

International Monetary System

I. Domestic Monetary Policy

II. International Monetary Policy

A. Fixed Exchange Rates

B. Floating Exchange Rates

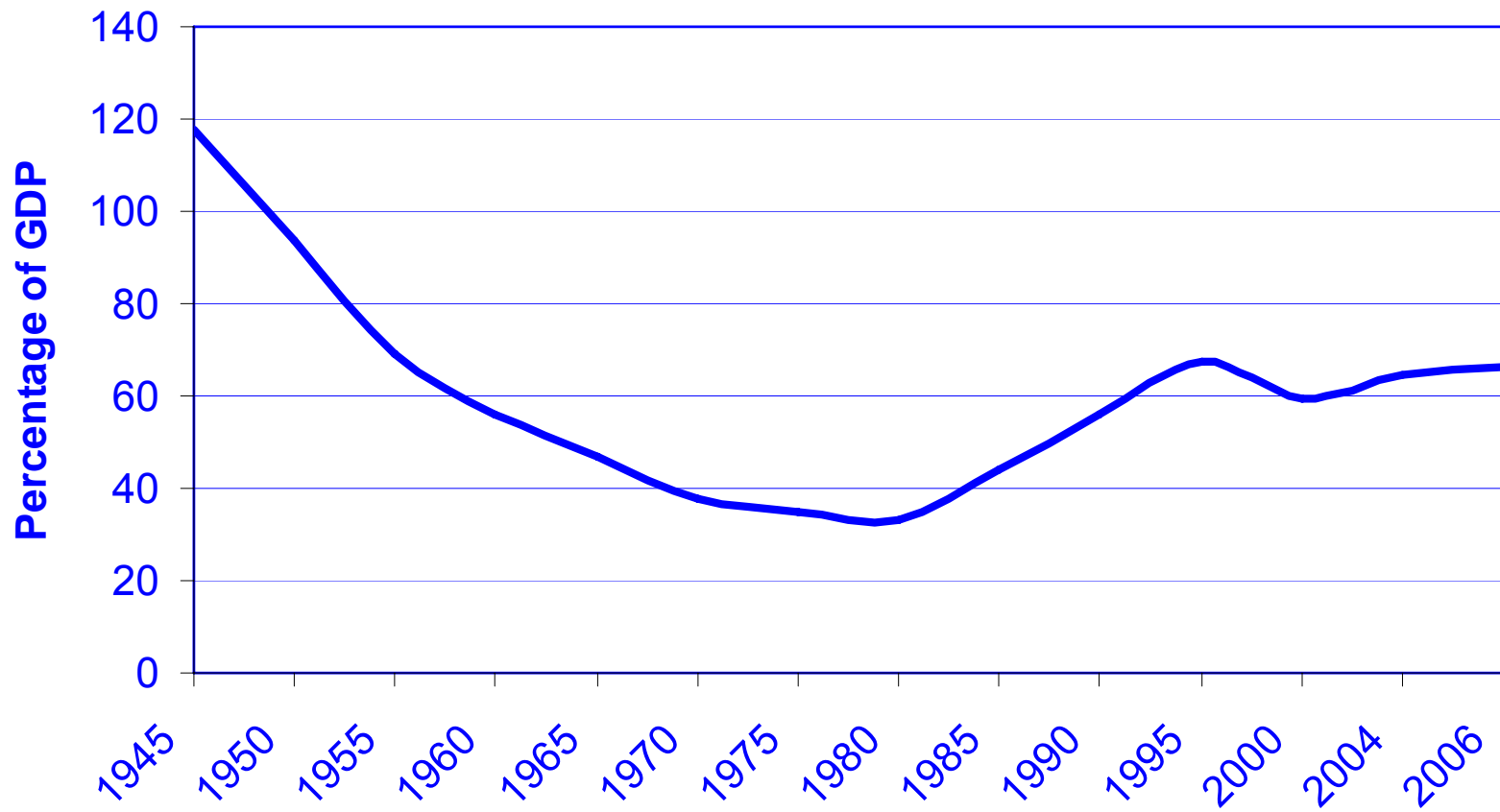
C. Managed Exchange Rates



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

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**

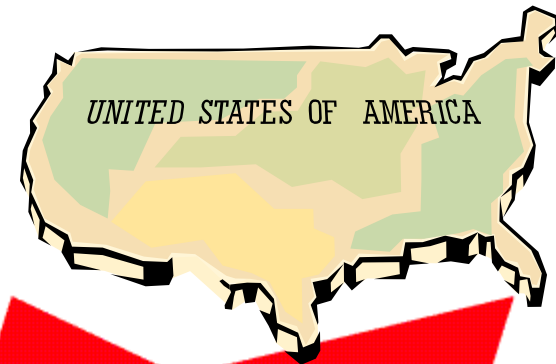
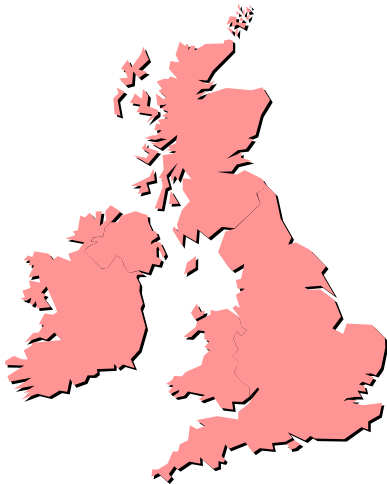
Examples of Fixed Exchange Rate Systems

- **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)

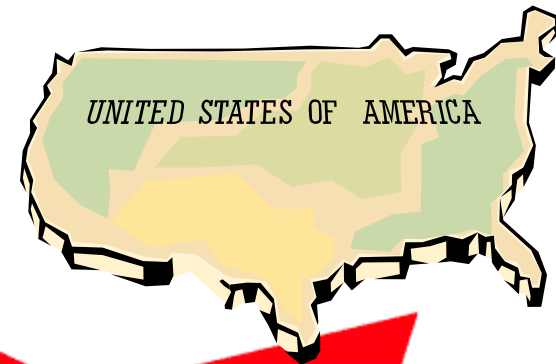
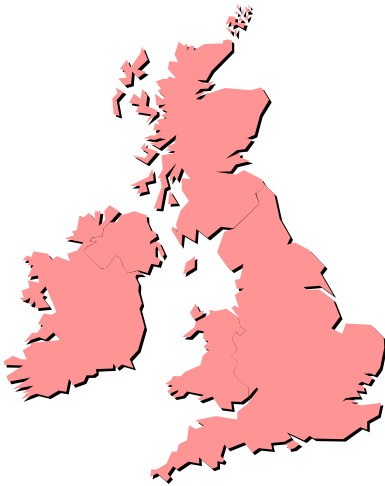
- **Bass Ale in UK costs £ 1**
- **Budweiser in US Costs \$1**
- **Budweiser in UK Costs £ 1**
- **Bass Ale in US costs \$1**



DAY 2: £ 1 (UK) = \$0.50 (US)

FALL in £; RISE in \$

- **Bass Ale in UK costs £ 1**
- **Budweiser in US Costs \$1**
- **Budweiser in UK Costs £ 2**
- **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 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” or “Mundell Trillema”

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!!