

## CHAPTER 10

The international monetary system is the legal and institutional framework—the laws, rules, customs, instruments, and organizations—within which the foreign exchange market operates. Over the past 120 years, the international monetary system has gone through major changes as it has evolved to its present structure.

Some form of trading in national currencies has existed for as long as there have been national currencies and an opportunity for buyers and sellers to trade them. From antiquity, gold was used as a monetary metal, and silver—a lighter and more prevalent metal—had an equal and, for much of the time, greater monetary role. Gradually, over several decades during the nineteenth century, at a time when the role of central banks was expanding in some industrial countries and classical economics was becoming more widely accepted, the gold standard was adopted by a substantial number of nations. Not all experience with bi-metalism had been successful, and with the discovery of extensive gold deposits in the nineteenth century, it became more feasible to have monetary systems based on gold alone.

Only when that happened was there a distinct, functioning international monetary

system in the sense that we now use that term—with a set of practices and “rules of the game,” accepted by a widespread membership including a large number of major nations. Specie transfers among participating countries were possible, and as more and more nations adopted the gold standard and confidence in the new system increased, it became the practice to settle many payments by debiting or crediting foreign accounts rather than by actual specie transfer. With the telegraph and, later, the telephone and other innovations, it was technologically possible to trade foreign exchange on an international basis.

Since the adoption of a system based on the gold standard around 1880, the international monetary system has gone through several distinct turning points and transformations. The history of those 120 years can be divided into four distinct periods.

## 1. THE GOLD STANDARD, 1880-1914

Britain adopted a gold standard after the Napoleonic wars in the early part of the nineteenth century. In the second half of that century, a number of nations in Europe and elsewhere followed suit, though some for a time based their currencies on a bimetallic gold/silver standard. The United States adopted the gold standard *de*

*facto* in 1879, by making the “greenbacks” that the Government had issued during the Civil War period convertible into gold; it then formally adopted the gold standard by legislation in 1900. By 1914, the gold standard had been accepted by a large number of countries, although it was certainly not universal.

The “gold specie” standard called for fixed exchange rates, with parities set for participating currencies in terms of gold, and provided that any paper currency could on demand be exchanged for gold specie at the central bank of issue. The system was designed to bring automatic adjustment in case of external deficits or surpluses in transactions between countries, that is, balance of payments imbalances. The underlying concept was that any deficit country would have to surrender gold to cover its deficit, with the result that the volume of its money would be reduced, leading to lower prices, while the influx of that gold into the surplus country would expand the volume of that country’s money and lead to higher prices.

In the foreign exchange market, under the gold standard, exchange rates could, in principle, fluctuate only within very narrow limits determined by the costs of shipping and insuring gold. Thus, if U.S. residents accumulated pounds sterling as a result of exporting more goods and services to Britain than they imported and being paid in pounds for the excess, the U.S. holders of sterling had the option of converting pounds into gold at par value at the Bank of England and shipping the gold back to New York. During the 1880-1914 period, the “mint parity” between the U.S. dollar and sterling was approximately \$4.87, based on a U.S. official gold price of \$20.67 per ounce and a U.K. official gold price of £ 4.24 per ounce. The sterling/dollar exchange rate would not fluctuate beyond the “gold points”—about three cents above and below the mint parity—which represented the cost of shipping and insuring gold, since at any exchange rate outside the gold points it would be possible to gain an arbitrage profit by converting currency into gold and shipping the gold to the other center.

While some gold transfers actually took place under this system, such shipments frequently

were obviated by monetary policy moves. In the example above, the U.K. might raise interest rates to attract capital inflows—i.e., increase the demand for sterling—and counterbalance the financial impact of the import excess. Presumably, higher interest rates also would have a deflationary effect in the deficit country.

This automatic operation of the balance of payments adjustment process under the gold standard required, in theory, that in their financial policies, participating countries give an absolute priority to external adjustment over domestic objectives. This meant that in any periods of conflict between domestic and external objectives, policy tools might not be available to be used for domestic problems of recession, unemployment, or inflation. But the philosophy widely held in those pre-Keynesian times was that economies would tend naturally toward reasonably high levels of employment and reasonable price stability without such government policy actions.

Assessments still vary concerning the historical record of the period of the gold standard during its heyday. It is true that for a forty-year period there were no changes in the exchange rates of the United States, Great Britain, Germany, and France (though the same did not hold for a number of other countries). There were few barriers to gold shipments and few capital controls in the major countries. Capital flows generally seem to have played a stabilizing, rather than destabilizing, role. Advocates of the gold standard point to the benefits of stable and predictable exchange rates, and the limits the gold standard placed on the extent to which central banks could pursue inflationary monetary policies. These advocates look back with nostalgia to what they regard as a stable period of prompt and smooth external adjustment without governmental interference.

But others argue that there is more myth than reality to that view. They object to a system that they feel always subordinated domestic objectives and living standards to the requirements of international adjustment. They express concern about the rigidities of a system that tied international reserves to a commodity such as gold, whose supply depended on the limitations and uncertainties of new production and competing demands for jewelry, industrial needs, and private hoarding. They contend that things did not, in fact, work so smoothly as alleged—that governments did not always follow the “rules of the game,” for example, in adjusting domestic money supply to gold reserves; that macroeconomic performance under the gold standard was not exceptional, as there were periods of inflation, deflation, and high unemployment; and that there were periodic financial crises. Their view

is that the successes associated with the gold standard resulted from special conditions of the time—a long period of political stability and economic expansion worldwide—with sterling the only international currency and London the unrivaled financial center, and with the British Commonwealth a large and rapidly growing producer of gold as important new sources were discovered.

The debate over the gold standard has continued. In 1981, President Ronald Reagan set up a U.S. Gold Commission to study a possible return to a gold standard. The Commission agreed that there is a strong need for monetary discipline but did not recommend a return to gold. At present, the opponents of a gold standard have the upper hand, and a restoration of a gold standard looks extremely unlikely in the foreseeable future.

## 2. THE INTER-WAR PERIOD, 1919-1939

After the outbreak of the First World War, one combatant country after another suspended gold convertibility, and floating exchange rates prevailed. The United States, which entered the war late, maintained gold convertibility, but the dollar effectively floated against the other currencies, which were no longer convertible into dollars.

After the war, and in the early and mid-twenties, many exchange rates fluctuated sharply. Most currencies experienced substantial devaluations against the dollar; the U.S. currency had greatly improved its competitive strength over European currencies during the war, in line with the strengthening of the relative position of the U.S. economy.

In Europe, especially in Great Britain, there was a widespread desire to return to the stability of the gold standard, and a worry about the growing attractiveness of the dollar—which was convertible into gold—and of dollar-denominated assets. After a lengthy internal debate, the United Kingdom reestablished gold convertibility at the pre-war parity against the U.S. dollar. The argument for restoring the pound’s pre-war parity rather than a devalued rate was that the pound had to be able “to look the dollar in the eye” in order to maintain worldwide confidence in sterling and in British financial institutions. Other nations followed Britain and went back to gold, but in many cases at devalued rates.

The distortions and disequilibria that had developed during the war were not adequately reflected in the par values that were established in the mid-twenties. Notably, the pound sterling was well over-valued, leading to severe payments deficits and deflation, while the French franc was fixed at a greatly depreciated level, resulting in large balance of payments surpluses. Under heavy financial pressures, the United Kingdom abandoned the gold standard in 1931, and others followed over the next few years.

During the 1930s, exchange markets often were turbulent and disorderly. In an environment of severe global depression and a lack of confidence, the international monetary system disintegrated into rival currency blocs,

competitive devaluations, discriminatory trade restrictions and exchange controls, high tariffs, and barter trade arrangements. Against the background of widespread international monetary disorder bordering on chaos, there were several failed efforts to reestablish order.

The collapse of international trade and finance left a profound impression on those who lived through it and on subsequent generations. Unlike the heyday of the gold standard, there was never any nostalgia for a return of the financial conditions of the 1930s. Quite the contrary, it was the experience of conflict, rivalry, and nationalism in the 1930s that created much of the support for international monetary cooperation after the Second World War.

### 3. THE BRETTON WOODS PAR VALUE PERIOD, 1946-1971

Work on plans for a postwar international monetary system started in the early years of World War II, in both the United States and United Kingdom. (Germany also broadcast reports of the kind of monetary system it was planning for the post-war world.)

There was a widespread feeling in the United Kingdom and the United States that inadequate international monetary arrangements had contributed to the Great Depression and the war, and there was a strong determination to prevent a recurrence in the future. Drafts were exchanged for several years, leading to formal negotiations near the end of the war.

The U.S. Administration wanted to build a new international monetary system based on principles of cooperation and non-discrimination. Treasury Secretary Henry Morgenthau and

Assistant Secretary Harry Dexter White envisioned a new system that would police exchange rates, mobilize international liquidity and, more generally, provide the machinery for resolving international monetary problems in a cooperative way. Many of these ideas were shared by the U.K. authorities. In particular, both the United States and the United Kingdom wanted a system of stable exchange rates, surveillance of exchange rates, financing facilities, and related arrangements by an international body. Both wanted to avoid the competitive devaluations that had been such a problem in the 1930s.

But in view of their war-ravaged economy, their thin financial resources, and their postwar goal of full employment, U.K. negotiators wanted to set up an international monetary system that would provide substantial external financing—international credit facilities with few if any

conditions—and that would place automatic disciplines for adjustment on creditor nations. The U.K. wanted to establish international liquidity arrangements under which—it seemed to the U.S. negotiators—the United States, as the only major creditor nation, would have borne much or all of the international burden of external financing and adjustment.

U.S. negotiators had no interest in making the United States a passive supplier of the world's financing needs—nor did they think the Congress would approve. The United States wanted a contributory, conditional fund for providing financing, based on conservative banking concepts. Given its dominant world position at that time, the United States prevailed in these negotiations, and the U.S. plan was accepted as the blueprint of the Bretton Woods system.

What emerged from these negotiations, in terms of foreign exchange rates and markets, was an adjustable peg exchange rate regime operating under a gold exchange standard, with currencies other than the U.S. dollar convertible into the dollar, and the dollar, in turn, convertible into gold for official holders. Member countries were to maintain “stable but adjustable” par values. But there was provision for modification of a par value, with the approval of the International Monetary Fund, in the event of “fundamental disequilibrium”—a concept that was not defined, but that conveyed the idea of large and persistent payments imbalances and reserve changes. Members were expected to maintain their exchange rates within margins of one percent on either side of par value. Members other than the United States generally were expected to meet that obligation by buying and selling dollars in the exchange markets; the United States was expected to meet its obligation by standing ready to meet requests of other monetary authorities to buy or sell gold

for dollars at \$35 per ounce. Other parts of the agreement called for members, after a transitional period, to eliminate exchange restrictions on international trade and current account (but not capital account) transactions, and to make their currencies “convertible” for non-residents—in the sense that non-residents receiving those currencies in current account transactions could exchange them for U.S. dollars or other desired currencies. Importantly, the agreement also provided for borrowing facilities in the IMF for nations in temporary balance of payments difficulties.

The U.S. dollar was thus accorded a central role in the Bretton Woods system. It provided the system's link to gold, in that the United States undertook to sell (and buy) gold at \$35 an ounce in transactions with the financial authorities of other member countries. With that guarantee of the dollar's convertibility into gold, it was expected that other countries would hold reserves mainly in the form of dollars and the dollar would be the world's reserve currency. The dollar, defined by its gold content, served as the numeraire, or standard measure of value, for the system.

Although the Bretton Woods agreement was negotiated in 1944 and the International Monetary Fund opened for business in 1946, the system envisaged in the IMF Articles did not become fully operational for a number of years. The financial difficulties of the early postwar years were far more severe than had been expected. The war-ravaged nations of Europe and Asia were unable to undertake their IMF obligations of eliminating discrimination and exchange restrictions on current account transactions and making their currencies freely convertible into the U.S. dollar. The IMF was put on hold, and the Marshall Plan was created to help restore the economies of Europe. The

Marshall Plan, rather than the IMF, became the framework for dealing with the financial problems of the major industrial nations in the immediate postwar period.

It was not until the end of 1958 that the major European nations had gained enough financial strength that they were willing, and felt themselves able, to accept their IMF obligations and take the step of making their currencies freely convertible for non-residents into dollars and other strong currencies. Leading up to that step, during the 1950s, as strength was restored to the European and Japanese economies, their balance of payments positions progressively improved. Conversely, the United States balance of payments position progressively weakened and moved into “official settlements” deficit—that is, the United States was in deficit in the total of its current plus long-term capital account position, and foreigners as a group were acquiring more dollars than they were spending.

Initially, the U.S. balance of payments deficits had been seen as beneficial and not a problem. The counterpart of those deficits was mainly a growth in dollar balances of the nations of Europe and elsewhere—a development that was regarded as necessary for European recovery and a welcome increase in those countries’ monetary reserves. But as the decade of the 1950s passed, the world dollar shortage turned into a dollar glut. As U.S. gold reserves progressively declined, and other nations’ holdings of dollar balances increased, questions arose about the ability of the United States to maintain the gold convertibility of the dollar. By late 1960—less than two years after the European nations had accepted in full the obligations of participating in the Bretton Woods par value system—the United States

was experiencing the first of many gold “crises,” with other countries worrying about their “excess” dollar holdings and seeking to exchange them for gold.

As Europe and Japan recovered and greatly improved their relative economic strength and competitiveness, the basic structure of the world economy changed. Some fundamental premises of the Bretton Woods par value system began to look doubtful. The United States was no longer the overwhelmingly dominant economic power, and it no longer owned such a large share of the world’s monetary gold. The United States’ unique role—as issuer of the world’s reserve currency, preserver of the link to gold for the entire system, and passive counterparty in the exchange markets—came under severe strain. The credibility of the U.S. obligation to convert officially held dollars into gold at \$35 per ounce weakened steadily over the years, as U.S. gold reserves grew smaller and smaller while other nations’ cumulative dollar holdings grew vastly larger, to a level far in excess of those U.S. gold holdings.

In part, this result reflected fundamental international changes—rapid real economic growth at different rates in different countries and a concomitant growth of trade imbalances. In part, it was also a natural consequence of the Bretton Woods system. From the late 1950s, experts had spoken about the “Triffin dilemma.” The problem, as pointed out by Professor Robert Triffin, was that the founders of Bretton Woods had created an international monetary system that required, and was dependent on, U.S. payments deficits for the increases in international liquidity needed to finance the system, but those very same U.S. deficits undermined the credibility of the dollar’s gold convertibility and weakened confidence in that international monetary

system. An expanding world economy needed an increasing level of world reserves. Reserves consisted essentially of gold and dollars. With gold production stagnant, the only way to get an increase in international reserves was for the United States to run balance of payments deficits, resulting in mounting dollar liabilities (other countries' dollar reserve holdings) and ever larger potential demands on the limited and declining U.S. gold stock.

Initially, the Triffin dilemma was seen as a longer-term danger, which would, in time, require systemic correction. More immediate attention was focused on the shorter-term concerns about the U.S. payments deficit—what caused it, how to reduce it, and how to finance it. For much of the 1960s, improvisations and innovative changes were introduced, and, for a while, considerable progress was made. These changes included a variety of measures designed to (1) restrict U.S. capital outflows, (2) strengthen the International Monetary Fund and other institutions, (3) limit upward market price pressures on gold, and (4) deal with pressures and disorderly conditions in the exchange market. Also, in 1969, an international agreement was reached to introduce a new IMF reserve asset, Special Drawing Rights

(SDRs), which was intended to supplement the U.S. dollar and provide a mechanism for expanding international liquidity without requiring additional U.S. payments deficits or additional dollar balances—a response to the Triffin dilemma.

These events had lasting effects on the evolution of the international monetary system. But the innovations introduced in the 1960s did not correct the fundamental problems of the international monetary system or eliminate the pressures on the dollar. Over time, the dollar faced increasingly greater pressures, reflecting chronic U.S. payments deficits—in part associated with the fiscal consequences of the Vietnam War and new domestic social programs in the United States, but related also to the stronger competitive position of a restored Europe and Japan—and an international monetary structure that, in the view of most authorities, could not easily be modified to reflect the changing economic realities in the world economy. On August 15, 1971, the United States, faced with rapidly mounting demands from other nations to convert their dollars into gold, suspended gold convertibility of the dollar, and the Bretton Woods par value system effectively ceased to function.

#### 4. THE FLOATING RATE PERIOD, 1971 TO PRESENT

After the United States suspended convertibility of the dollar into gold in August 1971, an effort was made, in the Smithsonian Agreement of December 1971, to reestablish a viable and stable par value structure of exchange rates. Specifically, the major industrial nations in the Group of Ten—Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States—

negotiated a multilateral realignment of exchange rates designed to eliminate the overvaluation of the dollar that had developed during the Bretton Woods par value regime, by devaluing the dollar and appreciating the par values or central rates of the currencies of certain other major industrial countries. However, the adjustment worked out in the Smithsonian negotiations represented only a

modest reduction in the market value of the dollar. Measured by trade-weighted averages, the dollar exchange rate was reduced by approximately 8 percent against the currencies of the other OECD countries; this adjustment was only about half as much as technicians at the U.S. Treasury thought was needed. The dollar's par value was changed from \$35 per ounce of gold to \$38, a devaluation of 7.9 percent. The United States agreed to the rate adjustments arranged at the Smithsonian, but was not willing under those circumstances to restore gold convertibility.

Not many months after the December 1971 Smithsonian Agreement, exchange markets again became volatile and disorderly. It was not just the dollar that was being hit—several European currencies, too, were subject to pressures of their own. Less than fifteen months after the Smithsonian realignment, the dollar was devalued for a second time, and the par value was reduced by an additional 10 percent, from \$38 to \$42.22 per ounce of gold. But foreign exchange markets continued to be unstable, affecting not only the dollar but several other major currencies, and in March 1973, the Group of Ten industrial nations announced that they would allow their currencies to float.

During the period between the two U.S. dollar devaluations in 1971 and 1973, discussions began in the International Monetary Fund on possible reform of the international monetary system. These discussions quickly revealed deep divergences over what kind of system should be constructed. In Europe, there was a widely held view that the failure of Bretton Woods was due to the “exorbitant privilege” of the United States in being able to finance its external deficits by issuing its own currency—dollars—which were

then held as reserves by the rest of the world. That concern led to European proposals to severely limit or eliminate the accumulation of reserve currencies, and to require the United States to settle any external deficits with “assets,” such as gold or foreign currency borrowing, rather than with dollar “liabilities.”

In the United States, by contrast, the failings of the Bretton Woods par value system were attributed largely to the system's rigidity and its inadequate incentives for adjustment. There was a strongly held U.S. view that any par value system, to remain viable, needed effective inducements for “adjustment” mechanisms that would provide the necessary incentives for both deficit and surplus nations to adopt policies that would eliminate their payments imbalances. Also, the United States favored more flexibility in the exchange rate system, and argued that even in a par value based system, there should be provision for floating exchange rates to be authorized in particular situations. There had been exceptions to the par value regime even during the time of Bretton Woods—Canada, among others, had floated its currency at times—but the IMF articles did not provide for that possibility.

Beginning in 1972, these issues were heavily debated, but they remained unresolved despite various efforts at compromise. As the debate continued, the world was becoming more accustomed to operating in the floating exchange rate environment that existed *de facto*. Also, there was growing support for a flexible, or floating, exchange rate system in academic and some U.S. legislative circles, as well as in parts of the business community. Indeed, when the world was hit by the first major oil crisis in late 1973, many expressed the view that a system of flexible exchange rates might have some advantages for dealing with the major

disruptions and enormous oil financing requirements that were emerging.

By 1976, international agreement had been reached on a change in approach. The new approach was based on the concept that good international behavior depended, not on whether a country was maintaining a fixed par value or floating its currency, or pegging to another currency or basket, but rather, on which exchange rate policies and practices the country was actually following. In other words, regardless of its exchange rate regime, a nation could be pursuing either destructive exchange rate policies or internationally responsible policies, and that should be the focus of the IMF's concern. In 1978, the IMF Articles of Agreement were amended to provide each member nation with freedom to choose an exchange rate regime that it felt best suited its needs, including individual floating and joint floating regimes such as those of the European Monetary Union—subject to the “firm surveillance” of the member's policies by the IMF. Instead of requiring a particular exchange rate regime, the amended IMF articles placed obligations on members to promote exchange stability, and to “avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain unfair competitive advantage.” The amendment took effect in 1978 and continues in force today.

Accordingly, at present, IMF member nations can choose from a variety of exchange rate regimes. As shown in Figure 4-2, nearly 40 percent of the members peg their exchange rates—either to the dollar, the French franc, another currency, or to some basket or composite currency such as the SDR. The remainder either allow their currencies to float independently, like the U.S. dollar;

maintain a cooperative joint floating arrangement, like the European Monetary Union; or operate some form of managed float or limited flexibility arrangement.

The basic structure of the exchange rate regime has remained in force since the amended IMF Articles of Agreement were adopted in 1978. Individual nations and groups of nations have used different approaches within the broader framework. In the United States, the dollar has continued to float independently throughout the period, and all of the shifts that have occurred in U.S. exchange rate policy since then have been variations on the basic theme of an independently floating regime. The exchange rate arrangements among the major European economies have gone through several modifications. Other nations have experimented with other schemes. Over the years, the trend has been toward the adoption of more flexible regimes on the part of a number of nations.

Various proposals have been put forward to modify the current structure of the international monetary system—to return to a general system of fixed rates, to move to target zones, or to introduce various other concepts. Undoubtedly there will be major changes in the international financial structure in the years ahead—with the introduction of the euro, the development of emerging markets, the evolution of transitional economies, the continuing advance of technology, and globalization. But while there may be widespread interest in finding improvements, at the present time there is no agreement on fundamental changes for the basic exchange rate system. Present efforts are focused on strengthening the system of international surveillance through the IMF, by improving the flow of financial and economic data—with greater

disclosure and transparency through more accurate, more complete, and more timely data collection and reporting—as well as by making surveillance more continuous and more candid. Many changes have been introduced to improve the effectiveness of IMF surveillance. Measures also are under

way to broaden the IMF's focus, to enable the fund to promote the orderly liberalization of capital movements, and to strengthen its surveillance over international capital flows. But the freedom of an IMF member to select the exchange rate regime best suited to its needs remains intact.

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