The International Monetary System

2

Chapter Two

Chapter Objective:

This chapter serves to introduce you to the institutional framework within which:

- International payments are made.
- The movement of capital is accommodated.
- Exchange rates are determined.

OUTLINE

- Evolution of the International Monetary System
- Current Exchange Rate Arrangements
- European Monetary System
- Euro and the European Monetary Union
- Fixed versus Flexible Exchange Rate Regimes

Evolution of the International Monetary System

- Classical Gold Standard: 1875-1914
- Interwar Period: 1915-1944
- Bretton Woods System: 1945-1972
- The Flexible Exchange Rate Regime: 1973-Present

Classical Gold Standard: 1875-1914

- During this period in most major countries:
  - Gold alone was assured of unrestricted coinage
  - There was two-way convertibility between gold and national currencies at a stable ratio.
  - Gold could be freely exported or imported.
- The exchange rate between two countries' currencies would be determined by their relative gold contents.
- Central banks could not issue more money unless they had more gold.

Classical Gold Standard: 1875-1914

For example, if the dollar is pegged to gold at U.S.$30 = 1 ounce of gold, and the British pound is pegged to gold at £6 = 1 ounce of gold, it must be the case that the exchange rate is determined by the relative gold contents:

$$\$30 = 1 \text{ ounce of gold} = £6$$

$$\$30 = £6$$

$$\$5 = £1$$

ADVANTAGES

- Exchange rate stability
- Price stability (low inflation)
- BOP adjustment occurs automatically (*price-specie-flow mechanism*)

Price-Specie-Flow Mechanism

- Suppose Great Britain exported more to France than France imported from Great Britain.
- This cannot persist under a gold standard.
  - Net export of goods from Great Britain to France will be accompanied by a net flow of gold from France to Great Britain.
  - This flow of gold will lead to a lower price level in France and, at the same time, a higher price level in Britain.
- The resultant change in relative price levels will slow exports from Great Britain and encourage exports from France.

DISADVANTAGES

- Ineffective monetary policy
  - The growth of output and the growth of gold supplies needs to be closely linked.
  - Cannot use monetary policy to fight domestic issues
- Volatility in the supply of gold could cause adverse shocks to the economy
- Difficulty in monitoring currency issued by governments
- The supply of newly minted gold is so restricted that the growth of world trade and investment can be hampered.
- Any national government could abandon the standard anytime.

INTERWAR PERIOD: 1915-1944

- Countries other than the U.S. stopped making their currencies convertible and started printing money to finance war-related expenses.
- Exchange rates fluctuated as countries widely used “predatory” depreciations of their currencies to gain advantage in the world export market.
- Attempts were made to restore the gold standard, but participants lacked the political will.
- With high inflation and large stock of outstanding money, a return to the old gold standard would entail a deep recession.

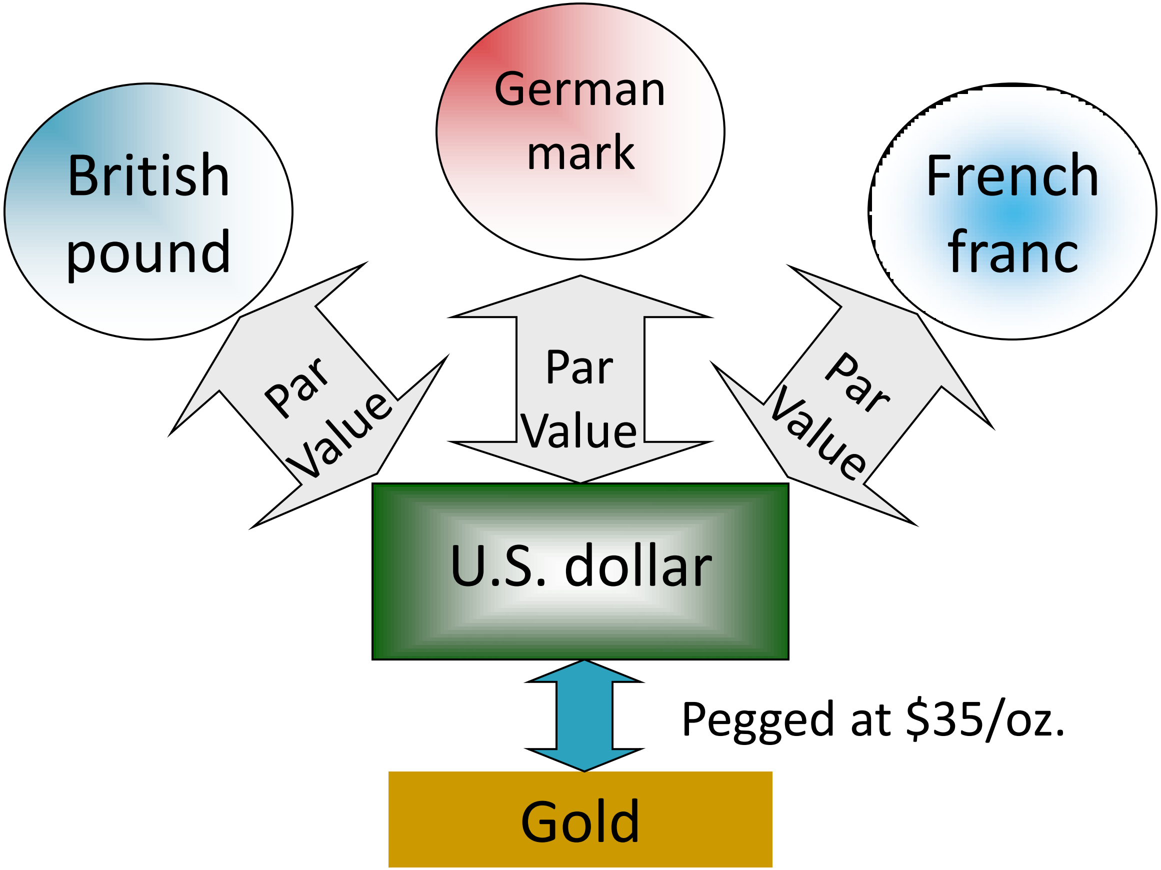
Bretton Woods System: 1945-1972

- Named for a 1944 meeting of 44 nations at Bretton Woods, New Hampshire.
- The purpose was to design a postwar international monetary system.
- The main hope was to stabilize exchange rate, provide capital for reconstruction from the war, and to foment international cooperation.
- The result was the creation of the IMF and the World Bank.

Bretton Woods System: 1945-1972

- Under the Bretton Woods system, the U.S. dollar was pegged to gold at $35 per ounce and other currencies were pegged to the U.S. dollar.
- Each country was responsible for maintaining its exchange rate within ±1% of the adopted par value by buying or selling foreign reserves as necessary.
- The Bretton Woods system was a dollar-based *gold-exchange* standard.

Bretton Woods System: 1945-1972



ADVANTAGES OF THE RESERVE CENTER COUNTRY

The U.S. was the reserve center country.

- The reserve country has no need to intervene.
- The reserve country can use monetary policy for its own domestic policy purposes while others cannot.

The Demise of the Bretton Woods System

- The U.S. began to experience trade deficits in the late 1950s through the 1960s.
- The total value of the U.S. gold stock fell short of foreign dollar holdings, casting doubt on the ability to convert $ into gold.
- Domestic U.S. policies such as the growing expenditure on the Vietnam War resulted in more printing of $
- In 1971, President Nixon suspended the convertibility of the dollar. A gold standard was replaced by a dollar standard.
- By 1973, the world had moved to search for a new financial system.

Current Exchange Rate Arrangements

- Free Float
  - The largest number of countries, about 48, allow market forces to determine their currency's value.
- Managed Float
  - About 25 countries combine government intervention with market forces to set exchange rates.
- Pegged to another currency
  - Peg to, for example, the U.S. dollar or euro.
- No national currency
  - Some countries do not bother printing their own, they just use the U.S. dollar. For example, Ecuador, Panama, and El Salvador have ***dollarized***.

European Monetary System

- Eleven European countries maintain exchange rates among their currencies within narrow bands, and jointly float against outside currencies.
- Objectives:
  - To establish a zone of monetary stability in Europe.
  - To coordinate exchange rate policies vis-à-vis non-European currencies.
  - To pave the way for the European Monetary Union.

What Is the Euro?

- The euro is the single currency of the European Monetary Union which was adopted by 11 Member States on 1 January 1999.
- These original member states were: Belgium, Germany, Spain, France, Ireland, Italy, Luxemburg, Finland, Austria, Portugal and the Netherlands.

Benefits of the Monetary Union

- Reduce transaction costs
- No exchange rate uncertainty; save hedging costs
- Enhance efficiency and competitiveness
- Promote capital market depth and liquidity
- Promote political cooperation and peace in Europe

Costs of the Monetary Union

- Loss of national monetary and exchange rate policy independence
- Loss of political independence

Optimal Currency Area

Question: Under what circumstances should a group of countries adopt a single currency?

Mundell's theory of optimal currency areas

Conditions for optimal currency area:

1. Countries should not be hit by asymmetric shocks

2. There is a high degree of labor mobility and/or wage flexibility between countries

3. There is a centralized fiscal policy in place for redistribution (rich helps poor)

The Long-Term Impact of the Euro

- If the euro proves successful, it will advance the political integration of Europe in a major way, eventually making a "United States of Europe" feasible.
- It is likely that the U.S. dollar will lose its place as the dominant world currency.
- The euro and the U.S. dollar will be the two major currencies (*and Chinese renminbi?*).

Fixed versus Flexible Exchange Rate Regimes

<u>Advantages of FIXED:</u>

- Exchange rate stability

(enhance trade, investment)

- More effective fiscal policy

<u>Weaknesses of FIXED:</u>

- Possibility of BOP crisis
- Less effective monetary policy
- FX stability may be short-lived

(may need realignment)

- Requires managing FX reserves

Fixed versus Flexible Exchange Rate Regimes

<u>Advantages of Flexible:</u>

- More effective monetary policy
- BOP crisis do not occur (in case of perfectly flexible)
- No need to intervene or to manage foreign reserves
- Facilitate adjustment to certain external shocks
- National policy autonomy

<u>Weaknesses of Flexible:</u>

- Fluctuations hurt trade & investment (But we can always hedge!)
- Less effective fiscal policy
- Subject to speculation