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Chapter 10

The International Monetary System

Introduction

Question: What is the international monetary system?

- The **international monetary** system refers to the institutional arrangements that govern exchange rates
- Recall that the foreign exchange market is the primary institution for determining exchange rates

Introduction

- A **floating exchange rate system** exists in countries where the foreign exchange market determines the relative value of a currency
 - Examples include the U.S. dollar, the European Union's euro, the Japanese yen, and the British pound
- A **pegged exchange rate system** exists when the value of a currency is fixed to a reference country and then the exchange rate between that currency and other currencies is determined by the reference currency exchange rate
 - Many developing countries have pegged exchange rates

Introduction

- A **dirty float** exists when the value of a currency is determined by market forces, but with central bank intervention if it depreciates too rapidly against an important reference currency
 - China adopted this policy in 2005
- With a **fixed exchange rate system** countries fix their currencies against each other at a mutually agreed upon value
 - Prior to the introduction of the euro, some European Union countries operated with fixed exchange rates within the context of the **European Monetary System (EMS)**

Introduction

Question: What role does the international monetary system play in determining exchange rates?

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- To answer this question, we have to look at the evolution of the international monetary system
 - The Gold Standard
 - The Bretton Woods system
 - The International Monetary Fund
 - The World Bank

Classroom Performance System

When the foreign exchange market determines the relative value of a currency, a _____ exchange rate system exists.

- a) Fixed
- b) Floating
- c) Pegged
- d) Market

The Gold Standard

Question: What is the Gold Standard?

- The origin of the gold standard dates back to ancient times when gold coins were a medium of exchange, unit of account, and store of value
- To facilitate trade, a system was developed so that payment could be made in paper currency that could then be converted to gold at a fixed rate of exchange

Mechanics of the Gold Standard

- The **gold standard** refers to the practice of pegging currencies to gold and guaranteeing convertibility
 - Under the gold standard one U.S. dollar was defined as equivalent to 23.22 grains of "fine (pure) gold"
- The exchange rate between currencies was based on the **gold par value** (the amount of a currency needed to purchase one ounce of gold)

Strength of the Gold Standard

- The key strength of the gold standard was its powerful mechanism for simultaneously achieving **balance-of-trade equilibrium** (when the income a country's residents earn from its exports is equal to the money its residents pay for imports) by all countries
- Many people today believe the world should return to the gold standard

The Period Between the Wars: 1918 - 1939

- The gold standard worked fairly well from the 1870s until the start of World War I
- After the war, in an effort to encourage exports and domestic employment, countries started regularly devaluing their currencies
- Confidence in the system fell, and people began to demand gold for their currency putting pressure on countries' gold reserves, and forcing them to suspend gold convertibility
- The Gold Standard ended in 1939

The Bretton Woods System

- A new international monetary system was designed in 1944 in Bretton Woods, New Hampshire
- The goal was to build an enduring economic order that would facilitate postwar economic growth
- The Bretton Woods Agreement established two multinational institutions
 1. The **International Monetary Fund (IMF)** to maintain order in the international monetary system
 2. The **World Bank** to promote general economic development

The Bretton Woods System

- Under the Bretton Woods Agreement
 - the US dollar was the only currency to be convertible to gold, and other currencies would set their exchange rates relative to the dollar
 - devaluations were not to be used for competitive purposes
 - a country could not devalue its currency by more than 10% without IMF approval

The Role of the IMF

- The IMF was responsible for avoiding a repetition of the chaos that occurred between the wars through a combination of

1. Discipline

- a fixed exchange rate puts a brake on competitive devaluations and brings stability to the world trade environment
- a fixed exchange rate regime imposes monetary discipline on countries, thereby curtailing price inflation

The Role of the IMF

2. Flexibility

- A rigid policy of fixed exchange rates would be too inflexible
- So, the IMF was ready to lend foreign currencies to members to tide them over during short periods of balance-of-payments deficits
- A country could devalue its currency by more than 10 percent with IMF approval

The Role of the World Bank

- The official name of the World Bank is the International Bank for Reconstruction and Development (IBRD)
- The World Bank lends money in two ways
 - under the IBRD scheme, money is raised through bond sales in the international capital market and borrowers pay what the bank calls a market rate of interest - the bank's cost of funds plus a margin for expenses.
 - under the International Development Agency scheme, loans go only to the poorest countries

Classroom Performance System

The gold standard was a _____ exchange rate system.

- a) Fixed
- b) Floating
- c) Pegged
- d) Market

The Collapse of the Fixed Exchange Rate System

Question: What caused the collapse of the Bretton Woods system?

- The collapse of the Bretton Woods system can be traced to U.S. macroeconomic policy decisions (1965 to 1968)
- During this time, the U.S. financed huge increases in welfare programs and the Vietnam War by increasing its money supply which then caused significant inflation
- Speculation that the dollar would have to be devalued relative to most other currencies forced other countries to increase the value of their currencies relative to the dollar

The Collapse of the Fixed Exchange Rate System

- The Bretton Woods system relied on an economically well managed U.S.
- So, when the U.S. began to print money, run high trade deficits, and experience high inflation, the system was strained to the breaking point
- The Bretton Woods Agreement collapsed in 1973

The Floating Exchange Rate Regime

Question: What followed the collapse of the Bretton Woods exchange rate system?

- Following the collapse of the Bretton Woods agreement, a floating exchange rate regime was formalized in 1976 in Jamaica
- The rules for the international monetary system that were agreed upon at the meeting are still in place today

The Jamaica Agreement

- At the Jamaica meeting, the IMF's Articles of Agreement were revised to reflect the new reality of floating exchange rates
- Under the Jamaican agreement
 - floating rates were declared acceptable
 - gold was abandoned as a reserve asset
 - total annual IMF quotas - the amount member countries contribute to the IMF - were increased to \$41 billion (today, this number is \$311 billion)

Exchange Rates Since 1973

- Since 1973, exchange rates have become more volatile and less predictable because of
 - the oil crisis in 1971
 - the loss of confidence in the dollar after U.S. inflation jumped between 1977 and 1978
 - the oil crisis of 1979
 - the rise in the dollar between 1980 and 1985
 - the partial collapse of the European Monetary System in 1992
 - the 1997 Asian currency crisis
 - the decline in the dollar in the mid to late 2000s

Classroom Performance System

Floating exchange rates were deemed acceptable under

- a) The Bretton Woods Agreement
- b) The Gold Standard
- c) The Jamaica Agreement
- d) The Louvre Accord

Fixed versus Floating Exchange Rates

Question: Which is better – a fixed exchange rate system or a floating exchange rate system?

- Disappointment with floating rates in recent years has led to renewed debate about the merits of a fixed exchange rate system

The Case for Floating Exchange Rates

- A floating exchange rate system provides two attractive features
 1. monetary policy autonomy
 2. automatic trade balance adjustments

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The Case for Floating Exchange Rates

1. Monetary Policy Autonomy

- The removal of the obligation to maintain exchange rate parity restores monetary control to a government
- In contrast, with a fixed system, a country's ability to expand or contract its money supply is limited by the need to maintain exchange rate parity

The Case for Floating Exchange Rates

2. Trade Balance Adjustments

- The balance of payments adjustment mechanism works more smoothly under a floating exchange rate regime
- Under the Bretton Woods system (fixed system), IMF approval was needed to correct a permanent deficit in a country's balance of trade that could not be corrected by domestic policy alone

The Case for Fixed Exchange Rates

- A fixed exchange rate system is attractive because
 1. of the monetary discipline it imposes
 2. it limits speculation
 3. it limits uncertainty
 4. of the lack of connection between the trade balance and exchange rates

The Case for Fixed Exchange Rates

1. Monetary Discipline

- Because a fixed exchange rate system requires maintaining exchange rate parity, it also ensures that governments do not expand their money supplies at inflationary rates

2. Speculation

- A fixed exchange rate regime prevents destabilizing speculation

The Case for Fixed Exchange Rates

3. Uncertainty

- The uncertainty associated with floating exchange rates makes business transactions more risky

4. Trade Balance Adjustments

- Floating rates help adjust trade imbalances

Who is Right?

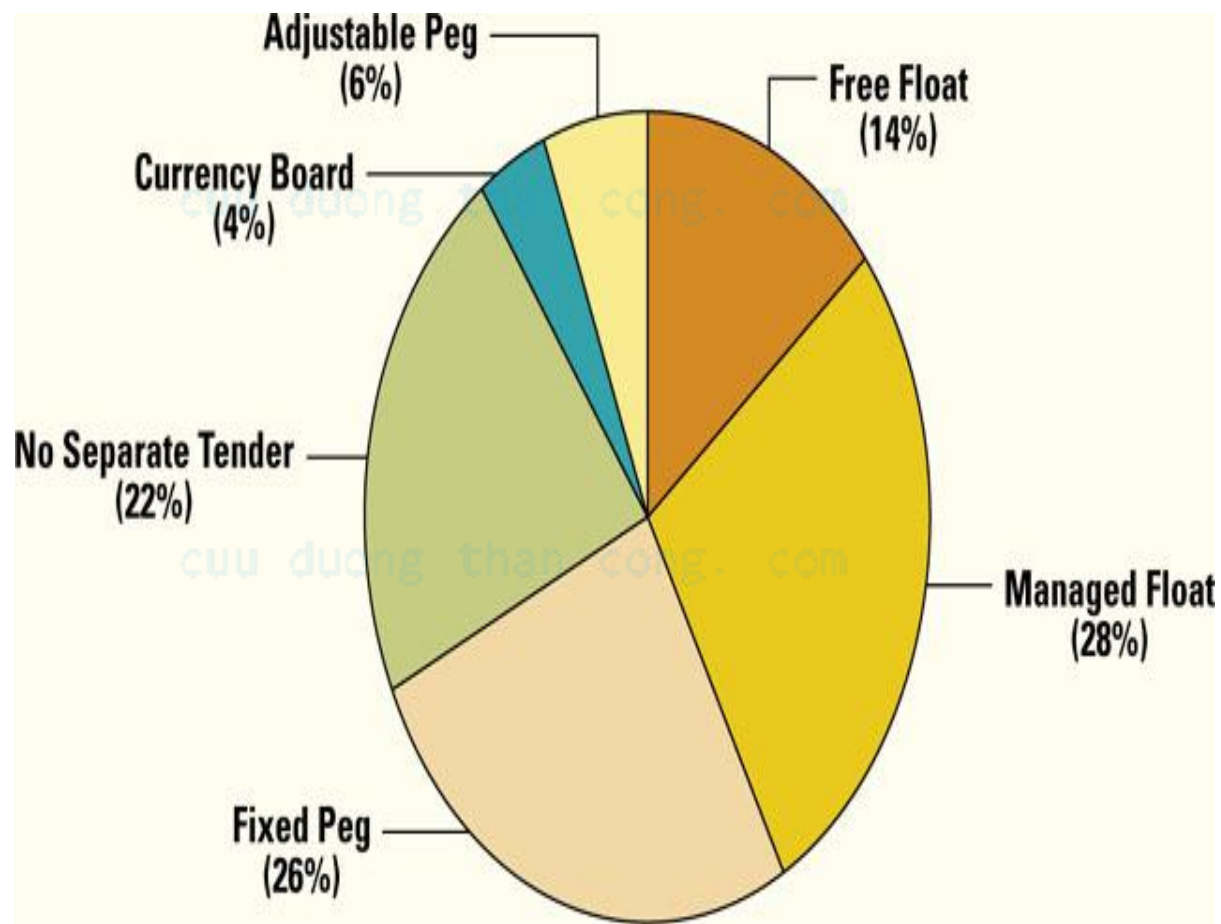
- There is no real agreement as to which system is better
- History shows that fixed exchange rate regime modeled along the lines of the Bretton Woods system will not work
- A different kind of fixed exchange rate system might be more enduring and might foster the kind of stability that would facilitate more rapid growth in international trade and investment

Exchange Rate Regimes in Practice

- Currently, there are several different exchange rate regimes in practice
- In 2006
 - 14% of IMF members allow their currencies to float freely
 - 26% of IMF members follow a managed float system
 - 28% of IMF members have no legal tender of their own
 - the remaining countries use less flexible systems such as pegged arrangements, or adjustable pegs

Exchange Rate Regimes in Practice

Exchange Rate Policies, IMF Members, 2006



Classroom Performance System

The most common exchange rate policy among IMF members today is the

- a) Free float
- b) Managed float
- c) Fixed peg
- d) Adjustable peg

Pegged Exchange Rates

- Under a pegged exchange rate regime countries peg the value of their currency to that of other major currencies
- Pegged exchange rates are popular among the world's smaller nations
- There is some evidence that adopting a pegged exchange rate regime moderates inflationary pressures in a country

Currency Boards

- A country with a **currency board** commits to converting its domestic currency on demand into another currency at a fixed exchange rate
- The currency board holds reserves of foreign currency equal at the fixed exchange rate to at least 100% of the domestic currency issued
 - Additional domestic notes and coins can be introduced only if there are foreign exchange reserves to back it

Crisis Management by the IMF

Question: What has been the role of the IMF in the international monetary systems since the collapse of Bretton Woods?

- The IMF has redefined its mission, and now focuses on lending money to countries experiencing financial crises in exchange for enacting certain macroeconomic policies
 - Membership in the IMF has grown to 185 countries in 2007, 68 of which has some type of IMF program in place

Financial Crises in the Post-Bretton Woods Era

- Three types of financial crises that have required involvement by the IMF are
 1. **A currency crisis** - occurs when a speculative attack on the exchange value of a currency results in a sharp depreciation in the value of the currency, or forces authorities to expend large volumes of international currency reserves and sharply increase interest rates in order to defend prevailing exchange rates

Financial Crises in the Post-Bretton Woods Era

- 2. A **banking crisis** - refers to a situation in which a loss of confidence in the banking system leads to a run on the banks, as individuals and companies withdraw their deposits
- 3. A **foreign debt crisis** - a situation in which a country cannot service its foreign debt obligations, whether private sector or government debt
- Two crises that are particularly significant are
 - 1. the 1995 Mexican currency crisis
 - 2. the 1997 Asian currency crisis

The Mexican Currency Crisis of 1995

- The Mexican currency crisis of 1995 was a result of high Mexican debts, and a pegged exchange rate that did not allow for a natural adjustment of prices
- In order to keep Mexico from defaulting on its debt, a \$50 billion aid package was created by the IMF
- By 1997, Mexico was well on the way to recovery

The Asian Crisis

Question: What were the causes of the 1997 Asian financial crisis?

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- The causes of the crisis can be traced to the previous decade when the region was experiencing unprecedented growth

1. The Investment Boom

- fueled by export-led growth
- large investments were often based on projections about future demand conditions that were unrealistic

The Asian Crisis

2. Excess Capacity

- investments made on the basis of unrealistic projections about future demand conditions created significant excess capacity

3. The Debt Bomb

- investments were often supported by dollar-based debts
- when inflation and increasing imports put pressure on the currencies, the resulting devaluations led to default on dollar denominated debts

4. Expanding Imports

- by the mid 1990s, imports were expanding across the region causing balance of payments deficits
- The balance of payments deficits made it difficult for countries to maintain their currencies against the U.S. dollar

The Asian Crisis

- By mid-1997, it became clear that several key Thai financial institutions were on the verge of default
- Foreign exchange dealers and hedge funds started to speculate against the Thai baht, selling it short
- After struggling to defend the peg, the Thai government abandoned its defense and announced that the baht would float freely against the dollar

The Asian Crisis

- Thailand turned to the IMF for help
- Speculation continued to affect other Asian countries including Malaysia, Indonesia, Singapore which all saw their currencies drop
- These devaluations were mainly a result of excess investment, high borrowings, much of it in dollar denominated debt, and a deteriorating balance of payments position
- South Korea was the final country in the region to fall

Evaluating the IMF's Policy Prescriptions

- Question: How successful is the IMF at getting countries back on track?
- In 2006, 59 countries were working IMF programs
- All IMF loan packages come with conditions attached, generally a combination of tight macroeconomic policy and tight monetary policy
- Many experts have criticized these policy prescriptions for three reasons

Evaluating the IMF's Policy Prescriptions

1. Inappropriate Policies

- The IMF has been criticized for having a “one-size-fits-all” approach to macroeconomic policy that is inappropriate for many countries

2. Moral Hazard

- The IMF has also been criticized for exacerbating moral hazard (when people behave recklessly because they know they will be saved if things go wrong)

Evaluating the IMF's Policy Prescriptions

3. Lack of Accountability

- The final criticism of the IMF is that it has become too powerful for an institution that lacks any real mechanism for accountability

Question: Who is right?

- As with many debates about international economics, it is not clear who is right

Implications for Managers

Question: What are the implications of the international monetary system for managers?

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○ The international monetary system affects international managers in three ways

1. Currency management
2. Business strategy
3. Corporate-government relations

Currency Management

1. Currency Management

- The current exchange rate system is a managed float
- So, government intervention and speculative activity influence currency values
- Firms can protect themselves from exchange rate volatility through forward markets and swaps

Business Strategy

2. Business Strategy

- Exchange rate movements can have a major impact on the competitive position of businesses
- The forward market can offer some protection from volatile exchange rates in the shorter term
- Firms can protect themselves from the uncertainty of exchange rate movements over the longer term by building strategic flexibility into their operations that minimizes economic exposure
 - Firms can disperse production to different locations
 - Firms can outsource manufacturing

Corporate-Government Relations

3. Corporate-Governance Relations

- Firms can influence government policy towards the international monetary system
- Firms should focus their efforts on encouraging the government to
 - promote the growth of international trade and investment
 - adopt an international monetary system that minimizes volatile exchange rates

Critical Discussion Question

1. Why did the gold standard collapse? Is there a case for returning to some type of gold standard? What is it?

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Critical Discussion Question

2. What opportunities might current IMF lending policies to developing nations create for international businesses? What threats might they create?

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Critical Discussion Question

3. Do you think the standard IMF policy prescriptions of tight monetary policy and reduced government spending are always appropriate for developing nations experiencing a currency crisis? How might the IMF change its approach? What would the implications be for international businesses?

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Critical Discussion Question

4. Debate the relative merits of fixed and floating exchange rate regimes. From the perspective of an international business, what are the most important criteria in a choice between the systems? Which system is the more desirable for an international business?

Critical Discussion Question

5. Imagine that Canada, the United States, and Mexico decide to adopt a fixed exchange rate system. What would be the likely consequences of such a system for (a) international businesses and (b) the flow of trade and investment among the three countries?

Critical Discussion Question

6. Reread the Country Focus on the U.S. dollar, oil prices, and recycling petrodollars, then answer the following questions:
- a) What will happen to the value of the U.S. dollar if oil producers decide to invest most of their earnings from oil sales in domestic infrastructure projects?
 - b) What factors determine the relative attractiveness of dollar, euro, and yen denominated assets to oil producers flush with petrodollars? What might lead them to direct more funds towards non-dollar denominated assets?
 - c) What will happen to the value of the dollar if OPEC members decide to invest more of their petrodollars towards non-dollar assets, such as euro denominated stocks and bonds?
 - d) In addition to oil producers, China is also accumulating a large stock of dollars, currently estimated to total \$1.4 trillion. What would happen to the value of the dollar if China and oil producing nations all shifted out of dollar denominated assets at the same time? What would be the consequence for the United States economy?