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CHAPTER 2 INTERNATIONAL MONETARY SYSTEM
ANSWERS & SOLUTIONS TO END-OF-CHAPTER QUESTIONS AND PROBLEMS

QUESTIONS

1. Explain Gresham's Law.

Answer: Gresham's law refers to the phenomenon that bad (abundant) money drives good (scarce) money out of circulation. This kind of phenomenon was often observed under the bimetallic standard under which both gold and silver were used as means of payments, with the exchange rate between the two fixed.

2. Explain the mechanism which restores the balance of payments equilibrium when it is disturbed under the gold standard.

Answer: The adjustment mechanism under the gold standard is referred to as the price-specie-flow mechanism expounded by David Hume. Under the gold standard, a balance of payment disequilibrium will be corrected by a counter-flow of gold. Suppose that the U.S. imports more from the U.K. than it exports to the latter. Under the classical gold standard, gold, which is the only means of international payments, will flow from the U.S. to the U.K. As a result, the U.S. (U.K.) will experience a decrease (increase) in money supply. This means that the price level will tend to fall in the U.S. and rise in the U.K. Consequently, the U.S. products become more competitive in the export market, while U.K. products become less competitive. This change will improve U.S. balance of payments and at the same time hurt the U.K. balance of payments, eventually eliminating the initial BOP disequilibrium.

3. Suppose that the pound is pegged to gold at 6 pounds per ounce, whereas the franc is pegged to gold at 12 francs per ounce. This, of course, implies that the equilibrium exchange rate should be two francs per pound. If the current market exchange rate is 2.2 francs per pound, how would you take advantage of this situation? What would be the effect of shipping costs?

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Answer: Suppose that you need to buy 6 pounds using French francs. If you buy 6 pounds directly in the foreign exchange market, it will cost you 13.2 francs. Alternatively, you can first buy an ounce of gold for 12 francs in France and then ship it to England and sell it for 6 pounds. In this case, it only costs you 12 francs to buy 6 pounds. It is thus beneficial to ship gold due to the overpricing of the pound. Of course, you can make an arbitrage profit by selling 6 pounds for 13.2 francs in the foreign exchange market. The arbitrage profit will be 1.2 francs. So far, we assumed that shipping costs do not exist. If it costs more than 1.2 francs to ship an ounce of gold, there will be no arbitrage profit.

4. Discuss the advantages and disadvantages of the gold standard.

Answer: The advantages of the gold standard include: (I) since the supply of gold is restricted, countries cannot have high inflation; (2) any BOP disequilibrium can be corrected automatically through cross-border flows of gold. On the other hand, the main disadvantages of the gold standard are: (I) the world economy can be subject to deflationary pressure due to restricted supply of gold; (ii) the gold standard itself has no mechanism to enforce the rules of the game, and, as a result, countries may pursue economic policies (like de-monetization of gold) that are incompatible with the gold standard.

5. What were the main objectives of the Bretton Woods system?

Answer: The main objectives of the Bretton Woods system are to achieve exchange rate stability and promote international trade and development.

6. Comment on the proposition that the Bretton Woods system was programmed to an eventual demise.

Answer: The answer to this question is related to the Triffin paradox. Under the gold-exchange system, the reserve-currency country should run BOP deficits to supply reserves to the world economy, but if the deficits are large and persistent, they can lead to a crisis of confidence in the reserve currency itself, eventually causing the downfall of the system.

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7. Explain how special drawing rights (SDR) are constructed. Also, discuss the circumstances under which the SDR was created.

Answer: SDR was created by the IMF in 1970 as a new reserve asset, partially to alleviate the pressure on the U.S. dollar as the key reserve currency. The SDR is a basket currency currently comprised of five major currencies, i.e., the U.S. dollar, euro, Chinese yuan, Japanese yen, and British pound. Currently, the dollar receives a 41.73% weight, euro 30.93%, yuan 10.92, yen 8.33%, and pound 8.09%. The weights for different currencies tend to change over time, reflecting the relative importance of each currency in international trade and finance.

8. Explain the arrangements and workings of the European Monetary System (EMS).

Answer: EMS was launched in 1979 in order to (i) establish a zone of monetary stability in Europe, (ii) coordinate exchange rate policies against the non-EMS currencies, and (iii) pave the way for the eventual European monetary union. The main instruments of EMS are the European Currency Unit (ECU) and the Exchange Rate Mechanism (ERM). Like SDR, the ECU is a basket currency constructed as a weighted average of currencies of EU member countries. The ECU works as the accounting unit of EMS and plays an important role in the workings of the ERM. The ERM is the procedure by which EMS member countries manage their exchange rates. The ERM is based on a parity grid system, with parity grids first computed by defining the par values of EMS currencies in terms of the ECU. If a country's ECU market exchange rate diverges from the central rate by as much as the maximum allowable deviation, the country has to adjust its policies to maintain its par values relative to other currencies. EMS achieved a complete monetary union in 1999 when the common European currency, the euro, was adopted.

9. There are arguments for and against the alternative exchange rate regimes.
   a. List the advantages of the flexible exchange rate regime.
   b. Criticize the flexible exchange rate regime from the viewpoint of the proponents of the fixed exchange rate regime.
   c. Rebut the above criticism from the viewpoint of the proponents of the flexible exchange rate regime.

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Answer: a. The advantages of the flexible exchange rate system include: (I) automatic achievement of balance of payments equilibrium and (ii) maintenance of national policy autonomy.
b. If exchange rates are fluctuating randomly, that may discourage international trade and encourage market segmentation. This, in turn, may lead to suboptimal allocation of resources.
c. Economic agents can hedge exchange risk by means of forward contracts and other techniques. They don't have to bear it if they choose not to. In addition, under a fixed exchange rate regime, governments often restrict international trade in order to maintain the exchange rate. This is a self-defeating measure. What's good about having the fixed exchange rate if international trade need to be restricted?

10. In an integrated world financial market, a financial crisis in a country can be quickly transmitted to other countries, causing a global crisis. What kind of measures would you propose to prevent the recurrence of an Asia-type crisis.

Answer: First, there should be a multinational safety net to safeguard the world financial system from the Asia-type crisis. Second, international institutions like IMF and the World Bank should monitor problematic countries more closely and provide timely advice to those countries. Countries should be required to fully disclose economic and financial information so that devaluation surprises can be prevented. Third, countries should depend more on domestic savings and long-term foreign investments, rather than short-term portfolio capital. There can be other suggestions.

11. Discuss the criteria for a 'good' international monetary system.

Answer: A good international monetary system should provide (i) sufficient liquidity to the world economy, (ii) smooth adjustments to BOP disequilibrium as it arises, and (iii) safeguard against the crisis of confidence in the system.

12. Once capital markets are integrated, it is difficult for a country to maintain a fixed exchange rate. Explain why this may be so.

Answer: Once capital markets are integrated internationally, vast amounts of money may flow in and out of a country in a short time period. This will make it very difficult for the country to

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maintain a fixed exchange rate.

13. Assess the possibility for the euro to become another global currency rivaling the U.S. dollar. If the euro really becomes a global currency, what impact will it have on the U.S. dollar and the world economy?

Answer: In light of the large transactions domain of the euro, which is comparable to that of the U.S. dollar, and the mandate for the European Central Bank (ECB) to guarantee the monetary stability in Europe, the euro may potentially become another global currency over time. A major uncertainty about this prospect is the lack of political (and fiscal) integration of Europe. If Europe becomes politically more integrated, the euro is more likely to become a global currency. If the euro becomes a global currency, it will come at the expense of the dollar. Currently, the U.S. derives substantial benefits from the dollar's status as the dominant global currency – for instance, the U.S. can run trade deficits without having to maintain substantial foreign exchange reserves, can carry out international commercial and financial transactions in dollars without bearing exchange risk, etc. If the euro is to be used as a major denomination, reserve, and invoice currency in the world economy, dollar-based agents will start to bear more exchange risk, among other things.

MINI CASE: Grexit or Not?

When the euro was introduced in 1999, Greece was conspicuously absent from the list of the European Union member countries adopting the common currency. The country was not ready. In a few short years, however, European leaders, probably motivated by their political agenda, allowed Greece to join the euro club in 2001 although it was not entirely clear if the country satisfied the entry conditions. In any case, joining the euro club allowed the Greek government, households, and firms to gain easy access to plentiful funds at historically low interest rates, ushering in a period of robust credit growth. For a while, Greeks enjoyed what seemed to be the fruits of becoming a full-fledged member of Europe. In December 2009, however, the new Greek government revealed that the government budget deficit would be 12.7% for 2009, not 3.7% as previously announced by the outgoing government, far exceeding the EU's convergence guideline of keeping the budget deficit below 3.0% of the GDP. As the true picture of the government finance became known, the prices of Greek government bonds began to fall sharply, prompting panic selling among international investors, threatening the sovereign defaults.

Several years into the crisis, the Greek government debt stands at around 180% of GDP and the jobless rate among youth is above 50%. The country's GDP declined by about

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25%. Severe austerity measures, such as sharply raised taxes and much reduced pension benefits, were imposed on Greece as conditions for the bailouts arranged by the EU, IMF, and the European Central Bank. In addition, people were allowed to have only restricted access to their bank deposits, to prevent bank runs. Opinion polls indicate that the majority of people in Germany, the main creditor nation for Greece, prefer the Greek exit from the euro-zone, popularly called Grexit, while some people in Greece are demanding Grexit themselves and restoration of the national currency, the drachma.

Discussion points: (i) the root causes of the Greek predicaments; (ii) the costs and benefits of staying in the euro-zone for Greece, (iii) the measures that need to be taken to keep Greece in the euro-zone in the long run if that is desirable, (iv) If you were a disinterested outside advisor for the Greek government, would you advise Grexit or not? Why or why not ?

Suggested Solution to Grexit or Not?

As is often the case with many sovereign debt crises in history, the Greek sovereign debt crisis, which raises the possibility of Grexit from the euro-zone, is attributable to the excessive borrowing and spending on the part of the government which cannot be adequately financed by the government revenues. As is well known, tax evasion is widely spread in Greece while pension benefits and other welfare services are lavish compared with the country's economic resources. And the lack of transparency of the government finance also contributed to the steep decline in the Greek government bond prices in late 2009 and 2010. Greece is still not out of crisis in part because the country now doesn't have its own monetary policy that can be tailored to address its dire economic conditions, like easy monetary policy and depreciation of the national currency to help the country recover from the crisis quickly. The lack of policy independence thus is a very major cost of remaining in the euro-zone. If Greece is to remain in the euro-zone, it has to reduce the government expenditures, cut business costs, and boost labor productivity, among other things. If it is difficult to implement the above and other measures to strengthen the competitiveness of the Greek economy, the country then may seriously consider getting out of the euro-zone and recovering national policy autonomy with its own currency.

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INTERNATIONAL Financial Management



The International Monetary System

Chapter Two

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Chapter Two Outline

- Evolution of the International Monetary System
- Bimetallism: Before 1875
- Classical Gold Standard: 1875-1914
- Interwar Period: 1915-1944
- Bretton Woods System: 1945-1972
- The Flexible Exchange Rate Regime: 1973-Present
- The Current Exchange Rate Arrangements
- European Monetary System
- The Euro and the European Monetary Union
- The Mexican Peso Crisis
- The Asian Currency Crisis
- The Argentine Peso Crisis
- Fixed versus Flexible Exchange Rate Regimes
- Summary

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Evolution of the International Monetary System

- Bimetallism: Before 1875
- Classical Gold Standard: 1875-1914
- Interwar Period: 1915-1944
- Bretton Woods System: 1945-1972
- The Flexible Exchange Rate Regime: 1973-Present

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Bimetallism: Before 1875

- Bimetallism was a “double standard” in the sense that both gold and silver were used as money.
- Some countries were on the gold standard, some on the silver standard, and some on both.
- Both gold and silver were used as an international means of payment, and the exchange rates among currencies were determined by either their gold or silver contents.

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Gresham's Law

- *Gresham's Law* implies that the least valuable metal is the one that tends to circulate.
- Suppose that you were a citizen of Germany during the period when there was a 20 German mark coin made of gold and a 5 German mark coin made of silver.
  - If gold suddenly and unexpectedly became much more valuable than silver, which coins would you spend if you wanted to buy a 20-mark item and which would you keep?

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Classical Gold Standard: 1875-1914

- During this period in most major countries:
  - Gold alone was assured of unrestricted coinage.
  - There was two-way convertibility between gold and national currencies at a stable ratio.
  - Gold could be freely exported or imported.
- The exchange rate between two country's currencies would be determined by their relative gold contents.

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Classical Gold Standard: 1875-1914

- For example, if the dollar is pegged to gold at U.S. $30 = 1 ounce of gold, and the British pound is pegged to gold at £6 = 1 ounce of gold, it must be the case that the exchange rate is determined by the relative gold contents:

$$\$30 = 1 \text{ ounce of gold} = £6$$

$$\$30 = £6$$

$$\$5 = £1$$

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Classical Gold Standard: 1875-1914

- Highly stable exchange rates under the classical gold standard provided an environment that was conducive to international trade and investment.
- Misalignment of exchange rates and international imbalances of payment were automatically corrected by the *price-specie-flow mechanism.*

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Price-Specie-Flow Mechanism

- Suppose Great Britain exports more to France than France imports from Great Britain.
- This cannot persist under a gold standard.
  - Net export of goods from Great Britain to France will be accompanied by a net flow of gold from France to Great Britain.
  - This flow of gold will lead to a lower price level in France and, at the same time, a higher price level in Britain.
- The resultant change in relative price levels will slow exports from Great Britain and encourage exports from France

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Interwar Period: 1915-1944

- Exchange rates fluctuated as countries widely used "predatory" depreciations of their currencies as a means of gaining advantage in the world export market.
- Attempts were made to restore the gold standard, but participants lacked the political will to "follow the rules of the game."
- The result for international trade and investment was profoundly detrimental.

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Bretton Woods System: 1945-1972

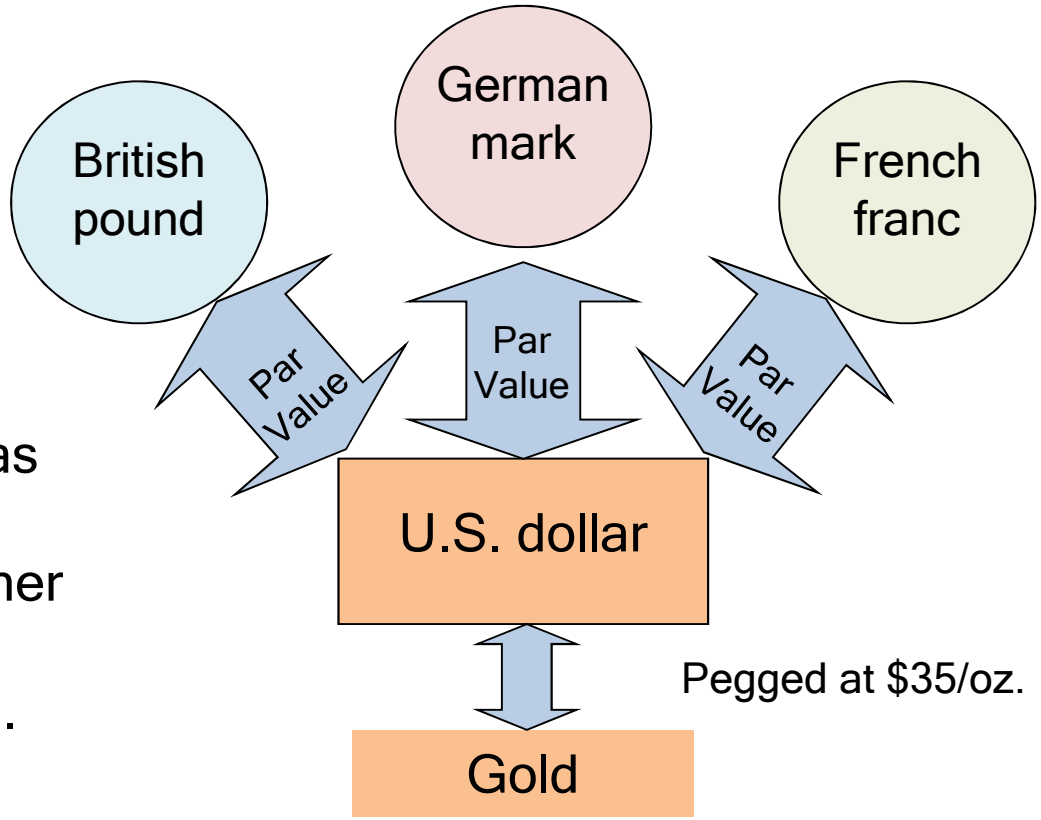
- Named for a 1944 meeting of 44 nations at Bretton Woods, New Hampshire.
- The purpose was to design a postwar international monetary system.
- The goal was exchange rate stability without the gold standard.
- The result was the creation of the IMF and the World Bank.

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Exhibit 2.1:
The Design of the Gold-Exchange System

Insert Exhibit 2.1 here (or use this art)



- The U.S. dollar was pegged to gold at $35/ounce and other currencies were pegged to the U.S. dollar.

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The Flexible Exchange Rate Regime: 1973-Present

- Flexible exchange rates were declared acceptable to the IMF members.
  - Central banks were allowed to intervene in the exchange rate markets to iron out unwarranted volatilities.
- Gold was abandoned as an international reserve asset.
- Non-oil-exporting countries and less-developed countries were given greater access to IMF funds.

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Current Exchange Rate Arrangements

- Free Float
  - The largest number of countries, about 33, allow market forces to determine their currency's value.
- Managed Float
  - About 46 countries combine government intervention with market forces to set exchange rates.
- Pegged to another currency
  - Such as the U.S. dollar or euro.
- No national currency
  - Some countries do not bother printing their own currency. For example, Ecuador, Panama, and El Salvador have *dollarized*. Montenegro and San Marino use the euro.

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Current Exchange Rate Arrangements

- Currency Board
  - Fixed exchange rates combined with restrictions on the issuing government.
  - Eliminates central bank functions such as monetary policy and lender of last resort (*e.g.*, Hong Kong).
- Conventional Peg
  - Exchange rate publicly fixed to another currency or basket of currencies.
  - Country buys or sells foreign exchange or uses other means to control the price of the currency (*e.g.,* Saudi Arabia, Jordan, and Morocco).

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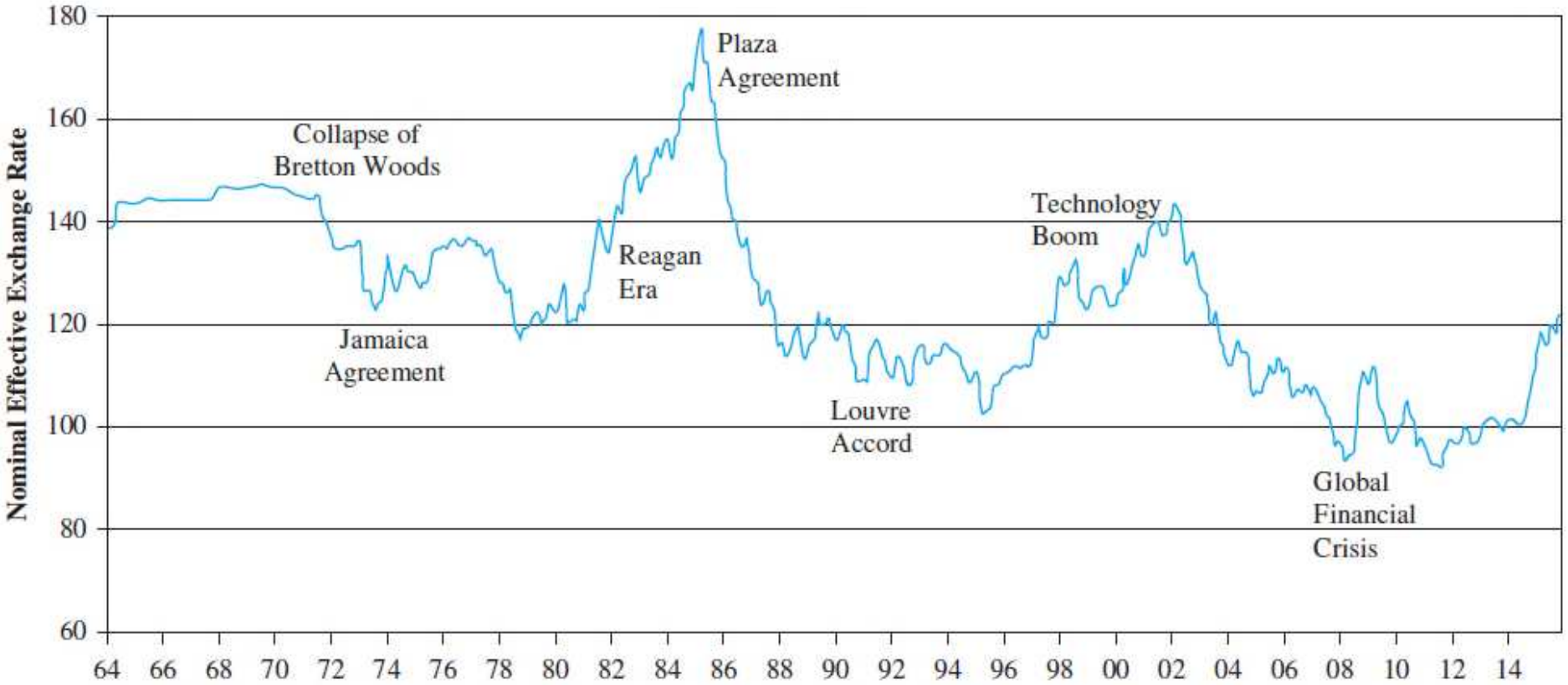
Current Exchange Rate Arrangements

- Stabilized Arrangement
  - A spot market exchange rate that remains within a margin of 2 percent for six months or more and is not floating (*e.g.,* China, Angola, and Lebanon).
- Crawling Peg
  - Like the conventional peg, but the crawling peg is adjusted in small amounts at a fixed rate of change or in response to changes in macro indicators, (*e.g.,* Bolivia, Iraq, and Nicaragua).

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Exhibit 2.3: The Trade-Weighted Value of the U.S. Dollar since 1964



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Exhibit 2.4 De Facto Classification of Exchange Rate Arrangements and Monetary Policy Frameworks (As of April 30, 2015)

Exchange rate arrangement (number of countries)	Monetary Policy Framework								
	Exchange rate anchor						Monetary aggregate target	Inflation-targeting framework	Other[1]
	U.S. dollar (42)		Euro (25)		Composite (12)	Other (8)	(25)	(36)	(43)
No separate legal tender (13)	Ecuador El Salvador Marshall Islands Micronesia	Palau Panama Timor-Leste Zimbabwe	Kosovo Montenegro	San Marino		Kiribati Tuvalu			
Currency board (11)	Djibouti Hong Kong SAR **ECCU** Antigua and Barbuda Dominica Grenada	St. Kitts and Nevis St. Lucia St. Vincent and the Grenadines	Bosnia and Herzegovina Bulgaria			Brunei Darussalam			
Conventional peg (44)	Aruba The Bahamas Bahrain Barbados Belize Curaçao and Sint Maarten Eritrea	Iraq (01/12) Jordan Oman Qatar Saudi Arabia South Sudan Turkmenistan United Arab Emirates Venezuela	Cabo Verde Comoros Denmark[2] Sao Tome and Principe **WAEMU** Benin BurkinaFaso Cote d'Ivoire Guinea Bissau Mali Niger	Senegal Togo **CEMAC** Cameroon Central African Rep. Chad. Rep. of Congo Equatorial Guinea Gabon	Fiji Kuwait Morocco[3] Samoa	Bhutan Lesotho Namibia Nepal Swaziland			Solomon Islands[4]
Stabilized arrangement (22)	Cambodia (01/14) Guyana Lebanon	Maldives Suriname Trinidad and Tobago	FYR Macedonia		Singapore Vietnam[3]		Bangladesh[5] Bolivia[5] Burundi[5] Democratic Rep. of the Congo[5] Guinea[5] Sri Lanka[5] Yemen[5]	Czech Rep.[6] (11/13)	Costa Rica (04/14) Azerbaijan[5] Egypt[5] Kazakhstan[5] (02/14) Mauritania[6] (11/13)

(Continued)

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Exhibit 2.4 De Facto Classification of Exchange Rate Arrangements and Monetary Policy Frameworks (As of April 30, 2015)

Exchange rate arrangement (number of countries)	Monetary Policy Framework								
	Exchange rate anchor						Monetary aggregate target	Inflation-targeting framework	Other[1]
	U.S. dollar (42)		Euro (25)		Composite (12)	Other (8)	(25)	(36)	(43)
Crawling peg (3)	Honduras[6] (07/11) Nicaragua				Botswana				
Crawl-like arrangement (20)	Jamaica[8]		Croatia		Iran[5,6,9] (03/14) Libya (03/14)		Belarus[5] China[5] Ethiopia[5] Uzbekistan[5] Rwanda[6] (09/13) Tajikistan[5] (05/14)	Armenia[5] Dominican Republic[5] Guatemala[5]	Angola[5] (09/14) Argentina[5] Haiti[5] Lao P.D.R.[5] Papua New Guinea (04/14) Switzerland[7] Tunisia[4,8]
Pegged exchange rate within horizontal bands (1)					Tonga				
Other managed arrangement (10)	Liberia				Algeria Syria		Myanmar Nigeria		Kyrgyz Rep. Malaysia Pakistan Sudan Vanuatu
Floating (37)							Afghanistan The Gambia (01/14) Madagascar Malawi Mozambique Seychelles (03/14) Sierra Leone Tanzania Ukraine (02/14) Uruguay	Albania Brazil Colombia Georgia Ghana Hungary Iceland India Indonesia Israel Korea Moldova New Zealand Paraguay Peru Philippines	Kenya[8] Mauritius Mongolia Zambia

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European Monetary System

- The chief goals of the European Monetary System are
  - To establish a "zone of monetary stability" in Europe
  - To coordinate exchange rate policies vis-à-vis the non-EMS currencies
  - To pave the way for the eventual European monetary union.
- The member countries agreed to closely coordinate their fiscal, monetary, and exchange rate policies and achieve a *convergence* of their economies.

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Exhibit 2.5: Chronology of the European Union

1951	The treaty establishing the European Coal and Steel Community (ECSC), which was inspired by French Foreign Minister Robert Schuman, was signed in Paris by six countries: France, Germany, Italy, Netherlands, Belgium, and Luxembourg.
1957	The treaty establishing the European Economic Community (EEC) was signed in Rome.
1968	The Custom Union became fully operational; trade restrictions among the EEC member countries were abolished and a common external tariff system was established.
1973	The U.K., Ireland, and Denmark became EEC members.
1978	The EEC became the European Community (EC).
1979	The European Monetary System (EMS) was established for the purpose of promoting exchange rate stability among the EC member countries.
1980	Greece became an EC member.
1986	Portugal and Spain became EC members.
1987	The Single European Act was adopted to provide a framework within which the common internal market could be achieved by the end of 1992.
1991	The Maastricht Treaty was signed and subsequently ratified by 12 member states. The treaty establishes a timetable for fulfilling the European Monetary Union (EMU). The treaty also commits the EC to political union.
1994	The European Community was renamed the European Union (EU).
1995	Austria, Finland, and Sweden became EU members.
1999	A common European currency, the euro, was adopted by 11 EU member countries.
2001	Greece adopted the euro on January 1.
2002	Euro notes and coins were introduced; national currencies were withdrawn from circulation.
2004	EU expanded by admitting 10 new member countries: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic, and Slovenia.
2007	Bulgaria and Romania were admitted to the EU. Slovenia adopted the euro.
2008	Cyprus and Malta adopted the euro.
2009	Slovakia adopted the euro.
2010	Europe's sovereign debt crisis.
2011	Estonia adopted the euro.
2013	Croatia joined the EU.
2014	Latvia adopted the euro.
2015	Lithuania adopted the euro.
2016	The United Kingdom decided to leave the EU, following the referendum on Brexit.

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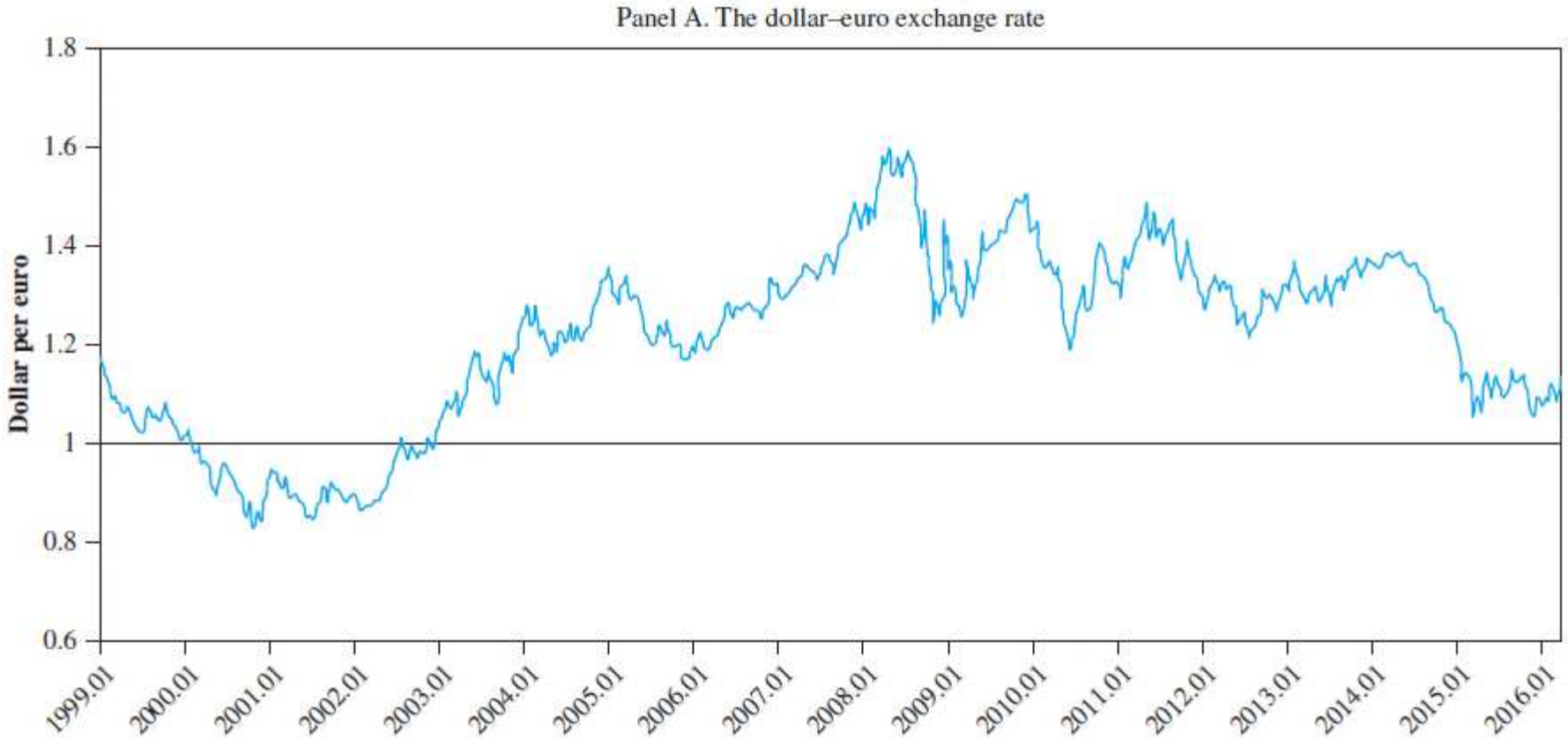
The Euro

- The euro is the currency of the European Monetary Union, adopted by 11 Member States on January 1, 1999.
- There are 7 euro notes and 8 euro coins.
- The notes are: €500, €200, €100, €50, €20, €10, and €5. The coins are: 2 euro, 1 euro, 50 euro cent, 20 euro cent, 10, euro cent, 5 euro cent, 2 euro cent, and 1 euro cent.
- The euro itself is divided into 100 cents, just like the U.S. dollar.

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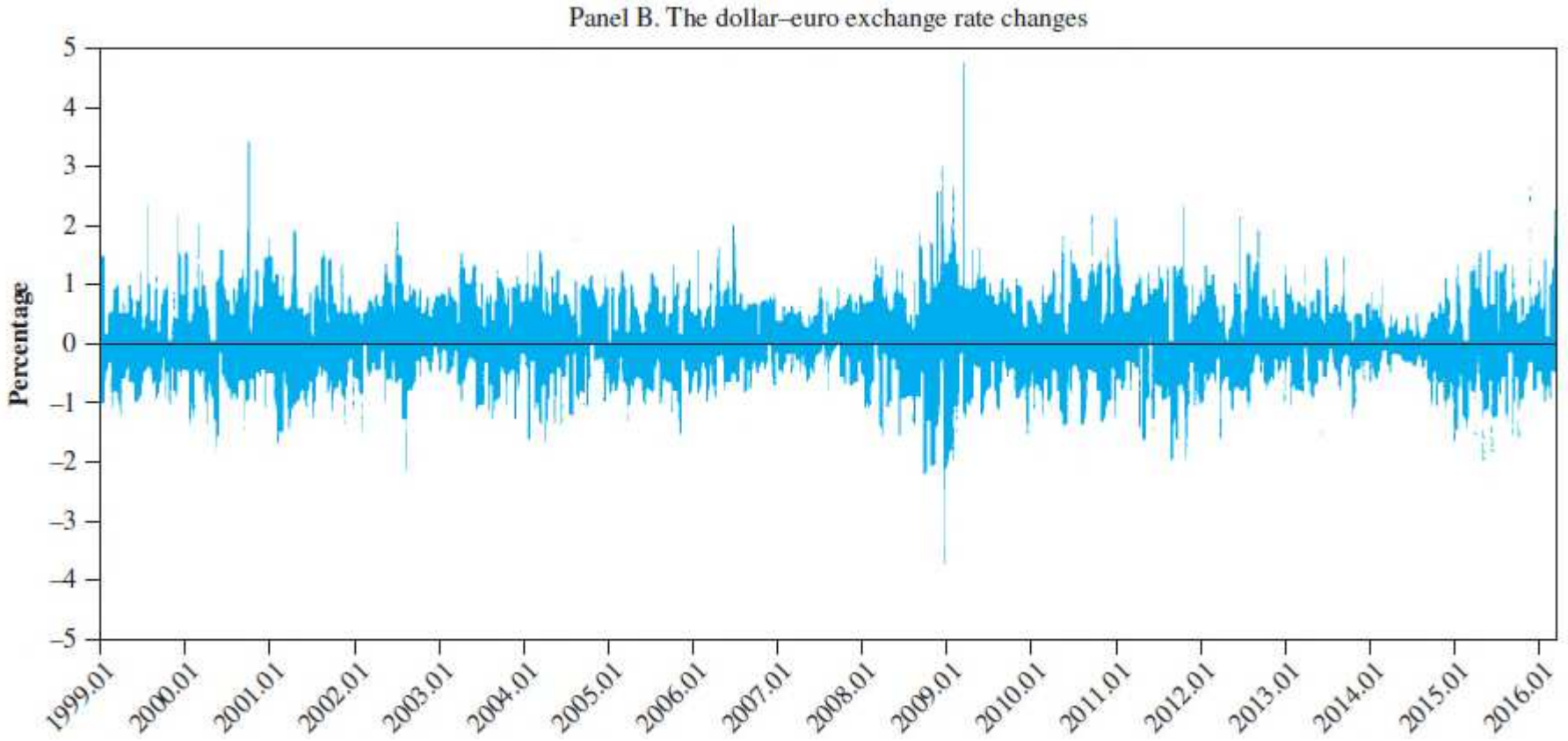
Exhibit 2.7:
The Daily Dollar-Euro Exchange Rate since the Euro's Inception



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Exhibit 2.7:
The Daily Dollar-Euro Exchange Rate since the Euro's Inception



The Long-Term Impact of the Euro

- As the euro proves successful, it will advance the political integration of Europe in a major way, making a “United States of Europe” feasible.
- It is possible that the U.S. dollar will lose its place as *the* dominant world currency.
- The euro and the U.S. dollar will be the two major currencies.

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Costs of Monetary Union

- The main cost of monetary union is the loss of national monetary and exchange rate policy independence.
  - The more trade-dependent and less diversified a country's economy is, the more prone to asymmetric shocks that country's economy would be.

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The Mexican Peso Crisis

- On December 20, 1994, the Mexican government announced a plan to devalue the peso against the dollar by 14 percent.
- This decision changed currency trader's expectations about the future value of the peso, and they stampeded for the exits.
- In their rush to get out the peso fell by as much as 40 percent.

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EXHIBIT 2.9
U.S. Dollar versus Mexican Peso Exchange Rate
(November 1, 1994–January 31, 1995)



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The Mexican Peso Crisis (concluded)

- The Mexican Peso crisis is unique in that it represents the first serious international financial crisis touched off by cross-border flight of portfolio capital.
- Two lessons emerge:
  - It is essential to have a multinational safety net in place to safeguard the world financial system from such crises.
  - An influx of foreign capital can lead to an overvaluation in the first place.

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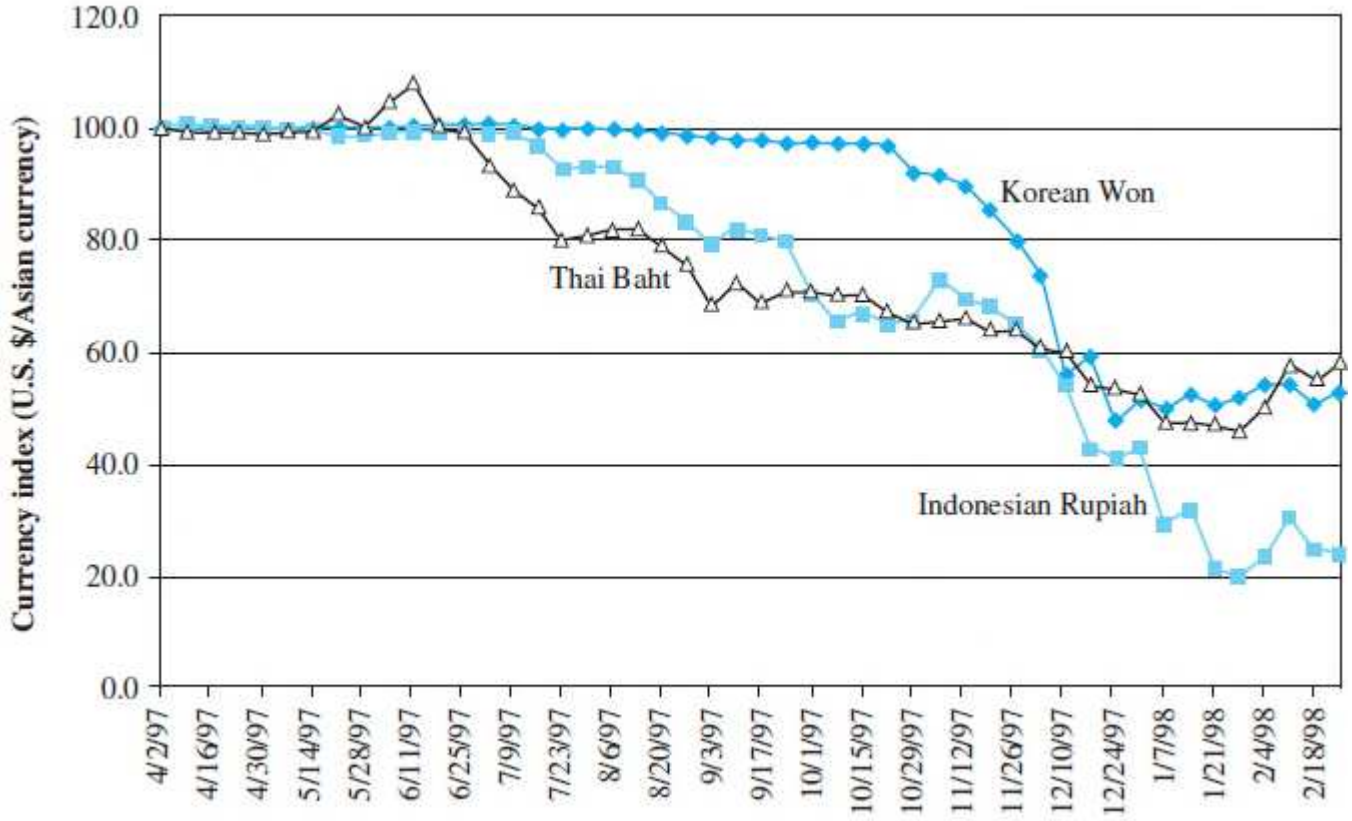
The Asian Currency Crisis

- The Asian currency crisis turned out to be far more serious than the Mexican peso crisis in terms of the extent of the contagion and the severity of the resultant economic and social costs.
- Many firms with foreign currency bonds were forced into bankruptcy.
- The region experienced a deep, widespread recession.

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Exhibit 2.10: The Asian Currency Crisis



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Origins of the Asian Currency Crisis

- As capital markets were opened, large inflows of private capital resulted in a credit boom in the Asian countries.
- Fixed or stable exchange rates also encouraged unhedged financial transactions and excessive risk-taking by both borrowers and lenders.
- The real exchange rate rose, which led to a slowdown in export growth.
- Also, Japan's recession (and yen depreciation) hurt.

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Origins of the Asian Currency Crisis (continued)

- If the Asian currencies had been allowed to depreciate in real terms (not possible due to the fixed exchange rates), the sudden and catastrophic changes in exchange rates observed in 1997 might have been avoided
- Eventually something had to give–it was the Thai bhat.
- The sudden collapse of the bhat touched off a panicky flight of capital from other Asian countries.

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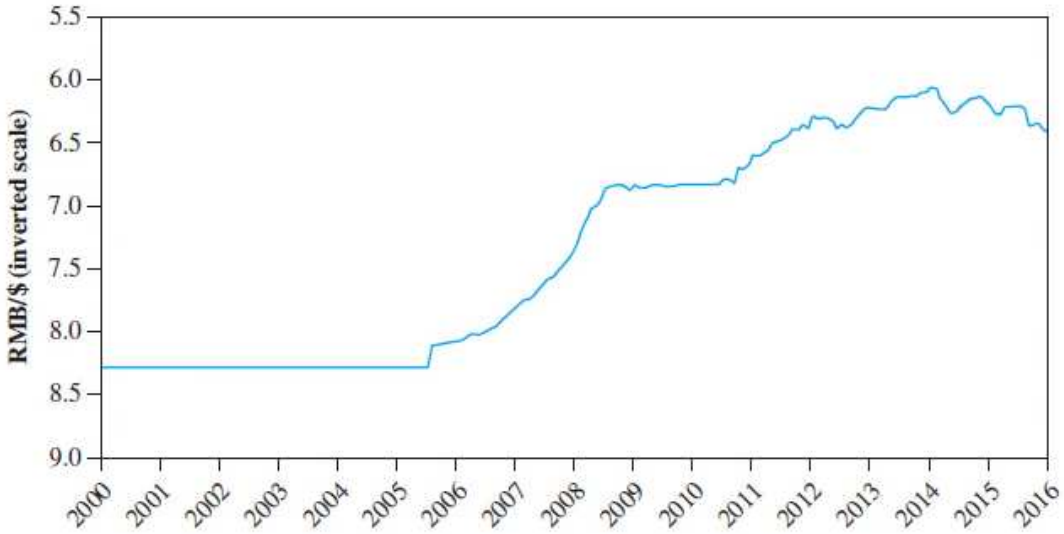
Lessons from the Asian Currency Crisis

- A fixed but adjustable exchange rate is problematic in the face of integrated international financial markets.
  - A country can attain only two the of three conditions:
    1. A fixed exchange rate.
    2. Free international flows of capital.
    3. Independent monetary policy.

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EXHIBIT 2.12
Renminbi (RMB) versus U.S. Dollar Exchange Rate



- China maintained a fixed exchange rate between the renminbi (RMB) yuan and the U.S. dollar for a long time.
  - The RMB floated between 2005 and 2008 and then again starting in 2010.
- There is mounting pressure from China's trading partners for a stronger RMB.

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Potential as a Global Currency

- For the RMB to become a full-fledged global currency, China will need to satisfy these conditions:
  - Full convertibility of its currency.
  - Open capital markets with depth and liquidity.
  - The rule of law and protection of property rights.
- The United States and the euro zone satisfy these conditions.

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The Argentinean Peso Crisis

- In 1991 the Argentine government passed a convertibility law that linked the peso to the U.S. dollar at parity.
- The initial economic effects were positive:
  - Argentina's chronic inflation was curtailed.
  - Foreign investment poured in.
- As the U.S. dollar appreciated on the world market the Argentine peso became stronger as well.

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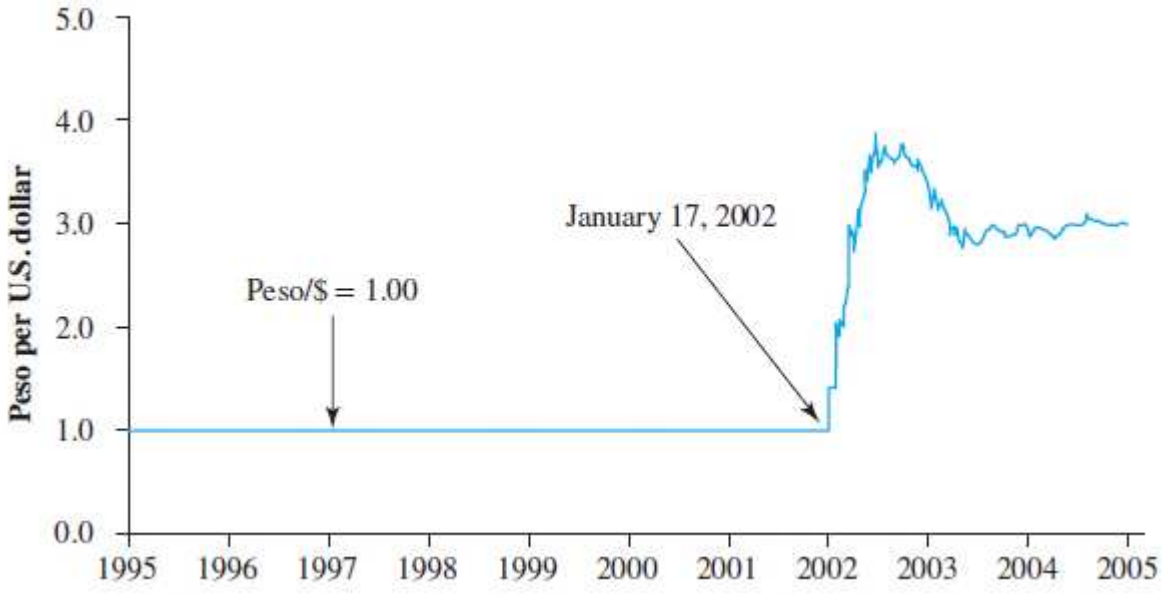
The Argentinean Peso Crisis (continued)

- However, the strong peso hurt exports from Argentina and caused a protracted economic downturn that led to the abandonment of peso-dollar parity in January 2002.
  - The unemployment rate rose above 20 percent.
  - The inflation rate reached a monthly rate of 20 percent.

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EXHIBIT 2.13
Collapse of the Currency Board Arrangement in Argentina



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The Argentinean Peso Crisis (concluded)

- There are at least three factors that are related to the collapse of the currency board arrangement and the ensuing economic crisis:
  - Lack of fiscal discipline.
  - Labor market inflexibility.
  - Contagion from the financial crises in Brazil and Russia.

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Currency Crisis Explanations

- In theory, a currency's value mirrors the fundamental strength of its underlying economy, relative to other economies, *in the long run*.
- *In the short run*, currency trader expectations play a much more important role.
- In today's environment, traders and lenders, using the most modern communications, act on fight-or-flight instincts. For example, if they expect others are about to sell Brazilian reals for U.S. dollars, they want to "get to the exits first."
- Thus, fears of depreciation become self-fulfilling prophecies.

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Fixed versus Flexible Exchange Rate Regimes

- Arguments in favor of flexible exchange rates:
  - Easier external adjustments.
  - National policy autonomy.
- Arguments against flexible exchange rates:
  - Exchange rate uncertainty may hamper international trade.
  - No safeguards to prevent crises.

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Fixed versus Flexible Exchange Rate Regimes: Example

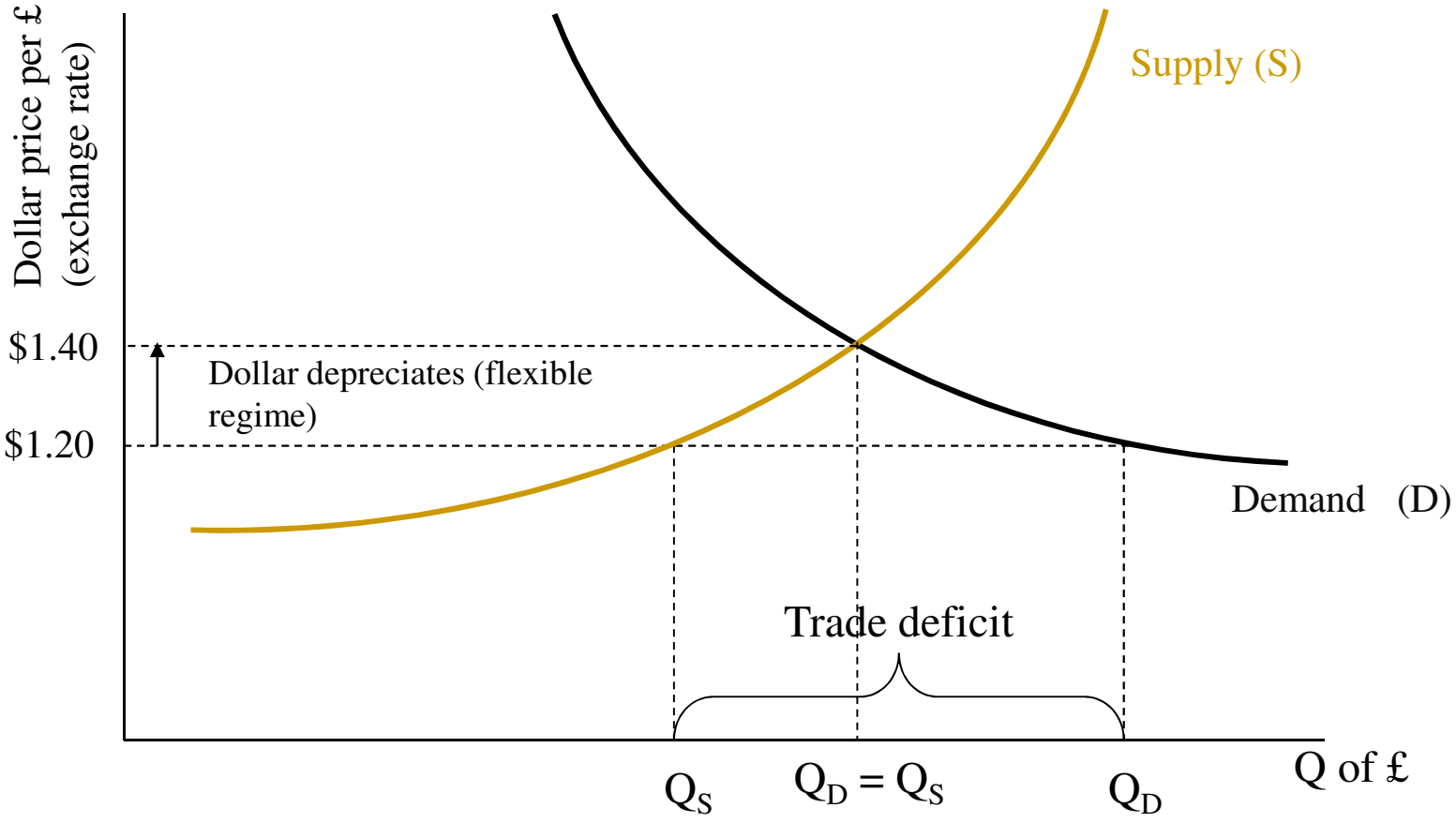
- Suppose the exchange rate is $1.20/£ today.
- In the next slide, we see that demand for the pound far exceeds supply at this exchange rate.
- The United States experiences trade deficits.
- Under a flexible exchange rate regime, the dollar will simply depreciate to $1.40/£, the price at which supply equals demand and the trade deficit disappears.

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EXHIBIT 2.14

External Adjustment Mechanism: Fixed versus Flexible Exchange Rates



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Fixed versus Flexible Exchange Rate Regimes: Example (continued)

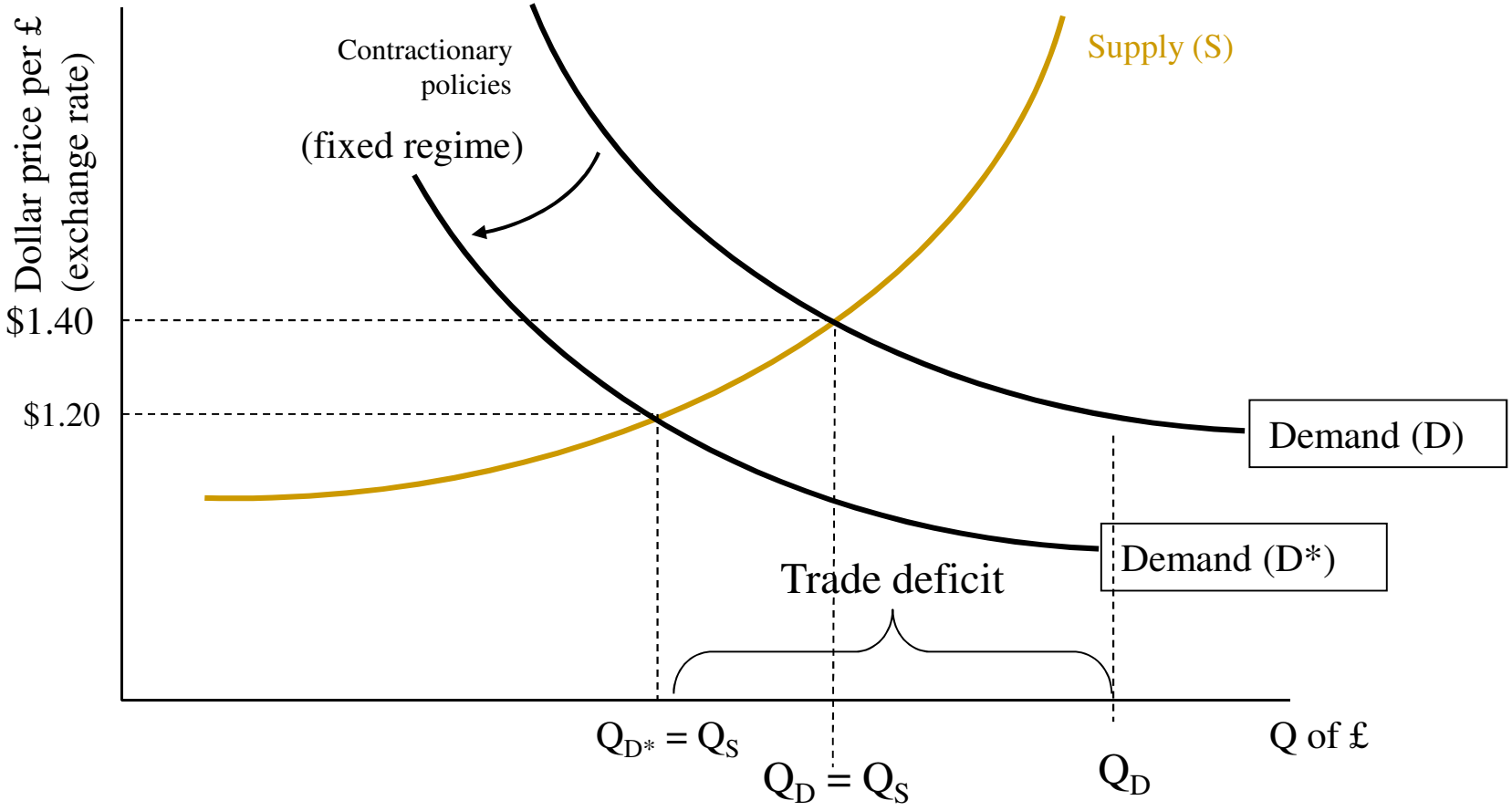
- Instead, suppose the exchange rate is "fixed" at $1.20/£, and thus the imbalance between supply and demand cannot be eliminated by a price change.
- The government would have to shift the demand curve from D to D*.
  - In this example, this shift corresponds to contractionary monetary and fiscal policies.

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EXHIBIT 2.14 (concluded)

External Adjustment Mechanism: Fixed versus Flexible Exchange Rates



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Summary

- The International Monetary System went through 5 stages of evolution.
- The classical gold standard determined exchange rates by the gold content of currencies. The gold standard still has ardent supporters.
- The Bretton Woods System was designed to offer a framework for stable exchange rates with pegs to the USD and the USD pegged to gold. It collapsed in 1973 due to U.S. inflation.
- The Flexible exchange rate system has been around since 1973.
- The Euro has been around since 1999.

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