International Monetary Systems

Historical review

Historical Review

- Gold Standard: 1870 – 1914
- Interwar years: 1918 – 1939
- Bretton Woods System: 1944 – 1973
- Floating Exchange Rate: 1973 -

Gold Standard

- A commodity money standard = the value of money is fixed relative to a commodity. A gold standard is an example.
- For example, suppose
  - 1 unit of currency A = 0.10 ounce of gold
  - 1 unit of currency B = 0.20 ounce of gold

  Then

  $E_{A/B} = 0.20 \div 0.10 = 2$ = price of currency B in terms of currency A

Gold Standard (cont'd)

- The gold standard leads all countries to the balance of payment equilibrium (i.e. BOP = 0).
- BOP < 0 $\Rightarrow$ outflow of gold $\Rightarrow$ the central bank reacts by reducing its domestic credit holding $\Rightarrow$ $M^S\downarrow$
  - $\Rightarrow P\downarrow \Rightarrow EP^*/P\uparrow \Rightarrow CA\uparrow \Rightarrow BOP>0 \Rightarrow$ inflow of gold $\Rightarrow M^S\uparrow \Rightarrow P\uparrow \Rightarrow EP^*/P\downarrow \Rightarrow CA\downarrow \Rightarrow BOP = 0$
  - $\Rightarrow i\uparrow \Rightarrow$ capital inflow $\Rightarrow$ BOP = 0

Gold Standard (cont'd)

- So, the system hit by shock will restore the equilibrium.
- Long-run price stability because money supply is restricted by gold supply.

Interwar years: 1918 - 39

- During WWI, the gold standard was abandoned by many countries.
- 1919: US returned to the gold standard
  ← little inflation during the war
- 1925: Britain returned to the gold standard at the parity prevailing before the war

Britain's case

$M^S\uparrow$ during and after the war $\Rightarrow$ $P\uparrow$

So, Britain had to have contractionary monetary policies $\Rightarrow$ unemployment$\uparrow$

$\Rightarrow$ economic stagnation in 1920s

$\Rightarrow$ London's decline as int'l financial center

$\Rightarrow$ Pound holders lost confidence in pounds and began converting their pound to gold $\rightarrow$ a run on British gold reserves

$\Rightarrow$ 1931 Britain was forced to abandon the gold standard

US’s case

- 1931: A run on US gold $\rightarrow$ 15% drop in US gold holdings
- 1933: US left the gold standard.
- 1934: US returned to the gold standard at $35 per ounce (devaluation from $20.67).

1930s

- Great depression $\Rightarrow$ Int'l economic disintegration
- A period of competitive devaluations: In trying to stimulate domestic economies by increasing exports, country after country devalued.
- FX controls
- Trade barriers

$\rightarrow$ int'l monetary warfare

Bretton Woods System: 1944 - 1973

- A desire to reform the int’l monetary system to one based on mutual cooperation and freely convertible currencies.
- 1944: Bretton Woods Agreement

Bretton Woods Agreement

- 1. International Monetary Fund (IMF)

  Purpose: To lend FX to any member whose supply of FX had become scarce. (To help the countries facing difficulty: CA deficit $\Rightarrow$ tight monetary policy $\Rightarrow$ employment$\downarrow$).

  Lending would be conditional on the member's pursuit of economic policies that IMF would think appropriate (IMF Conditionality).

Bretton Woods Agreement

- 2. The US dollar would be designed as a reserve currency, and other nations would maintain their FX reserves in the form of dollars.
- 3. Each country fixed its ex rate against the dollar and the value of dollar is defined by the official gold price $35 per ounce (Gold Exchange Standard).

Bretton Woods Agreement

- 4. A Fund member could change its par value only with Fund approval and only if the country’s BOP was in “fundamental disequilibrium”.
- 5. Countries would have to make a payment (subscription) of gold and currency to the IMF in order to become a member.

Bretton Woods System

- Fixed ex rate system imposes restriction on monetary policy of countries. Floating ex rates were regarded as a cause of speculative instability.

Decline and Fall of the Bretton Woods System

- 1958-65: Private capital outflows from US
- 1965-68: Johnson Administration

  The bad US macroeconomic policy package caused considerable damage to the US economy and the int'l monetary system.

  - Involvement in the Vietnam conflict
  - "Great Society" program

  $\Rightarrow G\uparrow \Rightarrow \text{Deficit}\uparrow \Rightarrow M^S\uparrow \Rightarrow P\uparrow$ & $CA\downarrow$ (stagflation)

Decline of and Fall of BW system

- 1971: US CA deficit $\Rightarrow$ massive private purchase of DM $\Rightarrow$ Bundesbank intervened in FX market by buying huge amount of dollars, then it gave up and allowed the DM to float.
- August 1, 1971: Nixon’s announcement
  - Stop to sell gold for dollars to foreign central banks
  - 10% tax on all imports until revaluation of each country’s currency against the dollars
  - Freeze on prices and wages.

Smithsonian agreement

- December 1971: Smithsonian agreement
  - The dollar was devalued against foreign currencies by about 8% ($38 per ounce of gold).
  - The currencies of the surplus countries were revalued.
  - Maintain the ex rate within ±2.25% of the stated parity.

Floating Exchange Rates: 1973 -

- Speculative attacks on the pound and the lira
- 1972: Britain allowed the pound to float.
- 1972-73: speculators began selling dollars massively.
- 1973: US devalued the dollar again ($42.22 per ounce of gold).
- By March 1973 major currencies were all floating.
- Managed float: central banks frequently intervene.

Choice of Exchange Rate Regimes

- Fixed or pegged ex rates would work like a gold standard.
- To keep their prices fixed, countries have to buy or sell their currencies in FX market (FX market Intervention).
- Floating (Flexible) ex rates --- the ex rates are determined by the market forces of demand and supply.
- No intervention takes place.

A variety of ex rate system

- Managed Floating: MA influences ex rates through active FX market intervention
- (Independently) Floating: the ex rate is market determined. No FX intervention.
- Currency Board: A legislative commitment to exchange domestic currency for a specified foreign currency at a fixed ex rate.

A variety of ex rate system

- Fixed Peg: The ex rate is fixed against a major currency. Active intervention needed.
- Crawling Peg: The ex rate is adjusted periodically in small amounts at a fixed, preannounced rate.
- Dollarization: The dollar circulates as the legal tender.

Advantage of Flexible rates

- Each country can produce independent macroeconomic policies.
- Countries can choose different inflation rates.

Advantage of Fixed rates

- Stable ex rates
- Each country's inflation rate is "anchored" to the inflation rate in the US. $\Rightarrow$ price stability

Disadvantage of Flexible rates

- The system is subject to destabilizing speculation
  - Increase the variability of ex rates
  - Self-fulfilling prophecy
  - “evening out” swings in ex rates

Disadvantage of Fixed rates

- A country cannot follow macroeconomic policies independent of those of other countries.
- To maintain the fixed rates, countries need to share a common inflation experience.

Choice of Peg or Float

- Peg
  - Small size (GDP)
  - Open economy
  - Harmonious inflation rate
  - Concentrated trade
- Float
  - Large size
  - Closed economy
  - Divergent inflation rate
  - Diversified trade