

Chapter 20

International Monetary Arrangements

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The Gold Standard

- Current 'system' is a mix of floating, pegged and inconvertible currencies
- Gold Standard:
 - An international monetary system where the value of each currency was fixed in terms of gold
 - Operated from 1870 to 1914
- Each country defined the gold content of its currency.
 - Could exchange a piece of paper for gold
- Official Parity Price:
 - Price of each currency in terms of gold

The Gold Standard

- Since each currency was known and fixed, exchange rates between countries were also fixed.
- Little to no inflation
 - Gov't must raise taxes or sell bonds
 - No Inflation risk
- Fixed exchange rates gave significant security to overseas business.
 - No Exchange Rate risk!

The Gold Standard

- Country's monetary base consisted of gold or currency backed by gold.
- Any balance of payments imbalance at current fixed exchange rate would set into motion a correction process to correct the imbalance.
 - $BoP = CA + KA$

The Gold Standard

- Balance of payments deficit
 - Rest of world accumulates more dollars than desired
 - Gold outflows from US to rest of world
 - Occurred automatically as dollars become cheaper in the foreign-exchange market
 - Traders could make small profits purchasing gold at fixed price with cheaper dollars.

The Gold Standard

- What happens in US? Gold flows out of the country
 - Outflow of gold causes the monetary base to fall or grow at a slower rate
 - Change in money supply would affect interest rates and aggregate demand to correct balance of payments deficit

The Gold Standard

- Benefits
 - Adjustment of price level and output to an external imbalance is completely automatic
 - Country only needs to be willing to buy and sell gold at stated price
 - No question what would happen if experience an external imbalance
 - Long-run price stability for economy
 - Average inflation rate for US during gold standard was 0.1 percent.

The Gold Standard

- Costs
 - Does not guarantee short-run price stability
 - Could have inflation some years and deflation others - Adjustment is a long-term deal
 - Overall balance of payments position heavily influences country's money supply
 - Deficit: contracting money and economy
 - Surplus: overheated economy with inflation
 - Therefore - unstable GDP growth rate

Bretton Woods

- Gold Exchange Standard:
 - International monetary system where the price of one currency is tied to gold, but all other currencies are tied to the value of that currency
 - U.S. dollar tied to gold but all other foreign currencies tied to dollar
- Countries agreed to creation of the International Monetary Fund (IMF)
 - International monetary institution

Purpose of Bretton Woods

- Countries' strong desire for a monetary system with fixed exchange rates
- Design a method to decouple the link between balance of payments and the money supply
- Bottom Line - Stability and Predictability

Bretton Woods

- Price of gold fixed at \$35 (Today's price: \$1208)
 - U.S. to maintain fixed price
 - U.S. would exchange dollars for gold at stated price without limitation or restrictions.
- Other currencies fixed to U.S. dollar
 - Meant other currencies fixed in relation to one another

Trouble with Bretton Woods

- Government had to actively intervene in the foreign-exchange market
 - Governments would have to buy or sell domestic or foreign currency to keep domestic currency from appreciating or depreciating.
- Measures needed to maintain currency stability might conflict with policies needed to respond to internal recessions or periods of growth

The IMF

- The Central Bank to the world's Central Banks - lender of last resort when countries have financial issues
- IMF restricted borrowing government to pursue monetary and fiscal policies consistent with long-run external balance
- Plays a major role today in developing countries as an aid agency

The Trouble with IMF

- No Profit motive makes for poor incentives for the bankers
- Bad reputation as being an instrument of the West
- Political Institution
- Poor Results as Aid Agency

The Demise of Bretton Woods

- Lack of Symmetry - focus on BoP deficits, but no attention to BoP Surpluses
 - Could not force country to pursue policies to correct surpluses
- US Currency Issues
 - Foreign banks increased holding of dollars
 - Surplus countries had to sell domestic currency for dollars to keep domestic currency from appreciating
 - Foreign central banks holding amount of dollars larger than US stock of gold at \$35/ounce

After Bretton Woods

- In 1971, US refused to continue to exchange gold for dollars and removed us from the gold exchange standard
- What to do?
 - Clean Float - let the market work
 - Monetary Policy becomes very critical
 - Peg the currency to another currency
 - Can moderate the risk to international traders
 - Inflation must be kept on par with that of pegged country
 - Dollarization - use another country's currency as your own

Today's 'System'

- Currently:
 - No rules
 - Each country can pursue own choices of policies
 - Countries are free to target internal balances
- Why no new system?
 - Movement toward more stable exchange rates requires more rules and/or more cooperation.
 - Moving toward gold standard takes away monetary policy so unlikely
 - Increasing cooperation is almost impossible if there are no rules
 - Unlikely to move from current system

Summary

- The gold standard operated from 1870-1914 and managed country's money supply.
- Bretton Woods, NH, in 1944, 44 countries created a new international monetary system called the gold-exchange standard.
 - Price of gold was defined in terms of the U.S. dollar

Summary

- The U.S. announcement in August 1971 that it would no longer redeem dollars for gold, ended the gold-exchange system.
- The current international monetary system is an array of currencies that :
 - Float
 - Are Pegged
 - Are Inconvertible

Final Exam

- 50 Multiple Choice questions
- Bring Scantron 882E and pencil(s)
- Covers all material from the semester - including articles on internet
- Will take 1 hour and 15 minutes.