Managed Float

- Hybrid of fixed and flexible
  - Small daily changes in response to market
  - Interventions to prevent large fluctuations

- Appreciation hurts exporters and employment

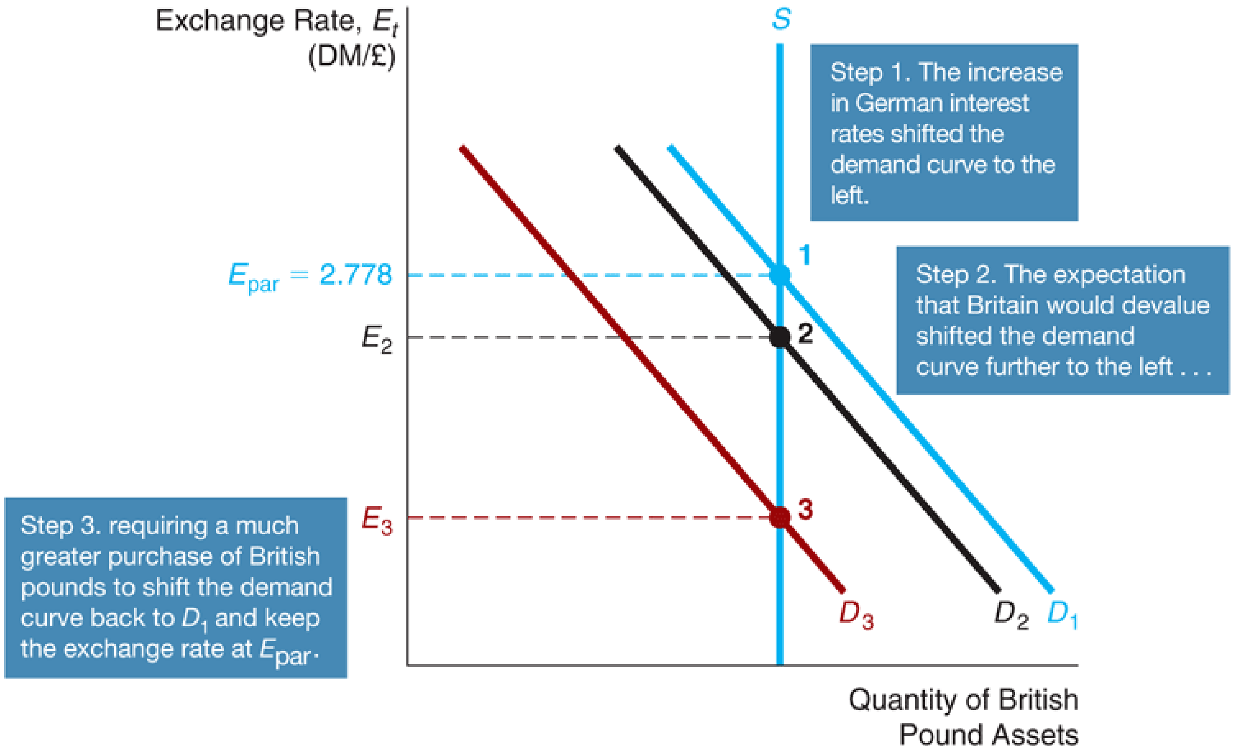
- Depreciation hurts imports and stimulates inflation

- Special drawing rights as substitute for gold

European Monetary System (EMS)

- 8 members of EEC fixed exchange rates with one another and floated against the U.S. dollar
- ECU value was tied to a basket of specified amounts of European currencies
- Fluctuated within limits
- Led to foreign exchange crises involving speculative attack

Figure 4 Foreign Exchange Market for British Pounds in 1992



The Role of the IMF

Origins:

- Before WWI, world was on a gold standard (currencies directly convertible into gold).
- WWI (1914-1918) and Great Depression (1929-1939) led to collapse of gold standard.

Bretton Woods Agreement (1944)

– Established fixed exchange rates

– Created IMF to promote world trade by helping countries maintain fixed exchange rates and avoid balance of payments crises

- Exchange rates adjusted only when experiencing a 'fundamental disequilibrium' (large persistent deficits in balance of payments). Exchange rates were only supposed to change in dire circumstances

- IMF supposed to loan international reserves to member countries to help maintain fixed rates or undertake orderly changes in these rates

- IMF encouraged contractionary monetary policies

- Devaluation only if IMF loans were not sufficient

- Problem: IMF could exert control over BOP deficit countries but not over BOP surplus countries to force E to increase

- U.S. could not devalue currency

After 1973, "flexible exchange rate system"

Flexible exchange rates work well in theory.

•In practice, flexible exchange rate systems can be “gamed” by speculators.

•Speculators can “run up” a currency by sudden surge of demand for the currency (demand curve shifts right in foreign exchange market).

•Speculators can then dump the currency at the resulting higher E price and make millions.

•To protect against this, central banks intervene by offsetting international reserve transactions.

After 1973 (Bretton Woods Agreement breakdown), IMF is no longer charged with maintaining fixed exchange rates.

However, IMF still functions as a
–Collector of international economic data

–Advisor to countries with BP problems

–Lender of last resort (international reserves).

IMF membership is voluntary, open to every independent country willing to adhere to IMF charter of rights and obligations.

•Membership in 2011 = 187 countries.

•Each member country initially contributes sum of money (“quota subscription”)

•This sum of money determines
–IMF’s pool of loanable funds
–borrowing rights of contributing country
–voting power of contributing country.

•IMF loans international reserves to member countries experiencing BOP crises.

•Loans are conditional on a country taking "appropriate economic reforms" for their own good and good of entire IMF membership.
•IMF cannot force a country to adopt any particular reform (but it can withhold loans)

IMF loans currency reserves to IMF member countries experiencing BOP crises.

•Rational for IMF as "lender of last resort":
– Permits an HC to support its current E value by obtaining ROW currency loans from the IMF
–Calms investor fears (reduces panic HC currency selling (shift of supply curve for HC currency to the right) that would worsen BOP crisis)
–Prevents spread of financial panics from one
country to another (contagion)

However:
-The safety net may lead to excessive risk taking (moral hazard problem)
-Austerity programs focus on tight macroeconomic policies rather than financial reform
-Response sometime too slow or not tough enough, which worsens crisis and increases costs

GLOBAL The Global Financial Crisis and the IMF

- When the global financial crisis became more virulent in October 2008, a number of emerging market countries, as well as Iceland and former communist countries, found that foreigners were pulling funds out of their financial systems

- The IMF created a new lending program at the end of October 2008, called the Short-Term Liquidity Facility, with $100 billion of funds to distribute loans where needed

Why is the IMF's Role in Global Financial Markets So Controversial?

•Potential inflation problems?
(injecting money into poorly managed economies)

•Moral hazard problems?
(protecting central banks from consequences of risky activities)

•Appropriateness of advice?
("one size fits all"?)

•"Economic imperialism"?
(intervening in the domestic affairs of sovereign nations)

•Timeliness of actions?
(oversight vs. speed)

Currency (Capital) Controls Instead?

Should governments simply put restrictions on HC/ROW currency flows to stop BOP crises?

- Controls on outflows
  - Promote financial instability by forcing a devaluation
  - Controls are seldom effective and may increase capital flight
  - Lead to corruption
  - Lose opportunity to improve the economy

- Controls on inflows
  - May stop speculative attacks
  - Lead to a lending boom and excessive risk taking by financial intermediaries
  - Controls may block funds for productions uses
  - Produce substantial distortion and misallocation
  - Lead to corruption

➔ Strong case for improving bank regulation and supervision

International Considerations and Monetary Policy

Balance of payment considerations:

- Current account deficits in the U.S. suggest that American businesses may be losing ability to compete because the dollar is too strong

- U.S. deficits mean surpluses in other countries$\Rightarrow$ large increases in their international reserve holdings$\Rightarrow$world inflation

Exchange rate considerations:

- A contractionary monetary policy will raise the domestic interest rate and strengthen the currency

- An expansionary monetary policy will lower interest rates and weaken currency

To Peg or Not to Peg: Exchange-Rate Targeting as an Alternative Monetary Policy Strategy

Advantages of Exchange-Rate Targeting:

- Contributes to keeping inflation under control
- Automatic rule for conduct of monetary policy
- Simplicity and clarity

Disadvantages of exchange-rate targeting:

- Cannot respond to domestic shocks and shocks to anchor country are transmitted
- Open to speculative attacks on currency
- Weakens the accountability of policymakers as the exchange rate loses value as signal

When Is Exchange-Rate Targeting Desirable for Industrialized Countries?

- Exchange-rate targeting for industrialized countries is desirable if:
  - Domestic monetary and political institutions are not conducive to good policy making
  - Other important benefits such as integration arise from this strategy

- Exchange-rate targeting for emerging market countries is desirable if:
  - Political and monetary institutions are weak (strategy becomes the stabilization policy of last resort).

Currency Boards

- Solution to lack of transparency and commitment to target
- Domestic currency is backed 100% by a foreign currency
- Note issuing authority establishes a fixed exchange rate and stands ready to exchange currency at this rate
- Money supply can expand only when foreign currency is exchanged for domestic currency
- Stronger commitment by central bank
- Loss of independent monetary policy and increased exposure to shock from anchor country
- Loss of ability to create money and act as lender of last resort

Dollarization

- Another solution to lack of transparency and commitment
- Adoption of another country's money
- Even stronger commitment mechanism
- Completely avoids possibility of speculative attack on domestic currency
- Lost of independent monetary policy and increased exposure to shocks from anchor country
- Inability to create money and act as lender of last resort
- Loss of seignorage