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Commerce Department

Module: International Finance

Branch: International Trade
Level: Third year Bachelor

Lecture 04: The Global Monetary System

1- Definition

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.

2- Evolution of the International Monetary System

The international monetary system went through several distinct stages of evolution. These stages are summarized as follows:

. Bimetallism: Before 1875.

. Classical gold standard: 1875–1914.

. Interwar period: 1915–1944

. Bretton Woods system: 1945–1972.

. Flexible exchange rate regime: Since 1973.

a-Bimetallism: Before 1875

Before the 1870s, many countries followed bimetallism, allowing the free coinage of both gold and silver. Britain abandoned it in 1816, the U.S. maintained it until 1873, and France upheld it until 1878. Other countries, like China, India, Germany, and Holland, used the silver standard. The international monetary system relied on gold and silver, with exchange rates based on metal content. However, wars and political instability caused some countries to adopt irredeemable currencies. Bimetallism often led to Gresham's law, where the more abundant metal displaced the scarcer one from circulation. For example, the influx of gold in the 1850s devalued gold, making the French franc effectively a gold currency.

b-Classical Gold Standard: 1875-1914

The gold standard was first fully implemented in Great Britain in 1821, followed by France (1878), Germany (1875), the U.S. (1879), and Russia and Japan (1897). It became the dominant international monetary system from 1875 to 1914, with London as the financial center.

Under the gold standard, currencies were directly linked to gold, ensuring stable exchange rates. Exchange rates between countries were determined by their gold content, providing a predictable financial environment that facilitated international trade and investment. Misalignments in exchange rates were corrected through gold flows, while trade imbalances were automatically adjusted by the price-specie-flow mechanism, attributed to David Hume.

Supporters argue that the gold standard prevents inflation since money supply is tied to a scarce resource. However, its major drawbacks include limited gold reserves, which can hinder economic growth and lead to deflation, and the lack of enforcement mechanisms, allowing countries to abandon it when politically necessary. Due to these issues, a return to the classical gold standard is considered unlikely.

c-Interwar Period: 1915-1944

World War I ended the classical gold standard in 1914 as major countries suspended gold redemption and exports. After the war, hyperinflation hit countries like Germany, Austria, and Russia, with Germany experiencing extreme price surges by 1923. Exchange rates fluctuated, and nations used currency depreciation to boost exports. Efforts to restore the gold standard followed, led by the U.S., which returned to it in 1919, while Great Britain did so in 1925. However, the system was weak, as countries prioritized domestic stability over strict adherence to gold standard rules. The Great Depression and financial crises led to widespread bank failures, capital flight, and gold outflows, particularly affecting Britain, which abandoned the gold standard in 1931. The U.S. followed in 1933, and France in 1936. The interwar period was marked by economic nationalism, instability, and the absence of a stable international monetary system, ultimately leading to the rise of the U.S. dollar as the dominant global currency.

d-Bretton Woods System: 1945-1972

The Bretton Woods system was established in July 1944 when representatives from 44 nations met to design a postwar international monetary framework. The key outcomes were the creation of the International Monetary Fund (IMF) to enforce monetary rules and the International Bank for Reconstruction and Development (World Bank) to finance development projects.

The system aimed to prevent economic nationalism and introduced fixed exchange rates, where currencies were pegged to the U.S. dollar, which was convertible to gold at $35 per ounce. The American proposal, led by Harry Dexter White, prevailed over the British idea of an international reserve asset called "bancor."

While the system provided monetary stability and facilitated international trade, economist Robert Triffin warned of an inherent flaw: the U.S. needed to run persistent balance-of-payments deficits to supply dollars globally, which could erode confidence in the dollar—known as the "Triffin Paradox."

By the 1960s, growing U.S. trade deficits and inflation raised concerns about the system’s viability. Various measures, such as the Interest Equalization Tax (IET) and Foreign Credit Restraint Program (FCRP), were introduced to stabilize the dollar, alongside the creation of Special Drawing Rights (SDRs) as a new international reserve asset.

Despite these efforts, the system collapsed in the early 1970s due to mounting inflation and monetary expansion in the U.S. In 1971, President Nixon suspended dollar-gold convertibility, effectively ending the system. A temporary solution, the Smithsonian Agreement, revalued gold and adjusted currency exchange bands, but by 1973, major currencies began floating freely, marking the definitive end of the Bretton Woods system.

e-The flexible Exchange Rate Regime: 1973- Present

After the collapse of the Bretton Woods system, IMF members formally adopted a flexible exchange rate regime through the Jamaica Agreement (1976). Key provisions included:

.Acceptance of flexible exchange rates, with central banks permitted to intervene to manage volatility.

.Demonetization of gold as a reserve asset, with IMF gold holdings partially redistributed to member nations and sold to aid poorer countries.

. Increased IMF financial support for developing and non-oil-exporting nations.

The IMF continued to assist countries with balance-of-payments issues, but its financial aid came with strict macroeconomic conditions, often leading to economic hardships and public resentment in developing nations.

Exchange Rate Volatility and Major Currency Events

Since 1973, exchange rates have become significantly more volatile. The U.S. dollar experienced notable fluctuations:

- 1980–1985: The dollar appreciated sharply due to high real interest rates in the U.S., attracting foreign capital.
- 1985–1988: The dollar declined following the Plaza Accord (1985), where G-5 nations (U.S., U.K., France, Germany, and Japan) agreed to intervene to depreciate the dollar and address U.S. trade deficits.
- 1987: Concerned about excessive currency fluctuations, the Louvre Accord (G-7 nations) established a managed-float system, aiming for greater exchange rate stability through coordinated economic policies and interventions.

1996–2001: U.S. Dollar Trends

- Appreciation (1996–2001): Fueled by strong economic growth and the technology boom, foreign investments surged, strengthening the dollar.
- Depreciation (2001 onward): The dollar weakened due to the stock market downturn, rising trade deficits, and political uncertainty following the September 11 attacks.

This period highlights the impact of government interventions, trade imbalances, and macroeconomic conditions on exchange rate fluctuations.

3- Fixed versus Flexible Exchange Rate Regimes

Countries have differing preferences regarding exchange rate systems—some, like the U.S. and Japan, favor flexible exchange rates, while others, such as the European Monetary Union (EMU) members and developing nations, prefer fixed exchange rates.

Arguments for Flexible Exchange Rates:

.Automatic External Adjustment – Exchange rates adjust naturally based on market forces, correcting balance-of-payments imbalances without government intervention.

.Policy Autonomy – Governments retain control over monetary and fiscal policies without being constrained by the need to maintain a fixed exchange rate.

Arguments for Fixed Exchange Rates:

.Reduced Uncertainty – Fixed rates eliminate exchange rate volatility, which can encourage international trade and investment by reducing risks for businesses.

.Economic Stability – Stability in exchange rates can prevent suboptimal resource allocation caused by unpredictable currency fluctuations.

A drawback of flexible exchange rates is currency volatility, which can discourage trade. However, firms can hedge exchange rate risks using financial instruments like forward contracts or options.

Trade-off Between Policy Independence and Economic Integration

- Countries prioritizing domestic economic goals tend to prefer flexible exchange rates for policy autonomy.
- Nations committed to economic integration (e.g., the EU) benefit more from fixed exchange rates, despite their constraints.

Ideal International Monetary System (IMS)

A well-functioning IMS should provide:

.Liquidity – Sufficient monetary reserves to support global trade and investment.

.Adjustment Mechanism – An efficient way to restore balance-of-payments equilibrium.

.Confidence – A safeguard against financial crises and currency instability.

Policymakers must balance these factors when designing the international monetary system to promote both economic stability and global trade.

Reference ;

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