

Chapter 3 The International Monetary System

Alternative exchange rate Systems
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Alternative exchange rate Systems:

- 1) A *floating exchange rate* is where *markets forces largely set the exchange rate*
- 2) A *managed float* is when a nation, from time-to-time, *attempts to reduce the impact of market forces* on its exchange rates, through its central bank.
- Managed floats are probably most common among major currencies.

Alternative exchange rate Systems:

- 3) A *fixed exchange rate*: the currency has a target rates based on another currency or a basket of other currencies.
- For examples of modern fixed exchange rates arrangements, see Exhibit 3.4.
- *China is linked to the USD in two different ways.*

Alternative Exchange-rate Systems:

- The old European Monetary System (EMS) was an example of a *target-zone arrangement*.
- The currencies in the EMS were tied to one another (really they were anchored to the the D Mark), *but allowed to fluctuate within a specific band*.
- This arrangement was the *predecessor for a single currency, the Euro*, replacing 12 or more different European currencies.

Alternative Exchange-rate Systems:

- *Current System* can best be characterized as a *hybrid system*.
- Major currencies such as the \$, Yen, Euro, and Pound use a *largely* floating method,
- while others *move in and out* of various fixed-rate or loosely-linked systems.

How Market Forces Affect Currency

- *1) Domestic inflation*: high inflation means a currency is losing local purchasing power.
- Example: Suppose it now costs twice as much to buy US cars, food, etc.
- Also, suppose Japan has no inflation, so cars, etc. still cost the same in Japan in terms of Yen.
- *If the exchange remains fixed*, American consumers will probably want to mostly Japanese cars as the cars still sell at the old price. The Japanese will only want to buy Japanese products.
- Thus little demand for USD, high demand for Yen. Price of USD should fall until?....

How Market Forces Affect Currency

- 2) **Raising interest rates** can make a currency more attractive to short-term investors.
- Raising rates is also associated with 'tighter' monetary policy – where inflation is less likely to be a problem in the future.
- 3). **High economic growth makes a country's stock market, and direct investments attractive.** One must first buy the USD in order to buy U.S. Investments.
- High US economic may explain the USD's strength in recent years.

1997: The Thai Baht

- First of the "Asian Contagion" currencies to fall.
- Pegged to the USD, the government eventually allowed the Baht to float. Devaluation of then pegged Korean Won, Malaysian Ringgit, etc. soon followed.
- The Baht fell because
- (1) domestic inflation had made the Baht overvalued.
- (2) Thailand was running a large trade deficit.
- (3) an economic slowdown had made Thailand less attractive to foreign investors.

1997-9 The Hong Kong Dollar

- Pegged to the U.S. dollar since 1982. The only currency in Asia that did not succumb to the "contagion".
- **Uses a currency board:** where the HK\$ is backed a huge amount of USDs. Peg has easily held over several crises.
- The HK government intervened (bought, big time) in the HK currency and the HK stock markets in the summer of 1998, and basically wiped out a number of short-selling speculators.
- Earned itself \$ billions in profits while doing this.

1998-9 The Brazilian Real:

- Because inflation was very high when the Real was first introduced at parity with the USD, the Real was now overvalued and Brazil had large trade deficit.
- After, a long period of using reserves to support the Real, the central bank went to a floating Real -a managed float.
- Note: unlike Mexico, the Brazilian intervention was not sterilized - Brazil ran a **tight monetary policy**, meaning **the central bank kept interest rates kept high and money supply growth low.**

1998-9 The Brazilian Real:

- Unfortunately Brazil also had a **loose fiscal policy**, meaning **taxes did not support government spending, so government deficits were high.**
- Government borrowing threatened to crowd out private borrowing unless the debt was monetized.
- Finally allowed the Real to float, lowered the need for high rates to keep money in the country.
- Speculators no longer were betting the currency would fall.

1998-9 The Brazilian Real:

- 2002, Brazil is under pressure from international investors who were burned when Argentina defaulted.
- When one country in a region gets into trouble, the effect often spreads, whether deserved or not, to neighboring countries.
- Investors now perceive higher risk in Brazil.
- The IMF has extended additional loans to Brazil.

Alternatives to Devaluation

- **Foreign Borrowing**, the local Central Bank borrows foreign reserves from, say, the Federal Reserve: Short-term solution (allows intervention to go on a little longer). The U.K. in 1992. Usually just postpones the inevitable.
- **Austerity**: IMF mostly promotes it - although lately not so much): **Keep domestic interest rates high, reduce government deficits.**
- Higher interest rates mean
- 1) it is more expensive to borrow local currency in order to buy USDs (as a speculation).
- 2) it is more attractive for locals to risk keeping their money in Reals, Baht, Pesos etc.

Alternatives to Devaluation

- **Austerity**: Also has the effect of reducing domestic inflation; if that is the cause of the weak currency, and high rates will also slow down economic growth, which reduces imports - thus improving the trade balance. Brazil tried it for a while, they finally floated, and they're still trying it.
- **Major criticism of Austerity**: the often poor economic growth from these measure **discourages foreign investment flows into the country** - so things could actually get worse (I never said this stuff was easy).
- **Supply-side economists hate the austerity policy.**

Alternatives to Devaluation

- **Exchange Controls**: since there are too many currency units on the foreign exchange market, **reduce the outflow of your currency by legislation or decree.**
- If people are allowed to freely sell the £ for, \$ or € then the selling increases the supply of the Pound, pushing the values down.
- Instead, the Govt. severely limits imports – since these transactions result in currency leaving the country.
- The amount of cash you can leave the country with is also limited (£50 for British tourists in the late 1960s)
- Discredited in Developed Countries (the U.K.) but not in the LDCs. China uses currency controls

History of Monetary System

- We start with **private and government coinage**: people used gold, silver and other metals.
- Role of government: **minted coins of standard value**, this reduced the need to exchange coins. Helped speed acceptance of coinage as a **medium of exchange.**
- Sometimes government abused this role by adding base metal to the precious metal. Old coins could be melted down, and lead added to get several new coins.
- This **debasement** (base metals added to precious metals) usually caused **inflation.**
- The debasement problem gave us **Gresham's Law**: **"Bad money drives out good."**

History of Monetary System

- Gold coins were heavy, could wear and it was dangerous for traveling merchants to carry large amounts.
- Instead, certainly by the Italian Renaissance, merchants would leave the gold with banks and travel with a draft or **note from bank representing ownership of the gold.**
- Thus, the ownership of the gold could be transferred to another merchant without have to move the gold from town to town.
- The gold was stored at the issuing bank. **The gold receipts themselves, became mediums of exchange,** and the **banknotes** became modern currency.
- Famous banking families could have branches in several cities. Medici, etc.

History of Monetary System

- Eventually government took over the issuance of paper money. For a time these notes were also convertible into Gold.
- For the currency to be 'acceptable', it needed to be backed by gold. Otherwise, government could print notes that became worthless.
- The supply of money was largely a function of mine output. Large gold strikes, like the California Gold Rush of 1849, could cause inflation!
- In the 1500s, Spanish gold and silver from Mexico and South America resulted in prices doubling in Europe.
- **Prices fell (deflation) when gold mine output fell behind world economic growth.**

History of Monetary System

- Still, in spite of short-term changes in the relative amount of gold, under the gold standard, there was little 'long-term' inflation.
- See Exhibit 3.5
- The gold standard was used for centuries and became a trusted way to back government currency.
- WWI bankrupted many countries (for example, Germany) and these dropped the gold standard.
- Germany then printed 'marks' without restraint - the policy caused *hyperinflation*.

History of Monetary System

- Others stayed with gold and suffered *30% deflation in prices*. (USA, UK). Deflation is very hard on borrowers (business, farmers)
- To deal with the *deflation*, the U.S. "*devalued*" the dollar relative to gold: from \$20/oz of gold, to \$32/oz. in the early 1930s. Essentially, this was the start of the end of the gold standard.
- This devaluation was meant to *expand the money supply* that was backed by gold and *stop price deflation*.
- *Historical note*: The old \$20 gold coins, the "double eagles", contained about one ounce of gold.

History of Monetary System

- Some believe the economic morass of the 1930s led to the rise of Hitler and WWII.
- *Bretton Woods System: 1944-71*: attempt to control world money supply without inflation or deflation.
- Only the U.S. dollar directly tied to gold.
- *Other currencies pegged to the USD, but on an indirect gold standard through their dollar reserves*.
- Central Banks held USD reserves *that in theory* could be converted into gold, held by the Federal Reserve and at Fort Knox. *However, in reality, this gold standard really a dollar standard.*

History of Monetary System

- *In theory, the Bretton Woods System could work better than the Gold Standard.*
- Under the gold standard, money supply and inflation was a function of mine output.
- World spent too much time and energy "*digging gold out of one hole and burying it in another*". JM Keynes characterized gold as a "*barbarous relic*".
- A wise US central bank could better control the underlying world money supply.
- Unfortunately, the *Federal Reserve was not wise*.

History of Monetary System

- Inflation became 'built in' as the *Fed monetized too much debt*.
- Vietnam and the 'Great Society' spending in the 1960's *accelerated the inflationary trend*. When the *U.S. government* became reluctant to raise taxes for an unpopular war, they *borrowed* instead. *The Fed monetized too much of the debt, too prevent crowding out of private borrowing*.
- See Exhibit 3.6: prices rose in the US, and this inflation spread world-wide.

History of Monetary System

- The Deutsche mark, Swiss franc, and the Yen were all now backed by an inflationary asset.
- France, (not a team player), specifically Charles DeGaulle, demanded gold for its dollar reserves.
- 1971-1973: An attempt to keep the dollar on some kind of gold standard: US\$ devalued (again) from 1/32 to 1/38 oz of gold.
- By 1973: World officially on a freely floating exchange rate system. Dollar *depreciated* against the "*undervalued*" Yen, DM, CHF.

History of Monetary System

- Conclusions:
- **Gold-backed currencies** are inflexible and can retard economic growth when gold is in short supply.
- **Fiat currency** (not backed) can lead to better price stability - if the central bank can avoid excessive money creation.
- People are now beginning to trust currencies again as many central banks seem to be taking their primary role of price stability more seriously. Central Bank independence from government pressure has been a key force in modern monetary finance

The European Monetary System

- **The European Monetary System (EMS)** was put in place as a **target-zone arrangement** in 1979, as a first step towards a single currency. **It required close macroeconomic policy coordination** to bring down inflation, etc to German levels.
- **Maastricht Treaty** approved in 1998 called for a single currency. **Finally named the Euro**, a stupid name which is confused with Eurodollars, EuroMarks etc.
- **Euro** introduced in many financial transactions in 1999, (stock markets quoted in Euros).
- **Euro currency began circulation in 2002.**

The European Monetary System

- Lead to economic reform such as ending much of state ownership and regulation of banks, utilities.
- Resulting **Privatization of state-owned industries** was good for local stocks markets.
- Citizens usually got a number of these shares at a discount. (at the initial public offering)
- Creation of the European Central Bank.
- Benefits of A Single Currency: Eliminates currency transactions costs and exchange rate risk within "Euroland".

The European Monetary System

- The Euro has created a "critical mass" of currency users that is similar in size to the USD. Financial markets based on the Euro have growth quickly since its introduction.
- Main cost of the Euro: loss of each country's freedom to set monetary policy.
- But, this freedom has been historically abused by Italy, Greece, France, UK, etc. So this loss of flexibility may not be such a bad thing.

The European Monetary System

- Who gets the seigniorage? Based on a formula linked to population and size of the economy. See the article on the web site.