Exchange Rate Flexibility and Currency Areas

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I. Introduction

The Second Amendment to the Articles of Agreement of the International Monetary Fund mark a watershed in international monetary affairs in that they allow each country to freely choose the type of exchange rate system that best suits its individuals needs. The freedom of choice is restricted only by the proviso that each member country "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates" (Revised Article IV, Section 1). The revised Articles of Agreement specifically mention that exchange arrangements may include (1) pegging to an individual currency; (2) pegging to a group of other currencies; (3) pegging of the currency to the SDR or any other denomination other than gold; or (4) other exchange arrangements of a member's choice, (Revised Article IV, Section 2).

There is little historical experience upon which countries can rely in their choice of an exchange rate system appropriate to their needs. While individual countries adopted floating exchange rates for limited periods in the fifties and sixties, generalized floating did not prevail until the early seventies. Several major countries had floating exchange rates for a while in 1971, but the Smithsonian Agreement of December 18, 1971 brought an end to this practice. Not until early 1973 did a significant group of countries again resort to floating.

Other countries have adopted exchange rate systems that resemble currency areas — and were indeed intended as a first step to eventual monetary unification or the formation of a currency area. The European system of narrower margins, generally referred to as the "snake," is the most prominent example of such a currency system. The snake has been in operation since the Basle Agreement of April 10, 1972, although its membership has fluctuated since then.

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