CHAPTER 7 (21)

INTERNATIONAL MONETARY SYSTEM: PAST, PRESENT AND FUTURE

Learning Goals

- Understand how the gold standard operated
- Describe how the post war Bretton Woods System operated and why it collapsed
- Know how the present international monetary system works
- Identify the major international economic problems facing the world today

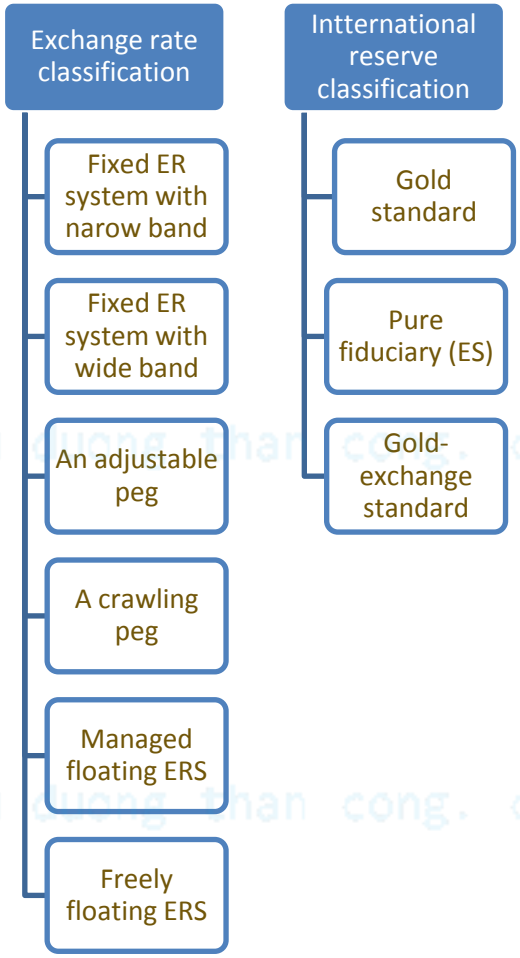
Contents

- Definition and classification
- Characteristics of an efficient international monetary system
- The first (gold standard) monetary system
- The Genoa monetary system
- The Bretton Woods system
- International economic policies and coordination under floating exchange rate

Definition

- International Monetary System (~ *order, regime):* the rules, customs, instruments, facilities, and organizastion for effecting international payments.

Classification



Characteristics of an efficient international monetary system

- Good IMS maximizes the flow of international trade and ivestments and leads to an "equitable" distribution of the gains from trade among the nations of the world

Characteristics of an efficient international monetary system

Efficient international monetary system

Adjustment

(Good IMS minimizes the cost and time required for adjustment of BoP disequilibria)

Liquidity

(Good IMS provides adequate international reserves for nation to correct BoP deficits)

Confidence

(The knowledge that the adjustment mechanism is working adequately and international reserves will retain their absolute and relative values)

Macroeconomic Goals

- "Internal balance" describes the macroeconomic goals of producing at **potential output** (or at "full employment" or with sustainable and effective use of resources) and of **price stability** (or low inflation).
  - An unsustainable use of resources (over-employment) tends to increase prices and an ineffective use of resources (underemployment) tends to decrease prices.
  - Volatile aggregate demand and output tend to create volatile prices.
    - And volatile prices makes planning for the future more difficult, imposes a cost of adjusting prices, and arbitrarily redistributes income between lenders and borrowers

Macroeconomic Goals

- "External balance" describes a current account that is not "too" negative or "too" positive.
  - A large current account *deficit* can make foreigners think that an economy can not repay its debts and therefore make them stop lending, causing a financial crisis.
  - A large current account *surplus* can cause protectionist or other political pressure by foreign governments (ex., pressure on Japan in the 1980s and China in the 2000s)

Macroeconomic Goals

- "External balance" can also mean a **balance of payments equilibrium**:
  - a current account (plus capital account) that matches the non-reserve financial account in a given period, so that official international reserves do not change.

The gold standard (1880-1914)

- Nation defined the gold content of its currency and ready to buy or sell any amount of gold at that price
- Gold content in one unit of each currency was fixed => Exchange rates were fixed = *mint parity*
- ERs fluctuated above and below the *mint parity* (within the *gold points* = the cost of shipping an amount of gold equal to one unit of the foreign currency between the two monetary centers)

The gold standard (1880-1914)

- The tendency of a currency to depreciate past the *gold export point* was halted by gold outflows from the nation (gold outflows = deficits in nation's BoP)
- The tendency of a currency to appreciate past the *gold import point* was halted by gold inflows (gold inflows = surplus in nation's BoP)

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The gold standard (1880-1914)

- The gold standard from 1870–1914 and after 1918 had mechanisms that prevented flows of gold reserves (the balance of payments) from becoming too positive or too negative.
  - Prices tended to adjust according the amount of gold circulating in an economy, which had effects on the flows of goods and services: the current account.
  - Central banks influenced financial asset flows, so that the non-reserve part of the financial account matched the current account in order to reduce gold outflows or inflows.

The gold standard (1880-1914)

- **Price specie flow mechanism** is the adjustment of prices as gold ("specie") flows into or out of a country, causing an adjustment in the flow of goods.
  - An inflow of gold tends to inflate prices.
  - An outflow of gold tends to deflate prices.
  - If a domestic country has a current account surplus in excess of the non-reserve financial account, gold earned from exports flows into the country—raising prices in that country and lowering prices in foreign countries.
    - Goods from the domestic country become expensive and goods from foreign countries become cheap, reducing the current account surplus of the domestic country and the deficits of the foreign countries.

The gold standard (1880-1914)

- Thus, price specie flow mechanism of the gold standard could automatically reduce current account surpluses and deficits, achieving a measure of external balance for all countries

The gold standard (1880-1914)

- The "**Rules of the Game**" under the gold standard refer to another adjustment process that was theoretically carried out by central banks:
  - The selling of domestic assets to acquire money when gold exited the country as payments for imports. This decreased the money supply and increased interest rates, attracting financial inflows to match a current account deficit.
    - This reversed or reduced gold outflows.
  - The buying of domestic assets when gold enters the country as income from exports. This increased the money supply and decreased interest rates, reducing financial inflows to match the current account.
    - This revered or reduced gold inflows.

The gold standard (1880-1914)

- Special conditions of the gold standard period:
  - Great economic expansion and stability
  - Pound –the only impportant international currency and London the only international monetary center (confidence)
  - Great price flexibility
- => Adjustment process was quick and smooth.
- => Any IMS would have worked fairly smooth

WWI led to an end of the classical gold standard

The Genoa monetary system

- April 1922, 27 governments: reorganized IMS
- Gold exchange standard: gold and currencies convertible into gold (pound, US dollar and French franc) – international reserves
- UK competitiveness ↓, pay for the war… =>BoP deficits and deflation
- France: Law 1928 requiring settlement BoP surplus in gold rather then in pounds; dicision to convert all of its pounds into gold => immedate cuase of the colapse of the gold exchange standard?

The Genoa monetary system

- Fundamental causes of the colapse of the gold exchange standard:
  - 1/ the lack of an adequate adjustment mechanism
  - 2/ the huge destabilzing capital flows between London and emerging interanational monetary centers of New York and Paris
  - 3/ outbreak of the Great Depression

The Bretton Woods system 1944-1973

- In July 1944, 44 countries met in Bretton Woods, New Hampshire , to design the Bretton Woods system:
  - a fixed exchange rates against the U.S. dollar and a fixed dollar price of gold ($35 per ounce).
- They also established other institutions:
  1. The International Monetary Fund
  2. The World Bank
  3. General Agreement on Trade and Tariffs (GATT), the predecessor to the World Trade Organization (WTO).

International Monetary Fund

- The IMF was constructed to lend to countries with persistent balance of payments deficits (or current account deficits), and to approve of devaluations.
  - Loans were made from a fund paid for by members in gold and currencies.
  - Each country had a quota, which determined its contribution to the fund and the maximum amount it could borrow.
  - Large loans were made conditional on the supervision of domestic policies by the IMF: **IMF conditionality**.
  - Devaluations could occur if the IMF determined that the economy was experiencing a “fundamental disequilibrium”.

International Monetary Fund

- Due to borrowing and occasional devaluations, the IMF was believed to give countries enough flexibility to attain an external balance, yet allow them to maintain an internal balance and stable exchange rates.
  - The volatility of exchange rates during 1918–1939, caused by devaluations and the vagaries of the gold standard, was viewed as a source of economic instability.

The Bretton Woods system 1944-1973

- In order to avoid sudden changes in the financial account (possibly causing a balance of payments crisis), countries in the Bretton Woods system often prevented flows of financial assets across countries.
- Yet, they encouraged flows of goods and services because of the view that trade benefits all economies.
  - Currencies were gradually made convertible (exchangeable) between member countries to encourage trade in goods and services valued in different currencies.

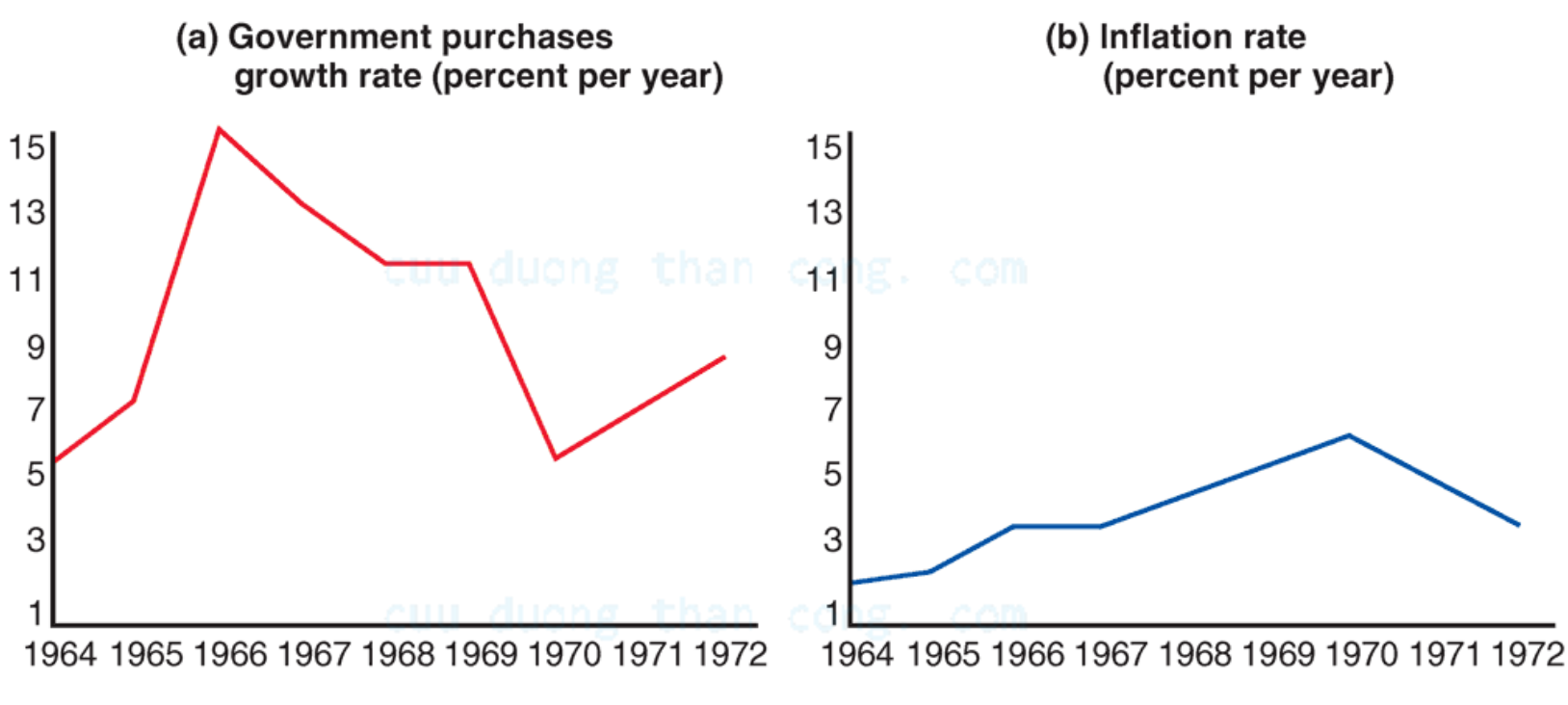
The Bretton Woods system 1944-1973

- Under a system of fixed exchange rates, all countries but the U.S. had ineffective monetary policies for internal balance.
- The principal tool for internal balance was fiscal policy (government purchases or taxes).
- The principal tools for external balance were borrowing from the IMF, restrictions on financial asset flows and infrequent changes in exchange rates.

The Bretton Woods system 1944-1973

- The collapse of the Bretton Woods system was caused primarily by imbalances of the U.S. during the 1960s and 1970s.
  - The U.S. current account surplus became a deficit in 1971.
  - Rapidly increasing government purchases increased aggregate demand and output, as well as prices.
  - Rising prices and a growing money supply caused the U.S. dollar to become overvalued in terms of gold and in terms of foreign currencies

U.S. Macroeconomic Data, 1964–1972



Source: *Economic Report of the President*, 1985. Money supply growth rate is the December to December percentage increase in M1. Inflation rate is the percentage increase in each year's average consumer price index over the average consumer price index for the previous year.

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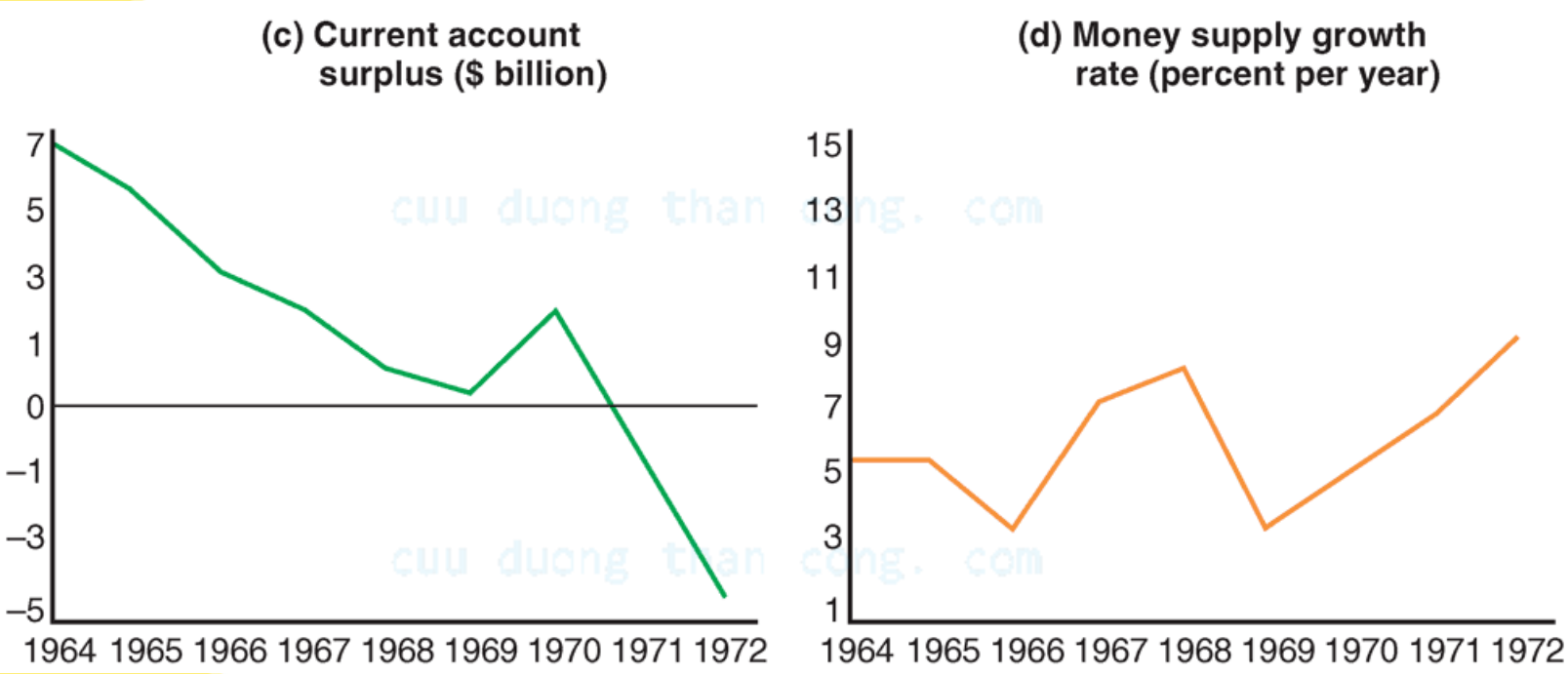

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Problems of a Fixed Exchange Rate

- Another problem was that as foreign economies grew, their need for official international reserves grew to maintain fixed exchange rates.
- But this rate of growth was faster than the growth rate of the gold reserves that central banks held.
  - Supply of gold from new discoveries was growing slowly.
  - Holding dollar denominated assets was the alternative.
- At some point, dollar denominated assets held by foreign central banks would be greater than the amount of gold held by the Federal Reserve.

Problems of a Fixed Exchange Rate

- The Federal Reserve would eventually not have enough gold: foreigners would *lose confidence* in the ability of the Federal Reserve to maintain the fixed price of gold at $35/ounce, and therefore would rush to redeem their dollar assets before the gold ran out.
  - This problem is similar to what any central bank may face when it tries to maintain a fixed exchange rate.
  - If markets perceive that the central bank does not have enough official international reserve assets to maintain a fixed rate, a balance of payments crisis is inevitable

Collapse of the Bretton Woods System

- The U.S. was not willing to reduce government purchases or increase taxes significantly, nor reduce money supply growth.
- These policies would have reduced aggregate demand, output and inflation, and increased unemployment.
  - The U.S. could have attained some semblance of external balance at a cost of a slower economy.
- A devaluation, however, could have avoided the costs of low output and high unemployment and still have attained external balance (an increased current account and official international reserves).

Collapse of the Bretton Woods System (cont.)

- The imbalances of the U.S., in turn, caused speculation about the value of the U.S. dollar, which caused imbalances for other countries and made the system of fixed exchange rates harder to maintain.
  - Financial markets had the perception that the U.S. economy was experiencing a “fundamental equilibrium” and that a devaluation would be necessary.

Collapse of the Bretton Woods System (cont.)

- First, speculation about a devaluation of the dollar caused investors to buy large quantities of gold.
  - The Federal Reserve sold large quantities of gold in March 1968, but closed markets afterwards.
  - Thereafter, individuals and private institutions were no longer allowed to redeem gold from the Federal Reserve or other central banks.
  - The Federal Reserve would sell only to other central banks at $35/ounce.
  - But even this arrangement did not hold: the U.S. devalued its dollar in terms of gold in December 1971 to $38/ounce.

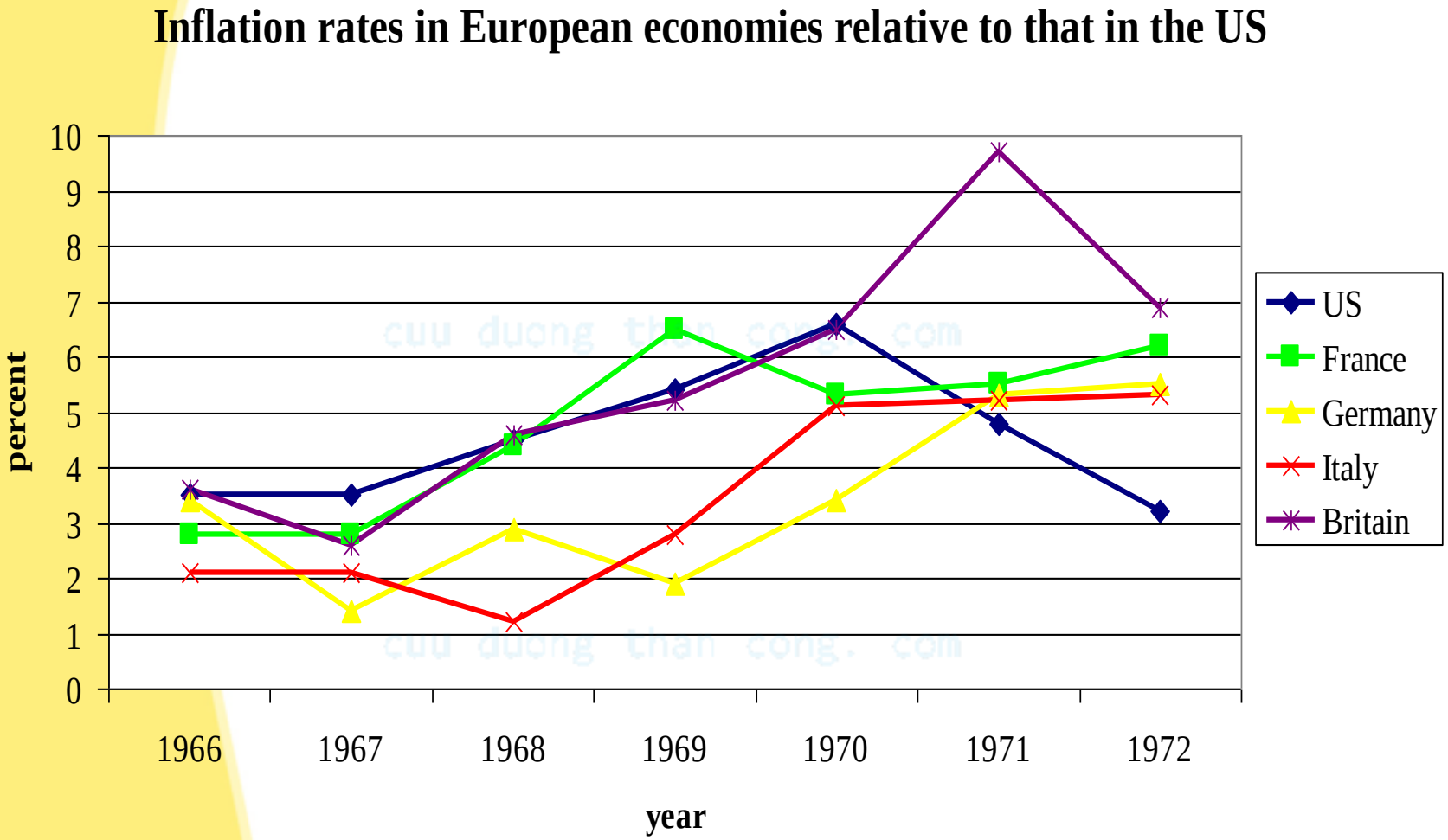
Collapse of the Bretton Woods System (cont.)

- Second, speculation about a devaluation of the dollar in terms of other currencies caused investors to buy large quantities of foreign currency assets.
  - A coordinated devaluation of the dollar against foreign currencies of about 8% occurred in December 1971.
  - Speculation about another devaluation occurred: European central banks sold huge quantities of European currencies in early February 1973, but closed markets afterwards.
  - Central banks in Japan and Europe stopped selling their currencies and stopped purchasing of dollars in March 1973, and allowed demand and supply of currencies to push the value of the dollar downward.

International Effects of U.S. Macroeconomic Policies

- Note that the monetary policy of the country which owns the reserve currency is able to influence other economies in a reserve currency system.
- In fact, the acceleration of inflation that occurred in the U.S. in the late 1960s also occurred internationally during that period.

International Effects of U.S. Macroeconomic Policies (cont.)



Source: Organization for Economic Cooperation and Development. Figures are annual percentage increases in consumer price indexes.

International Effects of U.S. Macroeconomic Policies (cont.)

- Evidence shows that money supply growth rates in other countries even exceeded the rate in the U.S.
- This could be due to the effect of speculation in the foreign exchange markets.
  - Central banks were forced to buy large quantities of dollars to maintain fixed exchange rates, which increased their money supplies at a more rapid rate than occurred in the U.S.

Changes in Germany's Money Supply and International Reserves, 1968–1972 (percent per year)

Growth rate of	1968	1969	1970	1971	1972
Money supply	6.4	−6.3	8.9	12.3	14.7
Official international reserves	37.8	−43.6	215.7	36.1	35.8

Source: Organization for Economic Cooperation and Development. *Main Economic Indicators: Historical Statistics, 1964–1983.* Paris: OECD, 1984. Figures are percentage increases in each year's end-of-year money supply or international reserves over the level at the end of the previous year. Official reserves are measured net of gold holdings.

Causes of the Collapse of the Bretton Woods System

- Immediate cause: huge BoP deficits of the US
- Fundamental causes:
  - Problem of liquidity (mostly US dollars?)
  - Problem of adjustment (US inability to devalue $ => unable to correct large and persistent BoP deficits)
  - Problem of confidence

Present (Jamaica) international monetary system

- Since 1973 the world has managed floating ERS
- Jamaica Accord 1976 formaly recognized the managed floating ERS and allow nations the choice of foreign ER regime as long as their actions did not prove disruptive to trade partners and the world economy
- Jamaica Accord took effect in April 1978

Present (Jamaica) international monetary system

- At present 187 nations members of IMF opted some form of ER flexibility
  - All of industtrial nations and manyy large developing nations (not mainland China): manage floating ER (independently or jointly)
  - Most of others: peg to $, euro, basket of currencies…

- **Crawling peg** is an exchange rate regime usually seen as a part of fixed exchange rate regimes which allows depreciation or appreciation in an exchange rate **gradually**. Some central banks use a formula which triggers a change when certain conditions are met (like need for adjustment for inflation), while others prefer not to use a preset formula and change exchange rate frequently to discourage speculations.

- **Conditionality** is a concept in international development, political economy and international relations and describes the use of conditions attached to a loan, debt relief, bilateral aid or membership of international organizations, typically by the international financial institutions, regional organizations or donor countries.

destabilizing speculation

- Speculation that increases the movements of the price in the market where the speculation occurs. Movement may be defined by amplitude, frequency, or some other measure

stabilizing speculation

- Speculation that decreases the movements of the price in the market where the speculation occurs. See destabilizing speculation. Friedman (1953) provided a classic argument that speculation on a floating exchange rate would be stabilizing