International Monetary System

I. Domestic Monetary Policy

II. International Monetary Policy
   A. Fixed Exchange Rates
   B. Floating Exchange Rates
   C. Managed Exchange Rates

III. A New Monetary Order?
Domestic Policy

- **Fiscal Policy**: Taxation and (Government) Spending
- **Monetary Policy**: Money Supply and Interest Rates

- Federal Reserve controls interest rates through:
  - Reserve Requirements (% of deposits banks cannot lend)
  - Discount Rate (interest rate Fed charges to banks)
  - Open Market Operations (buy/sell government bonds)
US National Debt as a Percentage of GDP

Source: Statistical Abstract of the United States, 2000
International Monetary Policy

- Primary deals with EXCHANGE RATES
- **Exchange Rate**: relative value of national currencies on international markets (or value of one currency in another currency)
- **Three Type of Exchange Rate Systems**:
  - Fixed (or Pegged)
  - Floating (or Flexible)
  - Managed (or Coordinated)
- **Goals**: Stability, Flexibility, Credibility
Examples of Fixed Exchange Rate Systems

- **Gold Standard:** currency pegged to a particular value/oz. in gold (Late 1800s-1920s)
- **Bretton Woods/Dollar Standard:** currencies pegged to dollar; value of dollar fixed at $35/oz. of gold.
  - *Triffin Dilemma:* Needed outflow of dollars to maintain liquidity of system, but this undermined value of dollar.
- **“The Snake”/EMS/ERM:** European systems of semi-fixed exchange rates; fluctuation within pre-set bands (i.e., +/- 2.25%).
Changes in Exchange Rates and Trade

**DAY 1: £ 1 (UK) = $1 (US)**

- **Bass Ale in UK costs £1**
- **Budweiser in UK Costs £1**
- **Budweiser in US Costs $1**
- **Bass Ale in US costs $1**
DAY 2: £ 1 (UK) = $0.50 (US)
FALL in £; RISE in $

- Bass Ale in UK costs £ 1
- Budweiser in UK Costs £ 2
- Budweiser in US Costs $1
- Bass Ale in US costs 50¢
Effects on Balance of Payments of Exchange Rate Changes

If currency value ($) RISES:

- Export Price UP ➤ Export Demand DOWN ➤ Export Volume DOWN ➤ Trade Deficit GROWING

If currency value ($) FALLS:

- Export Price DOWN ➤ Export Demand UP ➤ Export Volume UP ➤ Trade Deficit SHRINKING
Exchange Rates and Purchasing Power Parity (PPP)

- **Purchasing Power Parity**: The relative value (purchasing power) of currency both within and outside of a nation.
- If €1 = $1, then a product that costs $1 in the US, it SHOULD cost €1 in Europe.
- **PROBLEM**: What to product to measure?
- **Big Mac Index** (*The Economist*): Since Big Mac is almost exactly the same product worldwide, excellent indicator of PPP.
“Big Mac Index” and PPP

EX: $1 = €1
Big Mac (Boston) = $2
Big Mac (Berlin) = € 2

IF.... Big Mac (Boston) = $2
Big Mac (Berlin) = € 4 ($4)
€ is OVERVALUED by 50%
(X-rate value = $1; PPP value = $0.50)

IF.... Big Mac (Boston) = $2
Big Mac (Berlin) = € 1 ($1)
€ is UNDERVALUED by 50%
(X-rate value = $1; PPP value = $2)
Causes of Exchange Rate Fluctuations

- Inflation (Higher inflation → lower X-rate)
- Interest Rates (Higher IR → higher X-rate)
- Speculation (Investors in foreign exchange markets driving price up or down)
- Central Bank Intervention (limited given scale of foreign exchange markets)
The “Unholy Trinity”

Governments want to have:

- Monetary Policy Autonomy (raise/lower interest rates as see fit)
- International Capital Mobility (money freely flowing in/out of the country)
- Stable Exchange Rates

PROBLEM: Cannot achieve all three at once!!