CHAPTER 30
THE INTERNATIONAL MONETARY SYSTEM:
Past, Present, and Future

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1. An effective international monetary system needs to provide for relatively quick and smooth adjustment to imbalances in countries’ balance-of-payments positions. In addition, if exchange rates are not completely flexible, there must exist an adequate supply of internationally acceptable reserve assets so that effective intervention can be carried out without resort to trade and exchange controls. Since countries seem to differ in their internal macroeconomic target preferences, adjustment to and financing of imbalances should also be able to be undertaken without disruption of internal economic performance. Whether the current system meets these requirements is a matter of opinion. Some would say that the increasing exchange rate flexibility present in currencies provides for continuing adjustment without major interference in the attainment of domestic goals; others would say that domestic policy autonomy still needs to be sacrificed because of the need for coordination across countries, and that exchange rate changes are too slow in correcting current account imbalances. Also, many LDCs (who often have pegged rates) maintain extensive trade and exchange controls for balance of payments reasons, despite recent liberalization.

2. The problems with the Bretton Woods system are discussed in the chapter. The current system may provide greater adjustment of imbalances without undue interference with domestic performance, and the freedom of choice in exchange arrangements in the current system means that there is less danger of a “collapse” of the system as occurred with Bretton Woods. Further, the “confidence” problem seems to have been reduced. However, the increased international capital mobility since Bretton Woods has generated unstable exchange rates. Current account imbalances are also still prolonged, and the transmission of business cycles across countries is greater than was expected. Further, the level of international reserves may be inadequate in many LDCs.

3. An SDR is, like gold, an internationally acceptable reserve asset that is not simultaneously in use as a national currency. In addition, the growth rate of the asset can be kept relatively low, and the value of the asset is more stable than the value of any single (component) national currency. However, the SDR does not have a fixed official price (as gold did when it served as the principal reserve asset), and the SDR is not a physical asset with intrinsic value (it is only a bookkeeping entry at the IMF). SDRs can be used (within limits) in settlement of payments imbalances between countries and can provide international liquidity to SDR holders. Critical to the success of SDRs is that they have relative stability in value and, most importantly, that surplus countries are willing to accept SDRs in payment of imbalances. However, SDRs continue to be a very small fraction of international reserve assets held by central banks.

4. The growth of the world money supply is dependent on only one source in either system
(the world gold supply in one system, decisions at the world central bank in the other). Both rely on basically fixed exchange rates, and both have a mechanism for adjustment to imbalances in countries’ BOP positions. Also, both systems tend to sacrifice national autonomy in the pursuit of domestic goals to the requirement of external balance. An important difference between the systems is that the supply of gold is basically independent of international monetary needs, whereas the world central bank can control the growth of reserve assets. There are also competing demands for gold from the private sector that could potentially cause instability for the gold standard, while potentially destabilizing private sector activities with respect to a world currency in the world central bank plan could presumably be offset (at least in theory) by actions of the bank.

5. The original central purposes of the IMF were to provide relative stability in exchange rates through a pegged-rate system, to combine BOP adjustment with national autonomy in domestic macroeconomic policies, to encourage freedom in trade and payments (although capital controls were permitted in some circumstances), and to provide short-term financing for countries with BOP difficulties. Since the Bretton Woods system collapsed, pegged rates are no longer required but disruptive exchange rate movements are to be avoided, and the IMF has often expressed its desire to have SDRs substitute for gold and dollars as the principal assets in the international monetary system. Surveillance is justified by the IMF to meet its goal of avoiding disruptive and destabilizing movements in exchange rates.

6. With respect to a flexible-rate system, the target zone proposal permits the exchange rate to perform its adjustment function to some extent, allows for some protection against the transmission of real shocks across countries, and prevents speculation from driving currencies to wide swings. It also allows fiscal policy to perform a role in meeting internal goals. However, the freedom of exchange rates to move beyond narrow limits could potentially lead to wasteful resource movements as rates changed. There could also be enhanced risks associated with trade and foreign investment as compared to a fixed-rate system, and internal shocks could also generate greater instability in national income than would be the case with a fixed-rate system.

As with a fixed-rate system, the target zone system provides for some discipline and coordination in domestic macroeconomic policies, and, since exchange rates are limited in variability to some extent, trade and foreign investment may not be deterred because of exchange risk. However, countries may not be able to attain their preferred inflation/unemployment trade-offs because of having to take corrective policy steps regarding the exchange rate as the ceiling and floor of the zones are reached (although the ceiling and floor may not be reached in the Krugman version). The intervention needed could transmit business cycles across countries. If the intervention were predicted to be unsuccessful, one-way bets for speculators could also exist. Hence, the avoidance of destabilizing speculation crucially depends on confidence in the monetary authorities to keep rates within the limits.

7. The logic of the statement is that coordinated policies would keep real exchange rates stable, since countries will not be having incompatible inflationary stances, for example. (This assumes that the inflation differences are not entirely offset by relative purchasing-power-parity
exchange rate movements, in which case no coordinated policies would be necessary.) However, if the countries have compatible inflationary stances (or if relative PPP holds), there will be no need to specify ceilings and floors since the rates would not vary to any significant extent anyway: a fixed-rate system might as well be used. However, proponents of the target zones could say that the target zone system is superior to fixed rates because it provides more leeway in domestic policy, and they could also say that PPP tends to hold.

8. Advantages would include the decreased exchange rate risk associated with foreign trade and investment, which would enhance specialization and the gains from trade and would allocate capital more effectively toward its most productive uses. In addition, if member countries are adhering to the convergence criteria, more stable growth and less disruption from exchange rate crises would occur. Further, of course, there are political and economic advantages to a country from being a member of a group that is a very important player in world political activity and in world markets. Potential disadvantages would be that each country is less insulated from real shocks in other EU countries, and that national monetary autonomy is basically lost. Also, a tight money policy in a dominant country such as Germany could leave a smaller country with more unemployment than it desired in accordance with its own unemployment/inflation trade-off.

9. This statement ignores the causal factors of the debt problem that are associated with events external to the indebted LDCs. These are discussed in the text. However, the developing countries are not blameless, because they have often pursued inappropriate domestic policies involving price distortions, rapid inflation (leading to capital flight), usage of loans for purposes other than development, etc. Since both external and internal factors have been important in generating the problem, a case can be made that developed countries as well as LDCs should be involved in attempting to solve the problem. A reduction in the debt burden can make for greater stability and growth in the world as a whole, and it is in the interests of both the developed countries and the developing countries to seek solutions.

10. If the structure of the developing country’s economy cannot be expected to be transformed quickly, if its prospects for export, attraction of investment, formation of human capital, reform of policy institutions, etc., are poor while it has great import needs and an uncontrolled money supply growth, then the situation is most likely a “solvency” difficulty. (Several African countries fit this category.) These kinds of characteristics would need to be examined for the country in question. On the other hand, if policy institutions are amenable to change, if the current account looks capable of turnaround based on an assessment of industry prospects, etc., then the situation may rather be one of a lack of “liquidity.” (Chile has been in this category in recent years.) Clearly, however, this is a sketchy answer that would need to be fleshed out in detail by a thorough case study of the particular country under consideration.