Bretton Woods System in 1971.

- In an attempt to save the system, G-10 countries met at the Smithsonian Institution in December 1971 and reached an agreement to (1) increase the price of gold to $38/oz, (2) revalue their currencies by 10% against the dollar, and (3) increase the par value band to +/- 2.25%. Only official dollar was convertible to gold. De Gaulle and Banque de France.

- The price of gold was raised further to $42/oz in 1973 and later convertibility to gold was abandoned.

Flexible/Floating Exchange Rate System: Since 1971

- A system based purely on supply and demand for a currency in the foreign exchange market. Initiated by European countries that lost faith in the dollar.

Managed Float System: Since 1973 (Jamaica Agreement)

- Flexible exchange rates were declared acceptable to the IMF members, and central banks were allowed to intervene in the foreign exchange market to iron out unwarranted volatilities (rate smoothing vs. rate fixing)

- Impact on the level of international reserves and domestic money supply

- Gold was officially abandoned (demonetized) as an international reserve asset.

Dollarization
Countries like Ecuador, El Salvador, and Panama use the U.S. dollar as their sole legal tender and are therefore dependent on net dollar flows to facilitate economic growth.

Currency Board
A monetary regime based on an explicit legislative commitment to exchange domestic currency for a specified foreign currency at a fixed exchange rate, combined with restrictions on the issuing authority to ensure the fulfillment of its legal obligation, e.g., the Hong Kong dollar.

Pegged Exchange Rates and Crawling Pegs
The “euro”

Dr. Julian Gaspar