

Readings in International Economics

Autumn 2011 – Winter 2012

Lecture 3: Flexible/floating exchange rates
and the legacies of the Bretton Woods system

25 October 2011

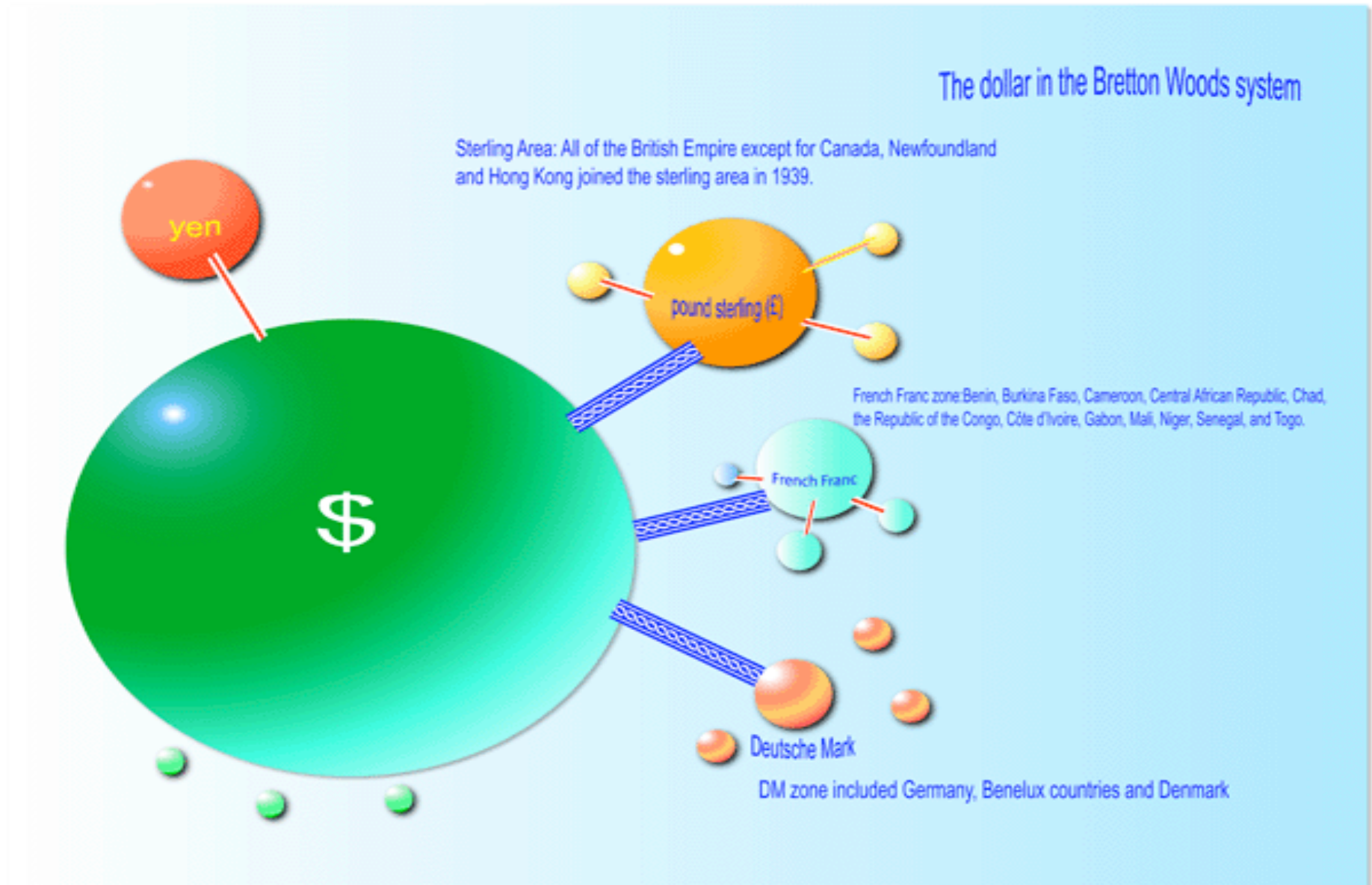
Overview of the previous class I

- **Exchange rate (ER) regimes: fixed and flexible**
固定相場制、変動相場制
- **Nominal and real exchange rates**
名目為替レート、実質為替レート
- **Evolution of the international monetary system from fixed to flexible ER regimes**

Two fixed ER systems:

- (1) the gold standard (1871–1914) 金本位制
- (2) the Bretton Woods (BW) system (1944–1973)
ブレトン・ウッズ体制

The dominant role of the US dollar under the BW system



Overview of the previous class II

- The gold standard's deflationary bias → difficulties in dealing with economic crises and high unemployment during the Great Depression

The BW system

- allowed an expansion of money supply (USD) around the world
- but the central banks of Western European countries and Japan had to follow passively the US monetary policy
- and it was an asymmetric system, i.e. the costs of adjustment were not borne by the US ("the reserve currency country") 非対称的なシステム

Overview of the previous class III

BOP imbalances under the BW system

- Since the end of 1950s, the US showed persisting BOP deficits; since the second half of 1960s, Japan and Germany – persisting BOP surpluses

The “Triffin dilemma”

- the US BOP deficits (USD outflows) were needed to sustain economic growth in Western Europe and Japan but also undermined the confidence of these countries in the USD
- In 1971, the “Nixon shock”
- In 1973, the move to a system of flexible exchange rates

The BW system: benefits for emerging economies in 1950s-1960s?

- **Stable exchange rates**

For example, the exchange rate of the USD to the JPY was fixed at \$1 = ¥360 for about 22 years (1949-1971)

- **Undervalued exchange rates** helped to increase Japanese manufacturing exports to the US market

- **Lower import tariffs** thanks to trade liberalization under GATT (General Agreement on Tariffs and Trade)

- **Lower volatility** due to *restrictions on capital flows**

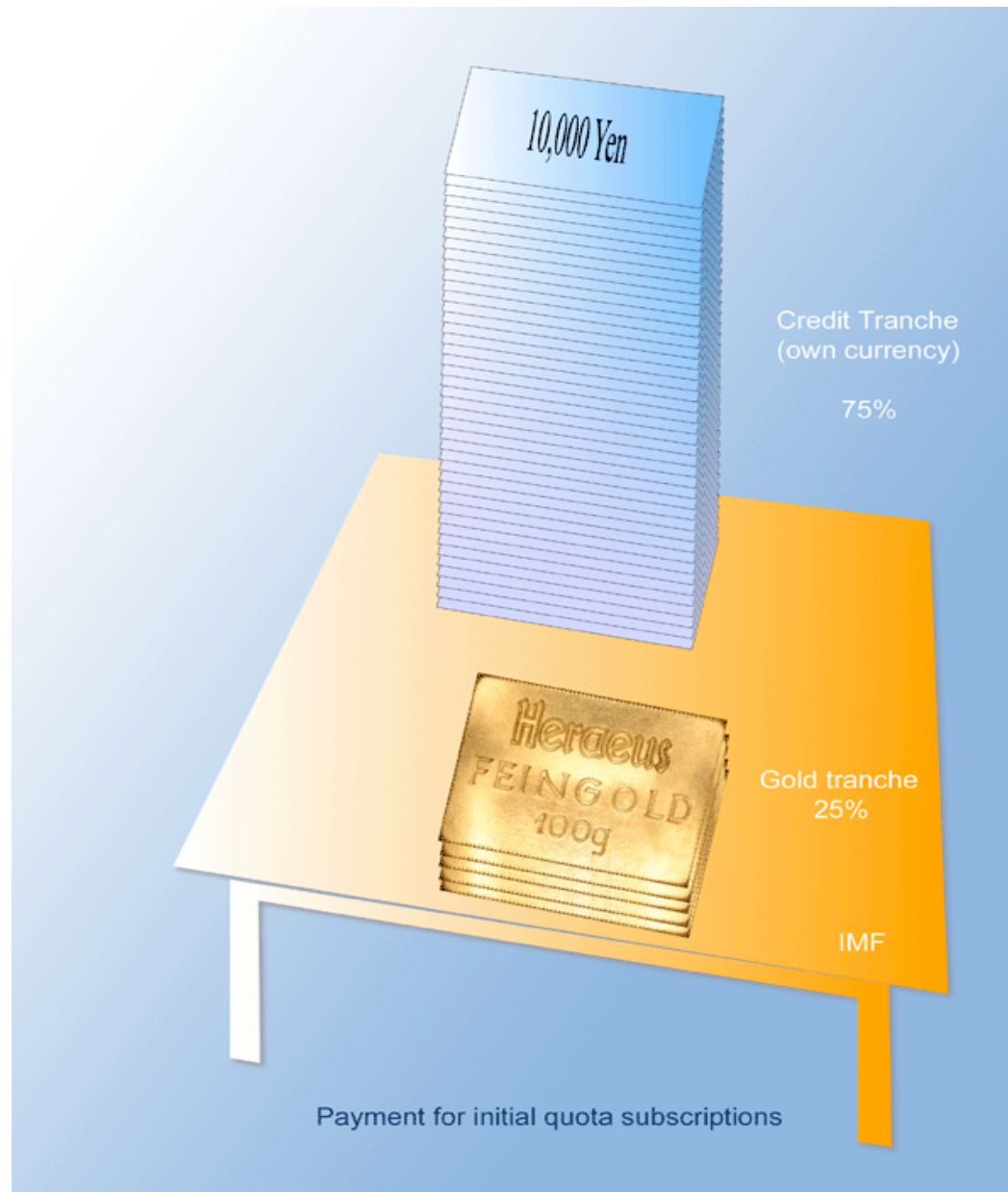
* Only “current account convertibility”, e.g the home country’s currency could be freely converted into foreign exchange only for international trade transactions

Legacies of the BW system (I): the IMF

國際通貨基金

- Created in 1944 to extend loans to countries with BOP deficits and coordinate ER adjustments (currency devaluations and revaluations)
- Gathers its resources from member countries' contributions called "quotas" (\$383 bln. in Aug. 2011; to be increased by another \$600 bln.)
- The quotas are based on the country's relative size in the world economy
- **A member's quota → its financial contribution to the IMF, voting power, and access to IMF financing**
- The member country paid one quarter of its quota in gold (today: in SDR) or widely used foreign currencies, and three quarters in its own national currency

Payment of member countries' quotas



Recent reforms of the IMF (Nov. 2010)

- **The finance ministers of G-20 decided to increase the quota and voting shares of emerging and developing economies in the IMF (see handout)**

Proposed quota and voting share changes:

- China and India will improve their rankings in IMF quota shares to 3rd and 8th, respectively
- The quota share of emerging and developing economies will increase from 38.4% to 42.3%
- The voting share of emerging and developing economies will rise to 44.7%
- **But the combined voting share of the US, EU and Japan will still be higher (52%)**

The IMF's decision making system

- The Board of Governors (BOG) is the main decision making body
- The BOG has 187 members who meet once a year (each member country is represented by either the country's finance minister or its central bank governor)
- There is also an Executive Board that is composed of 24 directors
- The advanced countries (e.g. the US, the EU and Japan) still dominate decision making at the IMF
- (Nov. 2010) The EU member countries agreed to give up 2 of their seats on the Executive Board in the future

The former and present heads of the IMF



Legacies of the BW system (2): the SDR

特別引出権

- **SDR (special drawing rights)**: “an international reserve asset created in 1969 to supplement IMF member countries’ official reserves”
- In 1969, the value of 1 SDR was equal to \$1 or 0.888671 grams of gold
- Today, the value of 1 SDR is equal to the value of a basket of four currencies (the basket composition and the currency weights: \$ 44%, € 34%, £ 11%, and ¥ 11%)
- The basket composition and the weights of the currencies in the SDR basket are reviewed once in 5 years
- On 21 Oct. 2011, 1 SDR = \$1.57502

IMF loans

- Since early 1980s, lending mainly to developing countries
- For example, two-year “standby loan” to support a country’s balance of payments
- After the 2008-2009 crisis, IMF loans to advanced countries in trouble (Iceland, Greece, Portugal, and Ireland)

IMF conditionality 条件付き融資

- Often criticized as being “one-size-fits-all”
- The disbursement of IMF loan’s tranches is linked to the achievement of specific performance criteria
- 2009: the “flexible credit line” that for the first time does not include such requirements (Mexico, Poland)

The international monetary system since 1973

- Flexible/floating exchange rates
- Fiat money (declared by the government as legal tender)
- Financial liberalization (first in the US and UK in the 1980s, later in developing and transition countries in the 1990s)
- Freedom of capital flows (FDI, portfolio investment, cross-border bank loans)

Results:

- Numerous financial crises
- Larger and persisting global imbalances
- Persisting reliance on the US dollar (in spite of its recently falling value)

Persisting USD domination and China's rising foreign exchange reserves

Greenbacked

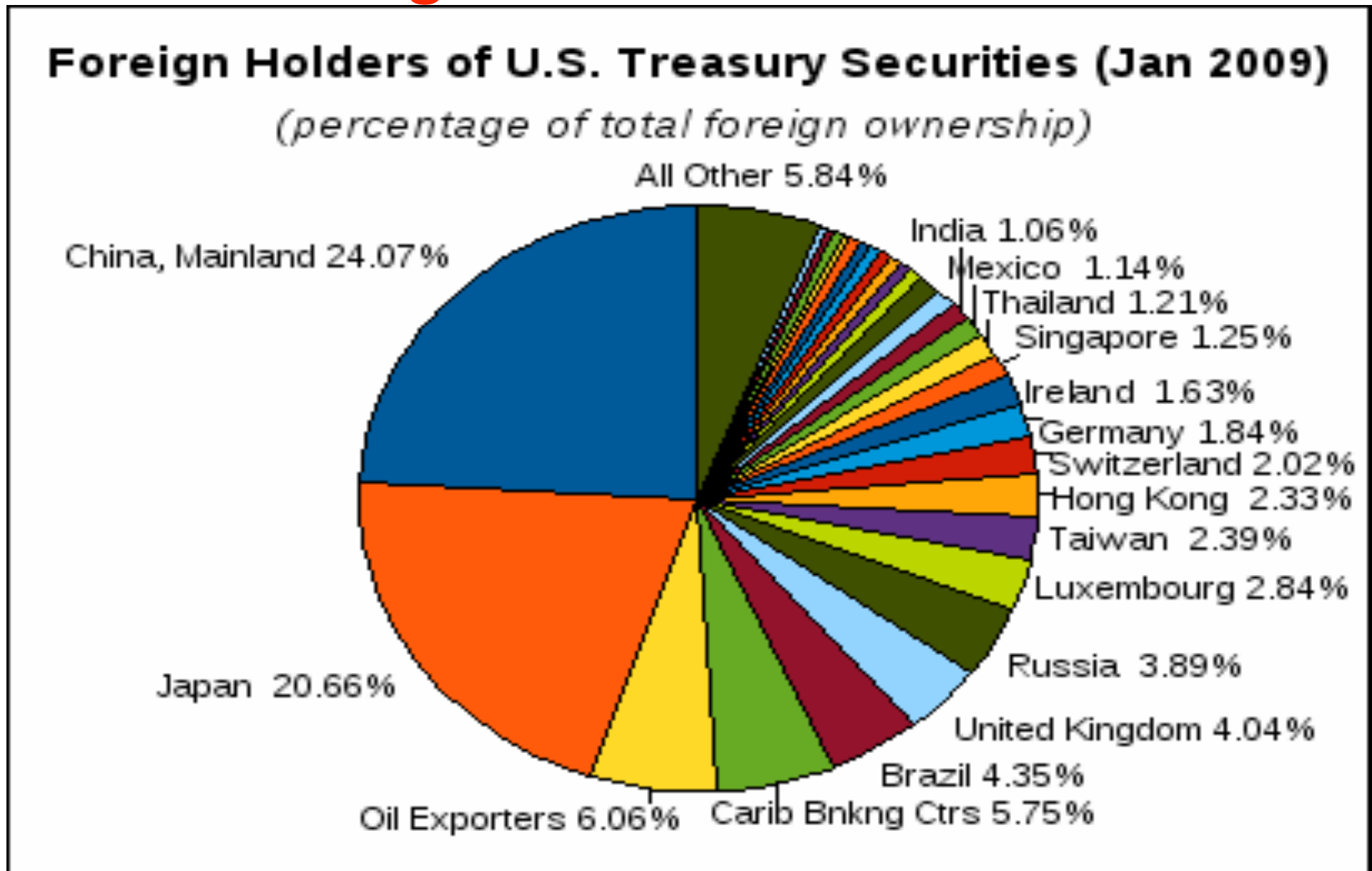


Sources: IMF; UBS

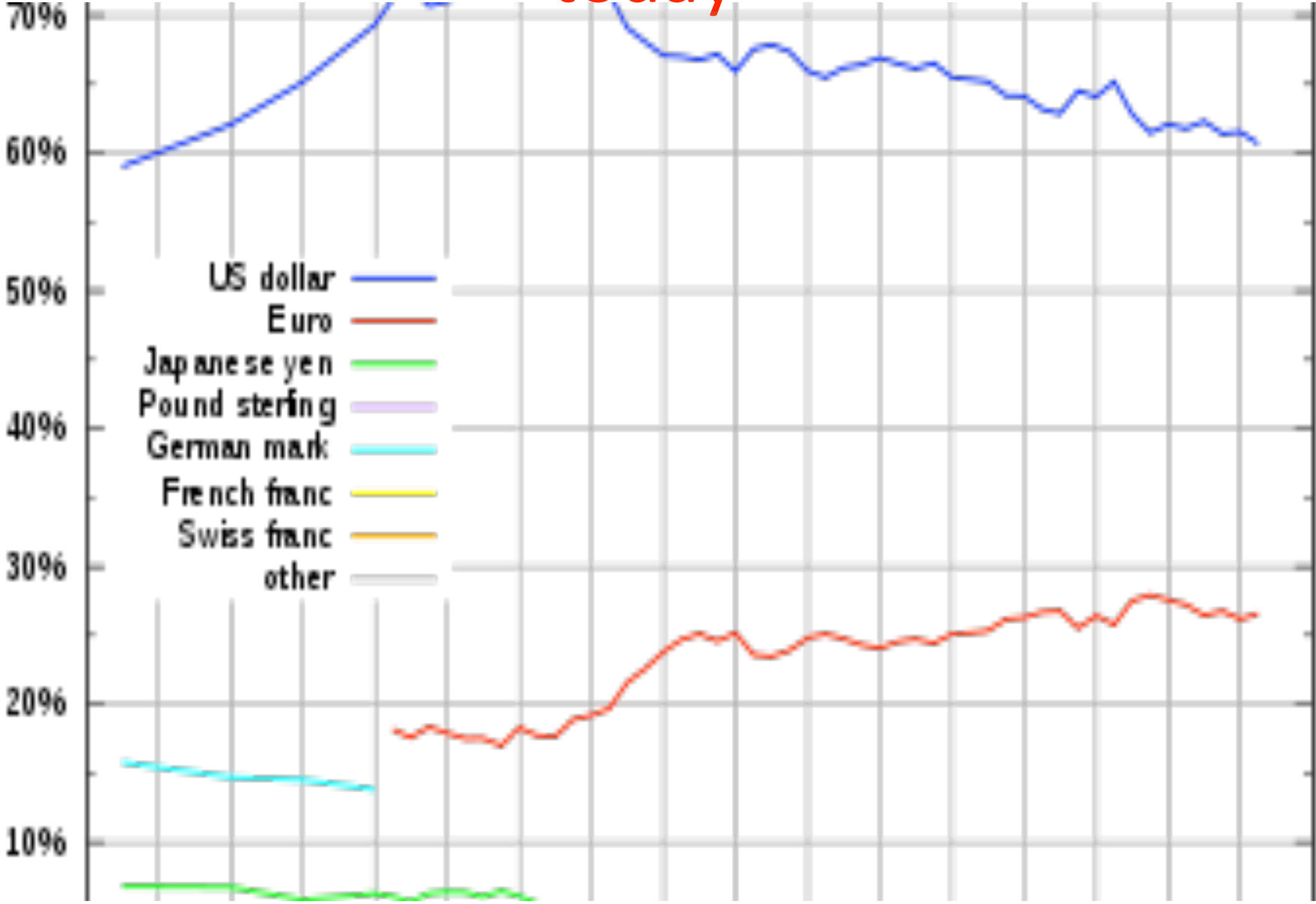


*Includes Fannie Mae and Freddie Mac

Which countries hold most of the US government debt?



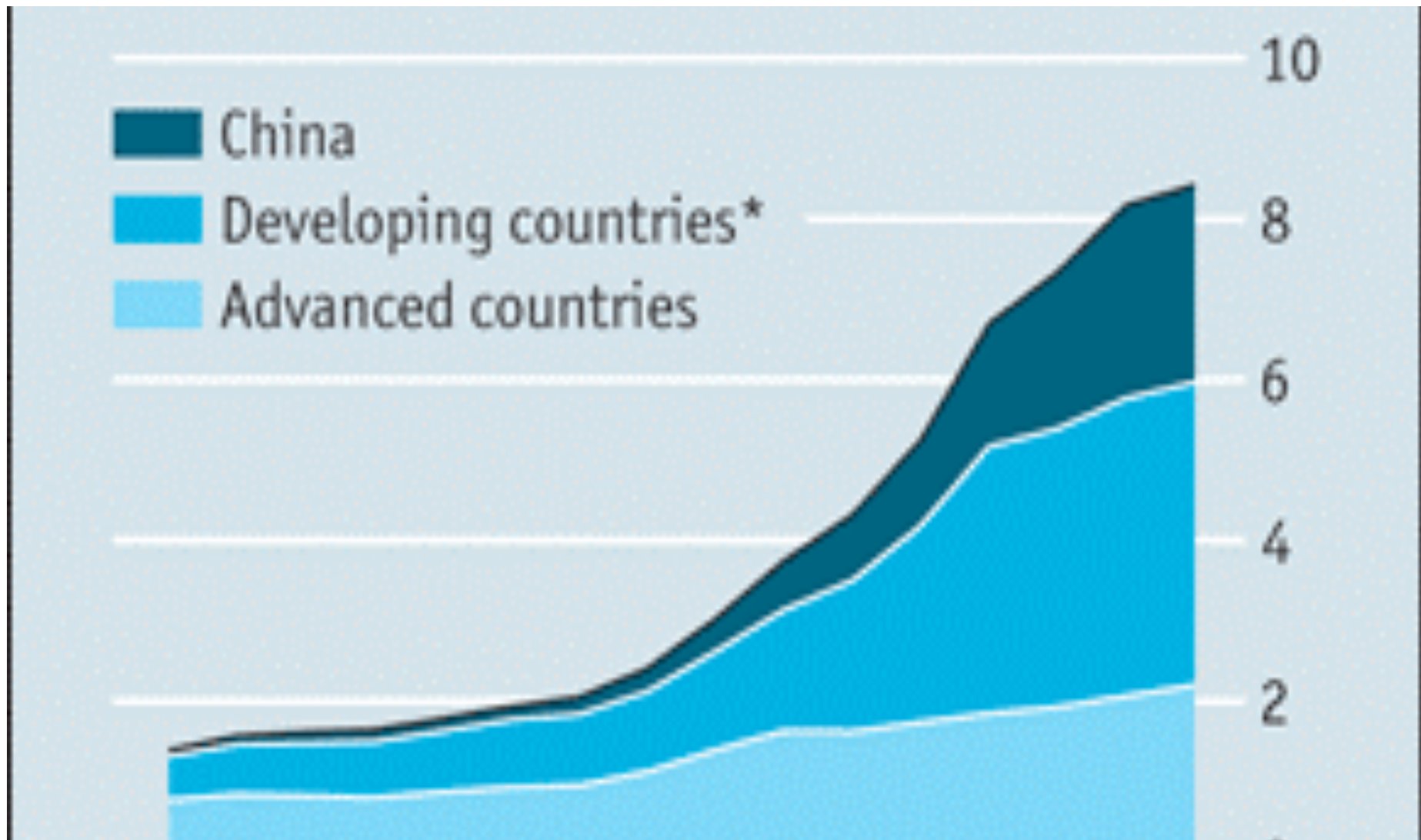
Reserve currencies from 1995 until today



The movement of the gold price from 1974 until today



The increase of foreign exchange reserves (\$ trln.) from 1995 until now



The Plaza agreement + Discussion

- Early 1980s: a strong US dollar, rising US fiscal and CA deficits; while Japan's CA surplus reached 3.7% of its GDP in 1985
- Sept. 1985: the Plaza agreement → US dollar depreciation, Japanese yen and German mark appreciation
- In 1985, \$1 = 240 yen; by the end of 1988, the yen had rapidly appreciated against the USD (\$1 = 128 yen); and in 1995, \$1 = 79.75 yen
- However, until today the CA imbalances have not been eliminated

Discussion:

- Are you in favor of a “second Plaza agreement” today? Or, a “second Bretton Woods system”?

Written assignment for 8 Nov.

- **Pls. find data on and analyze the changes in the trade structure of a country of your choice between 2008 and 2010**
- (1) main export and import products, share of commodity exports in merchandise exports, share of manufacturing exports in merchandise exports, share of hi-tech exports in manufacturing exports, terms of trade (2008 – 2010)
- (2) participation in various forms of regional economic integration
- (3) the degree of trade openness (the ratio of exports and imports to GDP)
- (4) the degree of trade freedom (Heritage Foundation & Wall Street Journal, Fraser Institute)*
- * Alternatively, you can try to find average tariff rates, indices of non-tariff barriers, data on the use of anti-dumping and safeguard measures (instead of the trade freedom indices)
- Please e-mail me the file until 6 pm on 7 Nov. (Mon.) and prepare a short talk on your assignment