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Chapter Two

The International Monetary System

Overview

Evolution of the International Monetary System.

Bimetallism: Before 1875.

Classical Gold Standard: 1875 to 1914.

Interwar Period: 1915 to 1944.

Bretton Woods System: 1945 to 1972.

Flexible Exchange Rate Regime: 1973 to Present.

Current Exchange Rate Arrangements.

Cryptocurrencies.

Euro and European Monetary Union.

Mexican Peso Crisis.

Asian Currency Crisis.

Argentine Peso Crisis.

Rise of Chinese RMB.

Fixed versus Flexible Exchange Rate Regimes.

International Monetary System

International monetary system is a complex set of agreements, rules, and mechanisms regarding exchange rates, international payments, and capital flow.

It is the institutional framework within which international payments are made, movements of capital are accommodated, and exchange rates among currencies are determined.

Evolution of the International Monetary System

International monetary system went through several distinct stages of evolution, summarized as follows:

- Bimetallism: Before 1875.
- Classical gold standard: 1875 to 1914.
- Interwar period: 1915 to 1944.
- Bretton Woods system: 1945 to 1972.
- Flexible exchange rate regime: Since 1973.

Bimetallism: Before 1875

Bimetallism was a “double standard” in that free coinage was maintained for both gold and silver.

- Exchange rates among currencies were determined by their gold or silver contents.

Countries on the bimetallic standard often experienced the well-known phenomenon referred to as Gresham’s law:

- **Gresham’s law:** Since the exchange ratio between the two metals was officially fixed, the abundant metal was used as money while the scarce metal was driven out of circulation.

Classical Gold Standard: 1875 to 1914

An international gold standard exists when:

- Gold alone is assured of unrestricted coinage.
- There is two–way convertibility between gold and national currencies at a stable ratio.
- Gold can be freely exported or imported.

Under the gold standard, the exchange rate between any two currencies will be determined by the gold contents.

London became the center of the international financial system during the classical gold standard era.

Classical Gold Standard: An Example

Suppose the pound (£) is pegged to gold at six pounds (£6) per ounce, whereas one ounce of gold is worth 12 francs (₣).

- £6 = 1 oz. gold.
- ₣12 = 1 oz. gold.

Deducing from the information above, £6 must equal ₣12.

- £6 = ₣12; therefore £1 = ₣2.

Exchange rate between the pound and the franc should then be two francs per pound.

Classical Gold Standard: Advantages

- Highly stable exchange rates that are conducive for international trade.
- Money supply cannot get out of control and cause inflation because gold is naturally scarce.
- No country can have a persistent trade deficit or surplus because countries' balance of payments will be regulated automatically via the movements of gold.

Classical Gold Standard: Shortcomings

- Lack of sufficient monetary reserves due to the restricted supply of newly minted gold can hamper the growth of world trade and investment.
- No mechanism to compel each major country to abide by the rules of the game.

Interwar Period: 1915 to 1944

World War I ended the classical gold standard in August 19
14.

Attempts were made to restore the gold standard, but they ultimately failed.

Period marked by the Great Depression and other economic and political instabilities.

No coherent international monetary system during this period, with detrimental impact on international trade and investment.

Bretton Woods System: 1945 to 1972 [1]

Named for the July 1944 meeting of 44 nations at Bretton Woods, New Hampshire.

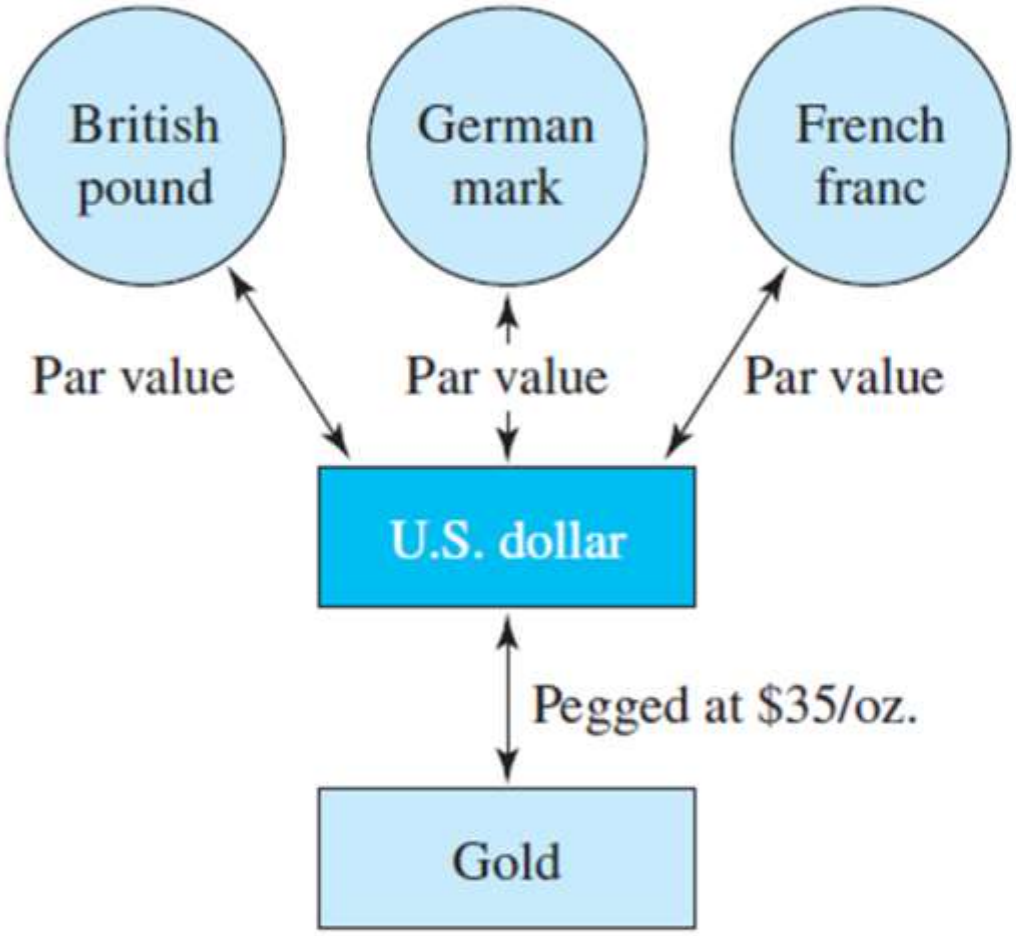
The purpose:

- To design a postwar international monetary system that would provide exchange rate stability without the gold standard.

The result:

- Dollar–based gold exchange standard: U.S. dollar was pegged to gold and other currencies were pegged to the U.S. dollar. U.S. dollar was the only currency fully convertible to gold.
- Dominance of U.S. dollar as the global currency.
- Creation of the IMF and the World Bank.

The Design of the Gold–Exchange System



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Bretton Woods System: 1945 to 1972 2

Advantages:

- Economizes on gold.
- Countries can earn interest on FX holdings.
- Lower transaction costs without the transportation of gold.
- Stable exchange rates.

Shortcomings (that is, **Triffin paradox**) that lead to the collapse of the system in the early 1970s:

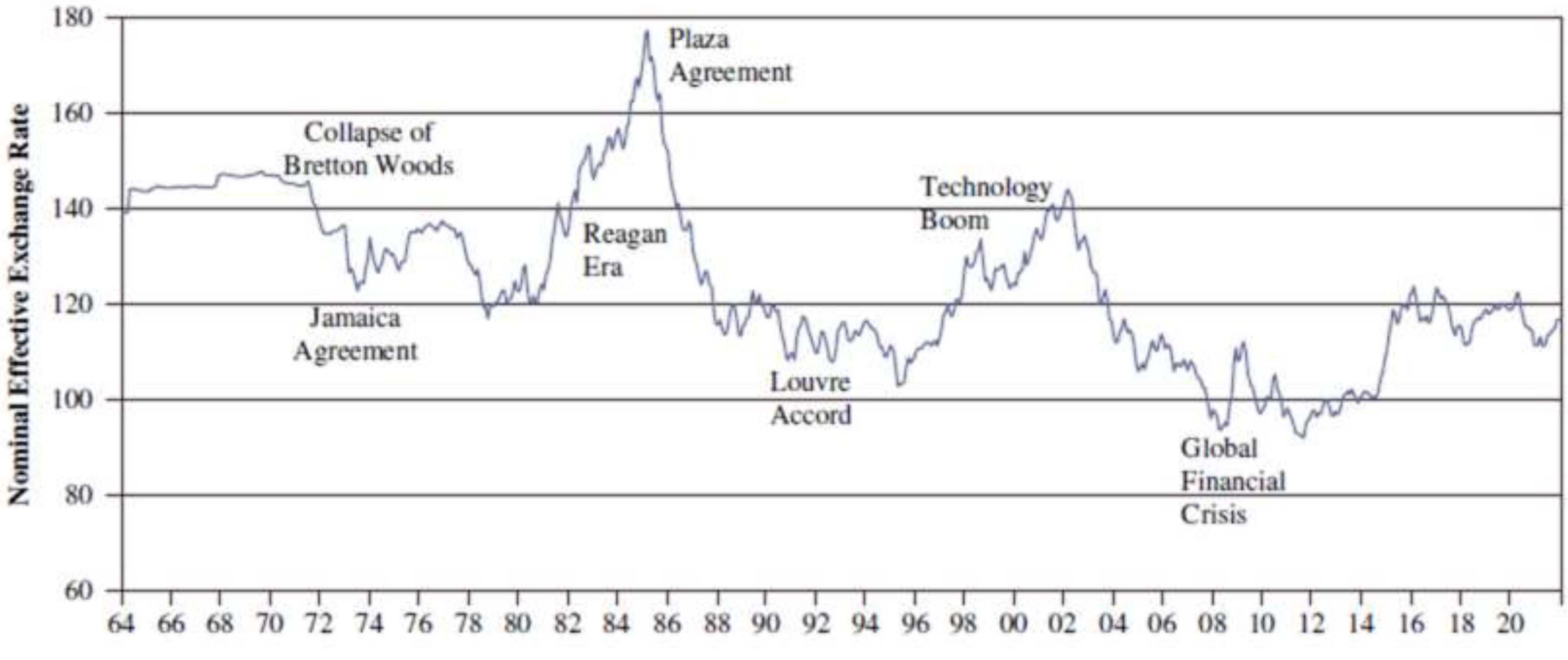
- The reserve currency country has to run a balance of payments deficit to satisfy the growing need for reserves from the rest of the world.
- It can decrease confidence in the reserve currency and lead to the downfall of the system.

The Flexible Exchange Rate Regime: 1973 to Present

Flexible exchange rate regime was ratified in January 1976 when the IMF members met in Jamaica and agreed to a new set of rules, referred to as the **Jamaica Agreement:**

1. Flexible exchange rates were declared acceptable to the I MF members; Central banks could intervene in exchange markets to iron out unwarranted volatilities.
2. Gold was officially abandoned (that is, demonetized) as an international reserve asset.
3. Non–oil–exporting countries and less–developed countries were given greater access to IMF funds.

The Trade–Weighted Value of the U.S. Dollar since 1964



The value of the U.S. dollar represents the nominal exchange rate index (2010 = 100) with weights derived from trade among 27 industrialized countries.

Source: Bank for International Settlements.

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Current Exchange Rate Arrangements 1

No separate legal tender:

- Currency of another country circulates as the sole legal tender (for example, Ecuador, El Salvador, and Panama).

Currency board:

- An extreme form of the fixed exchange rate regime under which local currency is fully backed by a foreign currency at a fixed exchange rate leaving little room for discretionary monetary policy (for example, Hong Kong, Bulgaria, and Brunei).

Conventional peg:

- Country formally pegs its currency at a fixed rate to another currency or basket of currencies (for example, Jordan, Saudi Arabia, and Nepal).

Stabilized arrangement:

- Entails a spot market exchange rate that remains within a margin of 2% for 6 months or more (for example, Vietnam, Nigeria, and Lebanon).

Current Exchange Rate Arrangements 2

Crawling peg:

- The currency is adjusted in small amounts at a fixed rate or in response to changes in selected indicators (for example, Honduras and Nicaragua).

Crawl–like arrangement:

- Exchange rate must remain within a narrow margin of 2% relative to a statistically identified trend for 6 months or more, and the exchange rate cannot be considered floating (for example, Singapore, Romania, and Tunisia).

Pegged exchange rate with horizontal bands:

- Value of the currency is maintained within certain margins of fluctuation of at least +/− 1% around a fixed central rate, or the margin between the maximum and minimum value of the exchange rate exceeds 2%.

Current Exchange Rate Arrangements 3

Other managed arrangement:

- Residual category used when the exchange rate arrangement does not meet the criteria for any of the other categories (for example, China, Argentina, and Kuwait).

Floating:

- Exchange rate is largely market determined, without an ascertainable or predictable path for the rate (for example, Brazil, Korea, Turkey, India, South Africa, and Thailand).

Free floating:

- Intervention occurs only exceptionally and aims to address disorderly market conditions; intervention has been limited to at most 3 instances in the previous 6 months, each lasting no more than 3 business days (for example, Australia, Canada, Mexico, Japan, U.K., U.S., and euro zone).

Cryptocurrencies [1]

Fiat currencies are put into circulation by governments and have no intrinsic values backed by claims on underlying real assets like gold, etc.

Cryptocurrency is a digital currency designed to function as a “medium of exchange” through a decentralized network of computers that keep public records of transaction data using mostly cryptographic technology, without the involvement of governments or central banks.

Central Bank Digital Currency (CBDC) is essentially a digital version of the fiat currency issued by the central bank. The majority of central banks are actively researching the potential for CBDCs, but they have not yet been formally adopted anywhere.

Cryptocurrencies 2

The first and most important cryptocurrency, Bitcoin, was introduced as an open–source software in January 2009, followed by many others like Ethereum and Litecoin, etc.

Given the extreme volatility of its price, Bitcoin was found to be unsuitable to serve the functions of money:

- unit of accounting.
- medium of exchange.
- storage of value.

Instead, Bitcoin has been used as a highly speculative asset class.

Despite its extreme volatility, El Salvador selected Bitcoin as legal tender in September 2021 and Central African Republic in April 2022.

European Monetary System

The European Monetary System (EMS) was formally launched in 1979 with the following goals:

- To establish a “zone of monetary stability” in Europe.
- To coordinate exchange rate policies vis-à-vis the non-EMS currencies.
- To pave the way for the eventual European monetary union.

Two main instruments of the EMS were:

- **European Currency Unit (ECU),** precursor of the euro.
- **Exchange Rate Mechanism (ERM).**

The EMS went through a series of realignments and paved the way for the **European Monetary Union** (EMU).

The Euro and the European Monetary Union [1]

On January 1, 1999, 11 of 15 EU countries adopted a common currency, the euro.

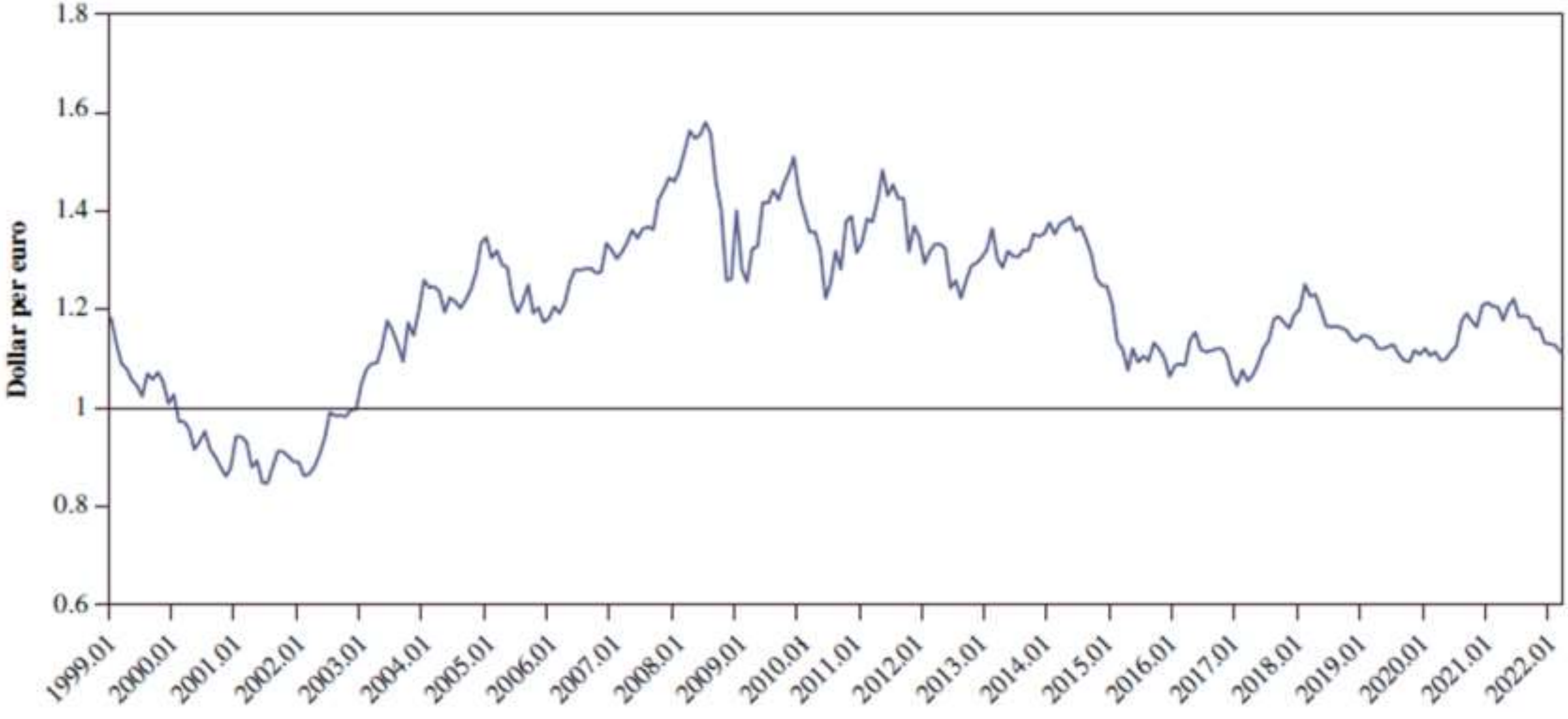
- **European Monetary Union** (EMU) was created.

Each national currency of the euro–11 countries was *irrevocably* fixed to the euro at a conversation rate as of January 1, 1999.

Euro notes and coins were introduced to circulation on January 1, 2002, while national bills and coins were being gradually withdrawn.

The first time sovereign countries voluntarily have given up their monetary independence to foster economic integration.

The Dollar–Euro Exchange Rate



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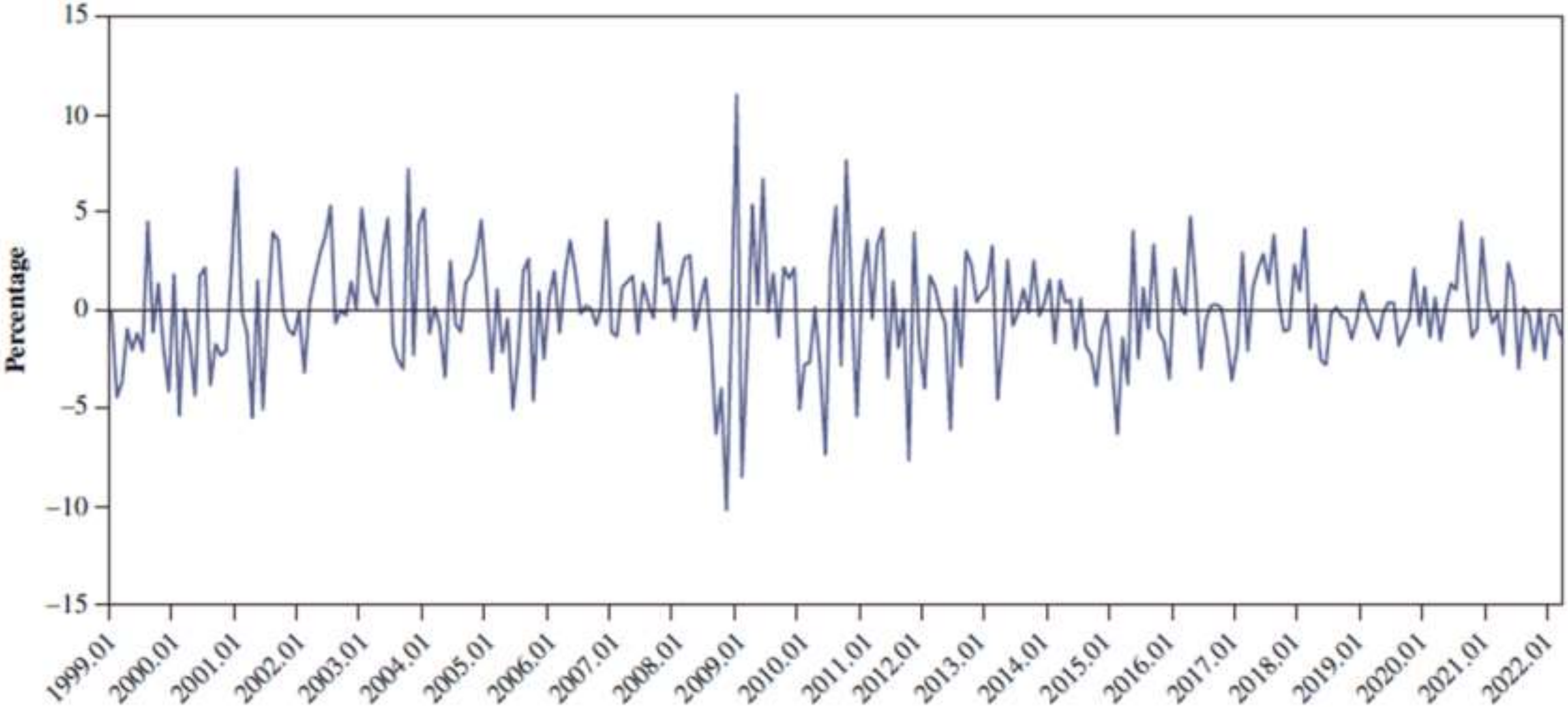
The Dollar–Euro Exchange Rate Changes



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The Euro and the European Monetary Union 2

Monetary policy for the euro zone countries is conducted by the **European Central Bank (ECB),** headquartered in Frankfurt.

- Primary objective is to maintain price stability.
- Independence is legally guaranteed.

Eurosystem is made up of the ECB and central banks of the euro–zone countries and is designed to:

- Define and implement common monetary policy of the Union.
- Conduct foreign exchange operations.
- Hold and manage official foreign reserves of euro member states.

Benefits and Costs of Monetary Union

Key benefits:

- Reduced transaction costs.
- Elimination of exchange rate uncertainty.
- Enhanced efficiency and competitiveness of the European economy.
- Development of continental capital markets with depth and liquidity comparable to those of the U.S.
- Political cooperation and peace in Europe.

Main cost:

- Loss of national monetary and exchange rate policy independence, which makes it hard to deal with asymmetric shocks.

Prospects of the Euro

The relevant criterion for an **optimum currency area** or a common currency zone is the degree of factor mobility within the zone.

Today, intra–euro–zone trade accounts for about 60 percent of foreign trade of the euro-zone countries.

The relative importance of “asymmetric” shocks has also decreased compared with the importance of “common” shocks in recent years.

The euro is emerging as the second global currency, challenging the dollar’s sole dominance.

Currency Crises

Three major currency crises revealed the fragility of the international monetary system (IMS):

- Mexican peso crisis (1994 to 1995).
- Asian currency crisis (1997 to 1998).
- Argentine peso crisis (2002).

The Mexican Peso Crisis 1

On December 20, 1994, the Mexican government announced a plan to devalue the peso against the dollar by 14 percent.

This decision caused pesos, as well as Mexican stocks and bonds, to be sold rapidly.

- By early January 1995, the peso had fallen against the U.S. dollar by as much as 40 percent, forcing the Mexican government to float the peso.

Peso crisis rapidly spilled over to other Latin American and Asian financial markets.

U.S. Dollar versus Mexican Peso Exchange Rate (November 1, 1994 to January 31, 1995)

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The Mexican Peso Crisis 2

Mexican Peso crisis is unique in that it represents the first serious international financial crisis touched off by cross-border flight of portfolio capital.

Two lessons emerge:

- It is essential to have a multinational safety net in place to safeguard the world financial system from such crises.
- Mexico excessively depended on foreign portfolio capital to finance economic development when a higher priority should have been placed on saving domestically.

The Asian Currency Crisis 1

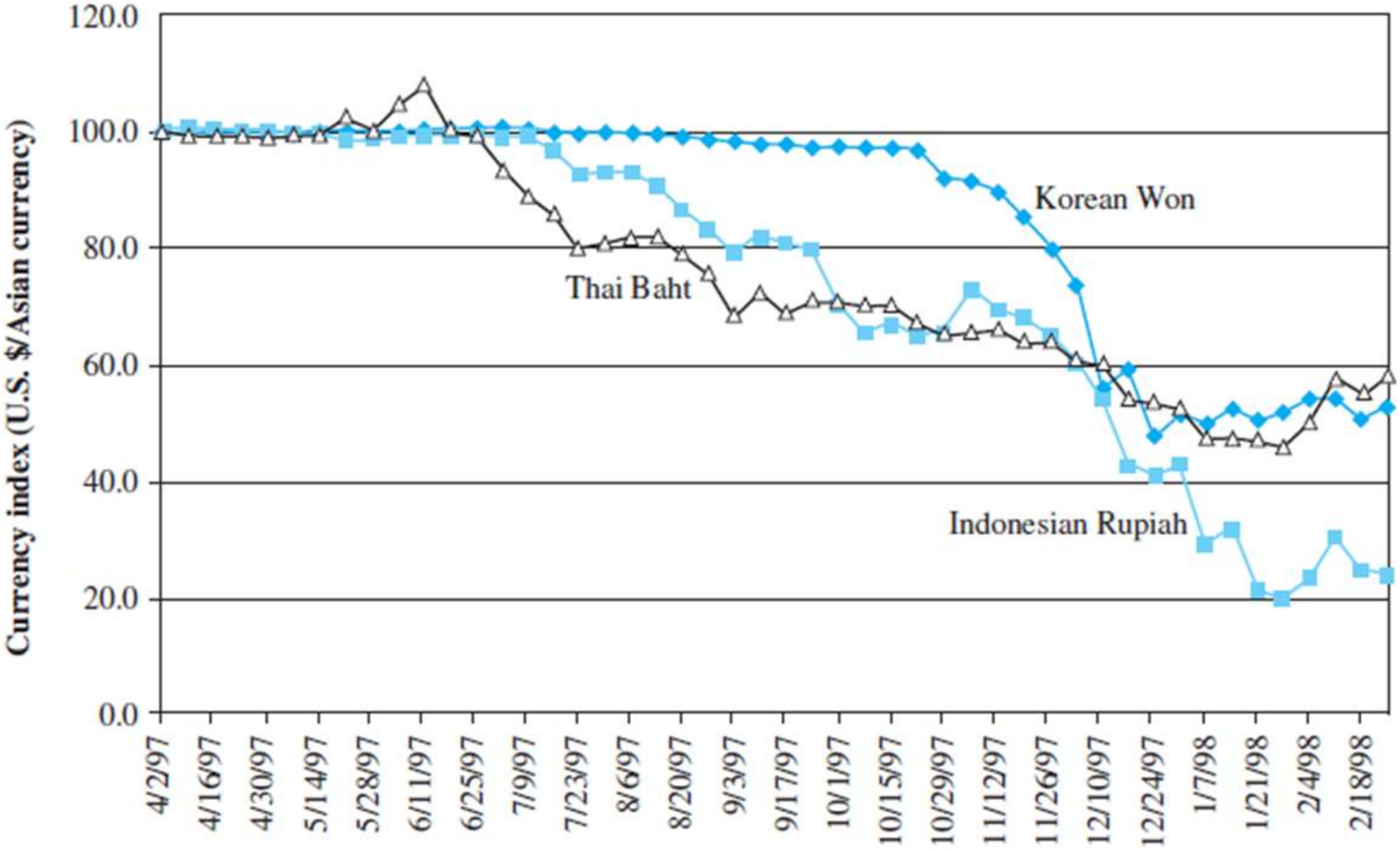
On July 2, 1997, the Thai baht, which had been largely fixed to the U.S. dollar, was suddenly devalued.

Sudden collapse of the baht touched off a panicky flight of capital from other Asian countries.

It quickly escalated into a global financial crisis far more serious than the EMS and Mexican peso crises.

It led to an unprecedented deep, widespread, and long-lasting recession in East Asia, a region that has enjoyed the most rapidly growing economy in the world over the previous decades.

The Asian Currency Crisis 2



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Origins of the Asian Currency Crisis

Factors responsible for the onset of the crisis:

- Weak domestic financial system with poor risk management and supervision.
- Free international capital flows that resulted in a credit boom and speculations in real estate and stock markets.
- Fixed or stable exchange rates encouraged unhedged financial transactions and excessive risk–taking by both borrowers and lenders.
- Booming economy with a fixed exchange rate also brought about an appreciation of the real exchange rate, which led to a slowdown in export growth.
- Japan’s long–lasting recession (and yen depreciation) hurt neighboring countries too.

Lessons from the Asian Currency Crisis

Generally, liberalization of financial markets when combined with a weak, underdeveloped domestic financial system tends to create an environment susceptible to currency and financial crises.

Incompatible trinity suggests it is very difficult, if not impossible, to have all three conditions:

1. A fixed exchange rate.
2. Free international flows of capital.
3. Independent monetary policy.

The Argentine Peso Crisis

In February 1991, the Argentine government passed the Convertibility Law, linking the peso to the U.S. dollar at parity.

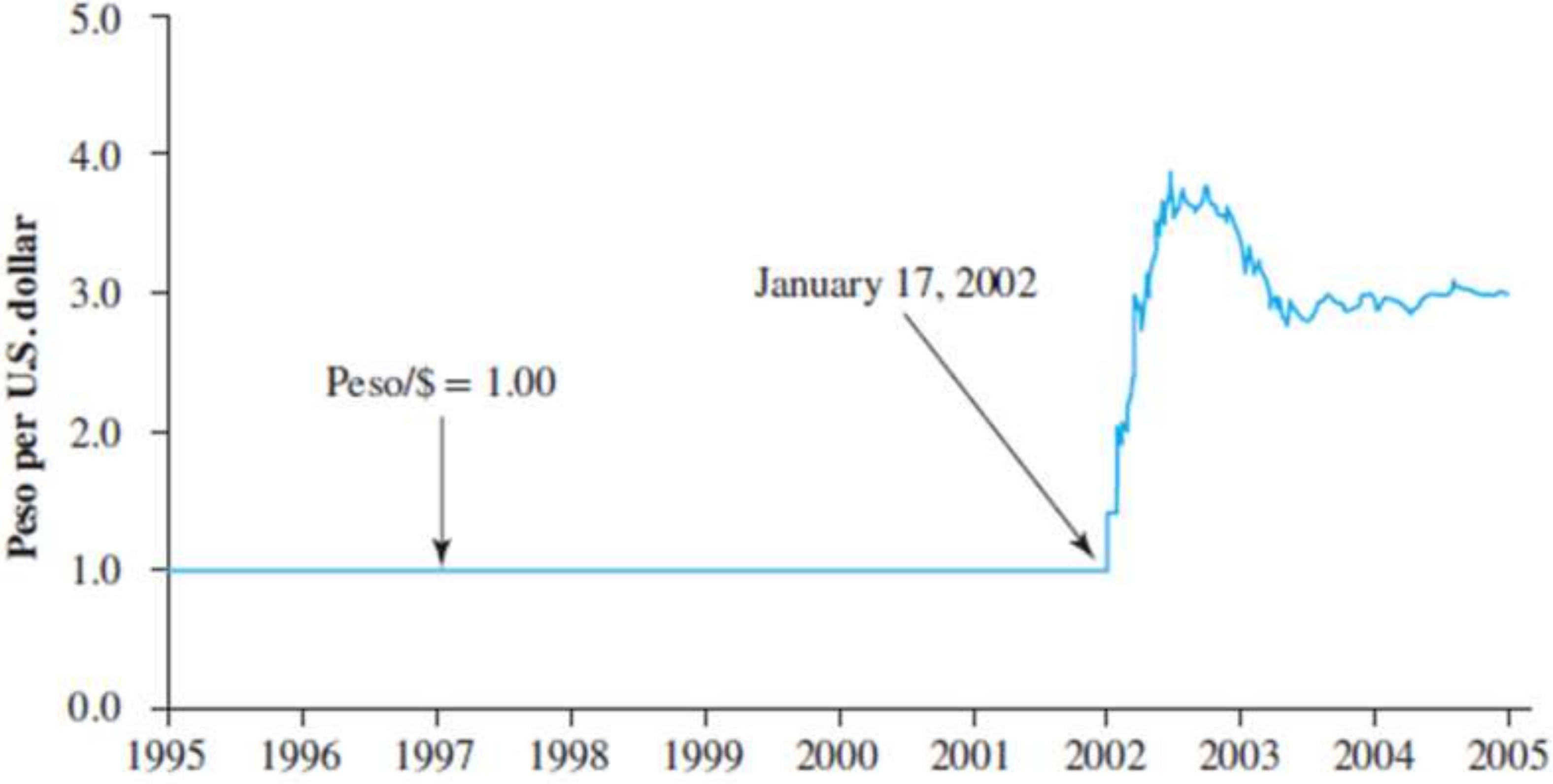
The initial economic effects were positive:

- Argentina’s chronic inflation was curtailed dramatically, and foreign investment began to pour in, leading to an economic boom.

As the U.S. dollar became increasingly stronger in the second half of the 1990s, peso appreciated against most currencies.

- A strong peso hurt exports from Argentina and caused a protracted economic downturn that led to the abandonment of peso–dollar parity in January 2002.
- This change, in turn, caused severe economic and political distress in the country.

Collapse of the Currency Board Arrangement in Argentina



Source: Bloomberg.

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Origins of the Argentine Peso Crisis

There are at least three factors that are related to the collapse of the currency board arrangement and the ensuing economic crisis:

- Lack of fiscal discipline.
- Labor market inflexibility.
- Contagion from the financial crises in Brazil and Russia.

Rise of the Chinese Renminbi

China has become one of the top trading powers and the second largest economy in the world, but its currency, the renminbi (RMB), has not achieved similar international prominence mainly due to the limited openness of China’s capital markets.

IMF included RMB as one of the constituent currencies of the SDR since 2016.

China has been gradually lowering barriers to international capital flows and promoting a greater usage of RMB in international transactions.

China’s currency has the potential to become a global currency, but China will need to meet a few critical conditions:

- Full convertibility of its currency.
- Open capital markets with depth and liquidity.
- Rule of law and protection of property rights.

Fixed versus Flexible Exchange Rate Regimes [1]

Arguments in favor of flexible exchange rates:

- Easier external adjustments.
- National policy autonomy.

Arguments against flexible exchange rates:

- Exchange rate uncertainty may hamper international trade and investment.
- No safeguards to prevent crises.

Fixed versus Flexible Exchange Rate Regimes 2

A “good” (or ideal) international monetary system should provide the following:

- Sufficient *liquidity* to support the growth of international trade and investment.
- Mechanism for *adjustment* that restores the balance of payments disequilibrium.
- Safeguard to prevent crises of *confidence* in the system.

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