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International Finance: The International Monetary System : A Review

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Introduction : The International Monetary Fund (www.imf.org) is like a central bank for the world's central banks. It is headquartered in Washington, D.C., has 184 member nations, and cooperates closely with the World Bank, which we discuss in The Global Market and Developing Nations. The IMF has a board of governors consisting of one representative from each member nation. The board of governors elects a 20-member executive board to conduct regular operations.

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The goals of the IMF are to promote world trade, stable exchange rates, and orderly correction of balance of payments problems. One important part of this is preventing situations in which a nation devalues its currency purely to promote its exports. That kind of devaluation is often considered unfairly competitive if underlying issues, such as poor fiscal and monetary policies, are not addressed by the nation.

International Monetary System

International Monetary System a system for promoting international trade and specialization while at the same time ensuring long-run individual Balance Of Payments Equilibrium. To be effective, an international monetary system must be able to:

- provide a system of exchange rates between national currencies;
- provide an adjustment mechanism capable of removing payments imbalance;
- provide a quantum of international reserves to finance payments deficits. In addition, because of the structural weaknesses of some countries, particularly developing countries, financial aid facilitates are required to help resolve problems of indebtedness (see INTERNATIONAL DEBT).

The three functions identified above are highly interrelated, and a crucial role is played by the degree of fixity or flexibility built into the exchange rate mechanism, as Fig. 98 indicates. Thus, if exchange rates are rigidly fixed (see fixed exchange rate system), balance of dis-equilibriums can only be removed by internal price and income adjustments (see balance of payments equilibrium), and countries will need to hold large stocks of international reserves to cover deficits while the necessary adjustments are given time to work. By contrast, where exchange rates are free to fluctuate in line with market forces (floating exchange rate system), continuous external price adjustments will work to remove incipient imbalances before they reach serious proportions, thus reducing countries' reserve requirements. Various international monetary systems have been tried, including the GOLD STANDARD and, currently, the international monetary fund system. See european monetary system. Member nations maintain funds in the form of currency reserve units called Special Drawing Rights (SDRs) on deposit with the IMF. (This is a bit like the federal funds that U.S. commercial banks keep on deposit with the Federal Reserve.) From 1974 to 1980, the value of SDRs was based on the currencies of 16 leading trading nations. Since 1980, it has been based on the currencies of the five largest exporting nations. From 1990 to 2000, these were the United States, Japan, Great Britain, Germany, and France. The value of SDRs is reassigned every five years.

Exchange Rate Policies

In July 1944, representatives from 45 nations met in Bretton Woods, New Hampshire to discuss the recovery of Europe from World War II and to resolve international trade and monetary issues. The resulting Bretton Woods Agreement established the International Bank for Reconstruction and Development (the World Bank) to provide long-term loans to assist Europe's recovery. It also established the International Monetary Fund (IMF) to manage the international monetary system of fixed exchange rates, which was also developed at the conference.

The new monetary system established more stable exchange rates than those of the 1930s, a decade characterized by restrictive trade policies. Under the Bretton Woods Agreement, IMF member nations agreed to a system of exchange rates that pegged the value of the dollar to the price of gold and pegged other currencies to the dollar. This system remained in place until 1972. In 1972, the Bretton Woods system of pegged exchange rates broke down forever and was replaced by the system of managed floating exchange rates that we have today.

The Bretton Woods system broke down because the dynamics of supply, demand, and prices in a nation affect the true value of its currency, regardless of fixed rate schemes or pegging policies. When those dynamics are not reflected in the foreign exchange value of the currency, the currency becomes overvalued or undervalued in terms of other currencies. Its price—fixed or otherwise—becomes too high or too low, given the economic fundamentals of the nation and the dynamics of supply, demand, and prices. When this occurs, the flows of international trade and payments are distorted.

In the 1960s, rising costs in the United States made U.S. exports uncompetitive. At the same time, western Europe and Japan emerged from the wreckage of World War II to become productive economies that could compete with the United States. As a result, the U.S. dollar became overvalued under the fixed exchange rate system. This caused a drain on the U.S. gold supply, because foreigners preferred to hold gold rather than overvalued dollars. By 1970, U.S. gold reserves decreased to about $10 billion, a drop of more than 50 percent from the peak of $24 billion in 1949.

In 1971, the U.S. decided to let the dollar float against other currencies so it could find its proper value and imbalances in trade and international funds flows could be corrected. This indeed occurred and evolved into the managed float system of today.

A nation manages the value of its currency by buying or selling it on the foreign exchange market. If a nation's central bank buys its currency, the supply of that currency decreases and the supply of other currencies increases relative to it. This increases the value of its currency.

On the other hand, if a nation's central bank sells its currency, the supply of that currency on the market increases, and the supply of other currencies decreases relative to it. This decreases the value of its currency.

The International Monetary Fund plays a key role in operations that help a nation manage the value of its currency.

Conclusion :

The rules and procedures for exchanging national currencies are collectively known as the international monetary system. This system doesn't have a physical presence, like the Federal

Reserve System, nor is it as codified as the Social Security system. Instead, it consists of interlocking rules and procedures and is subject to the foreign exchange market, and therefore to the judgments of currency traders about a currency.

An international monetary system is a set of internationally agreed rules, conventions and supporting institutions that facilitate international trade, cross border investment and generally the reallocation of capital between nation states. It should provide means of payment acceptable to buyers and sellers of different nationalities, including deferred payment. To operate successfully, it needs to inspire confidence, to provide sufficient liquidity for fluctuating levels of trade, and to provide means by which global imbalances can be corrected. The system can grow organically as the collective result of numerous individual agreements between international economic factors spread over several decades. Alternatively, it can arise from a single architectural vision, as happened at Bretton Woods in 1944.

Yet there are rules and procedures—exchange rate policies—which public finance officials of various nations have developed and from time to time modify. There are also physical institutions that oversee the international monetary system, the most important of these being the International Monetary Fund.

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