NYU 上海 SHANGHAI 纽约大学

International Political Economy (SOCS-SHU 222)

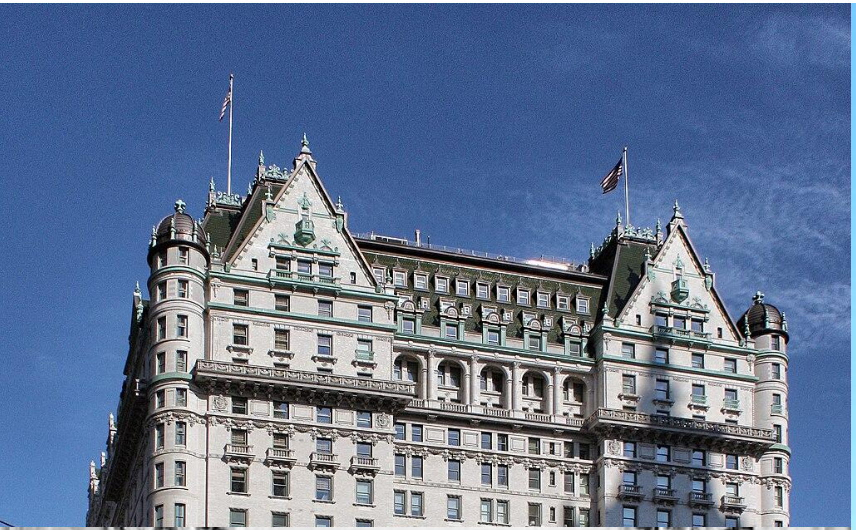
COOPERATION, CONFLICT, AND CRISIS IN THE CONTEMPORARY INTERNATIONAL MONETARY SYSTEM

Instructor: JING QIAN

Reminder:
Class this Sunday, Apr 13

The Plaza Hotel

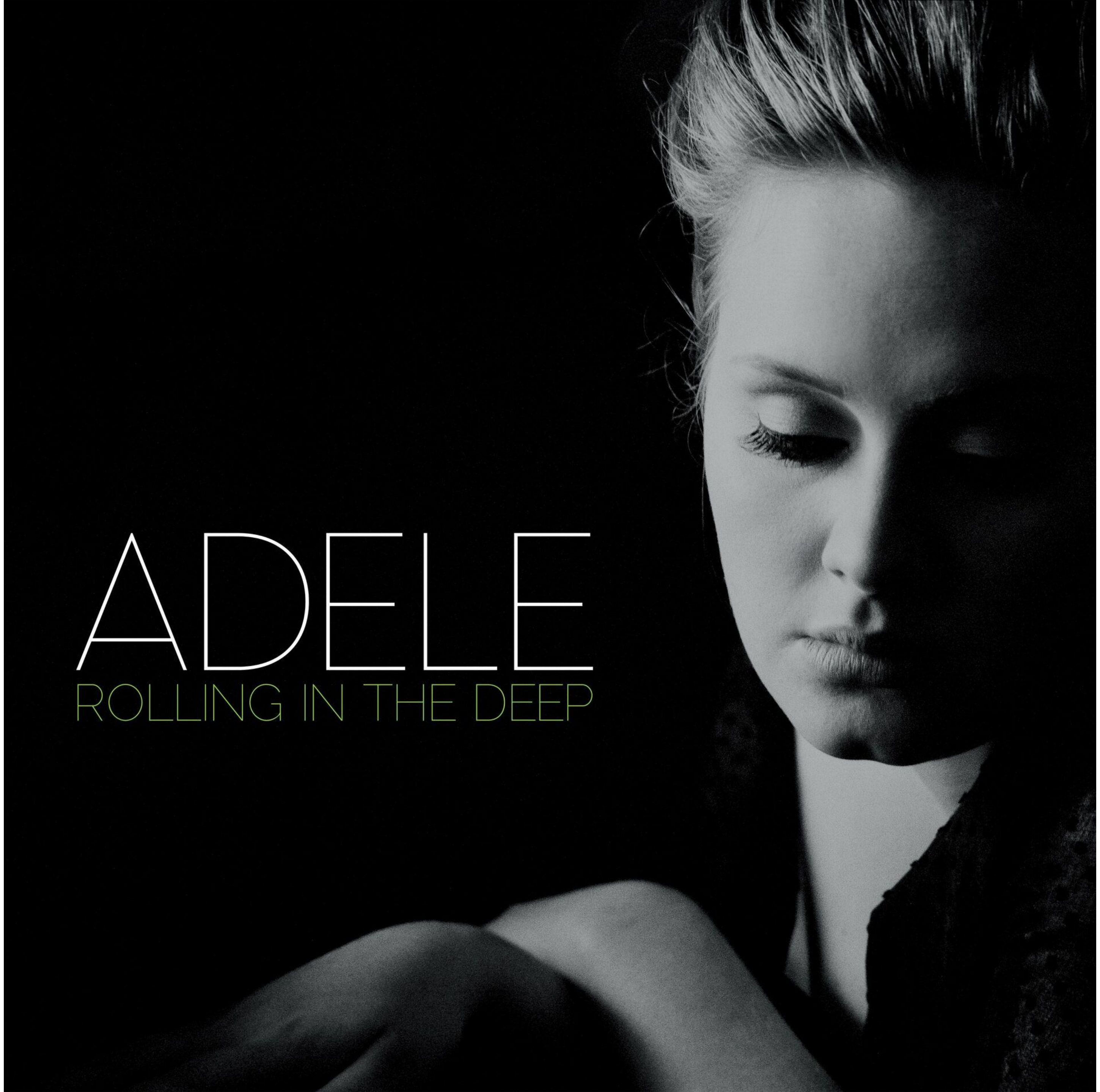
Mar-a-Lago



Cooperation, Conflict, and Crisis in the Contemporary International Monetary System

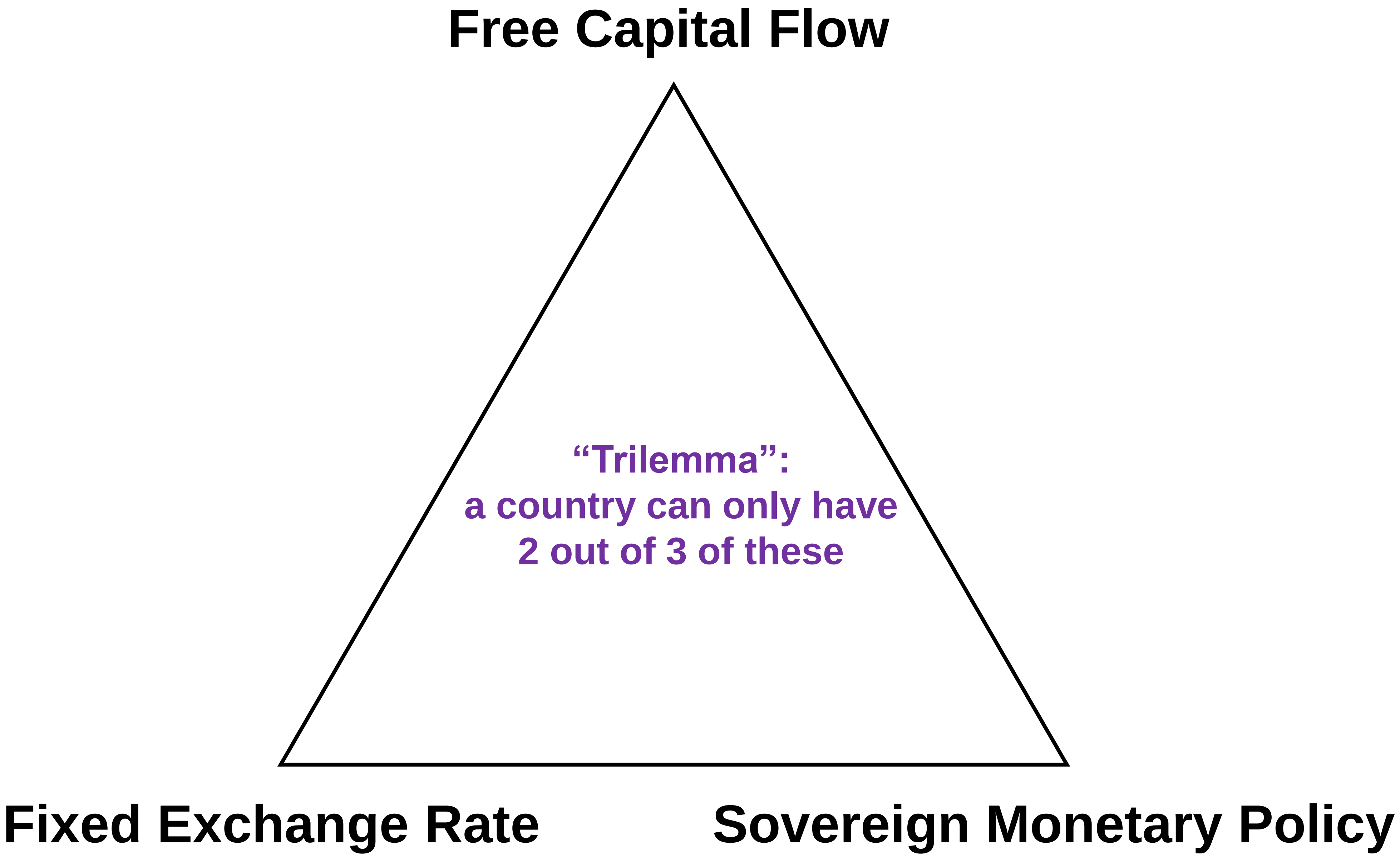
READING ASSIGNMENT:

Oatley Chapter 11


ADELE
ROLLING IN THE DEEP

We cou[illegible]ad it all?

The “Trilemma”


Free Capital Flow
“Trilemma”:
a country can only have
2 out of 3 of these
Fixed Exchange Rate
Sovereign Monetary Policy

The Trilemma

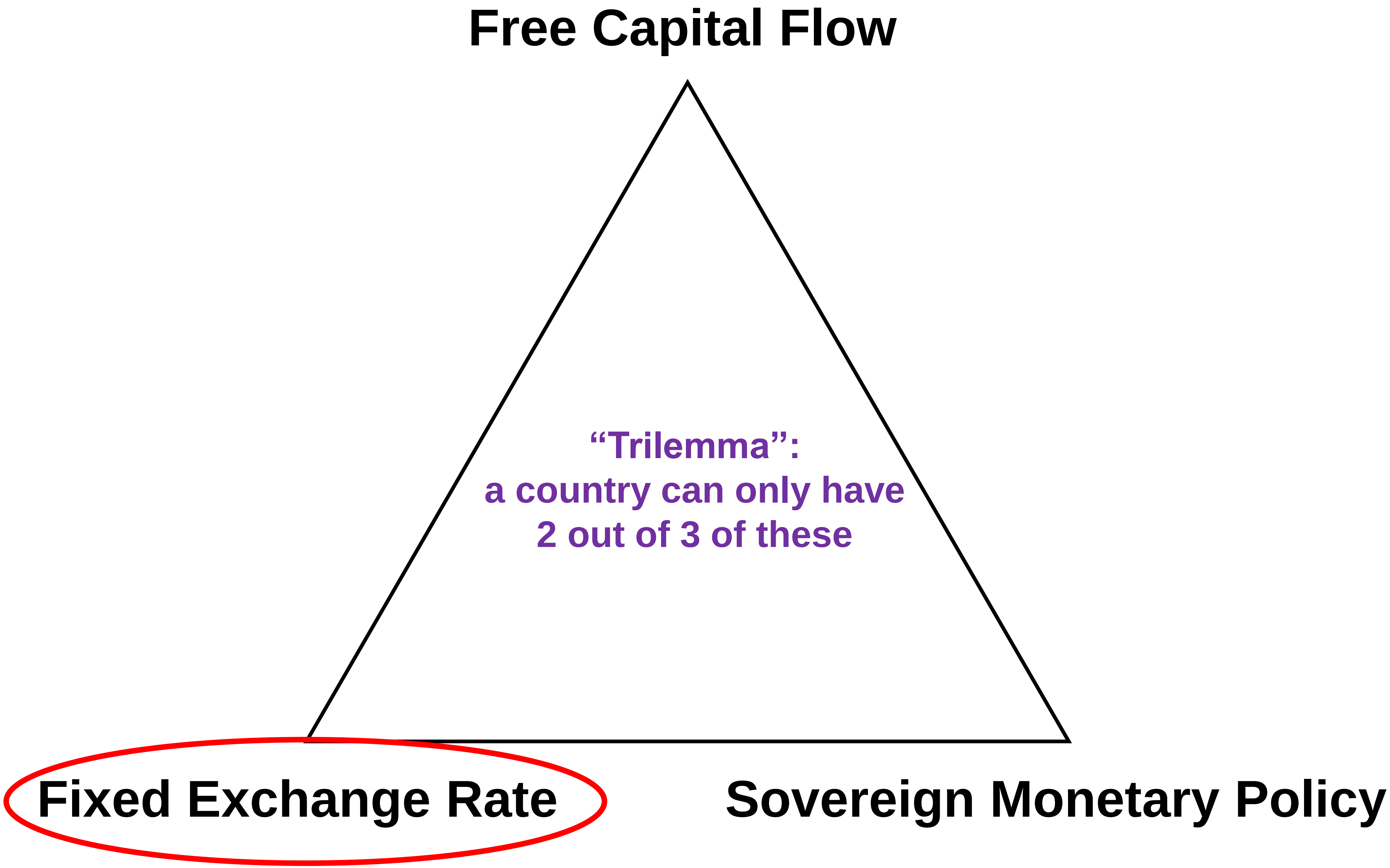
Open Capital Flows

Fixed Exchange Rate

Sovereign Monetary Policy

Why would you want…

- Free Capital Flow?
  - Draw on the savings of the rest of the world
  - Investment opportunities abroad
- Fixed Exchange Rate?
  - Reduce uncertainty in trade
- Sovereign Monetary Policy?
  - Address inflation/unemployment


Free Capital Flow
"Trilemma":
a country can only have
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Fixed Exchange Rate
Sovereign Monetary Policy

The Exchange Rate System

A set of rules governing how much national currencies can appreciate and depreciate in the foreign exchange market

FIXED-BUT-ADJUSTABLE

MANAGED FLOAT

FIXED

FLOATING

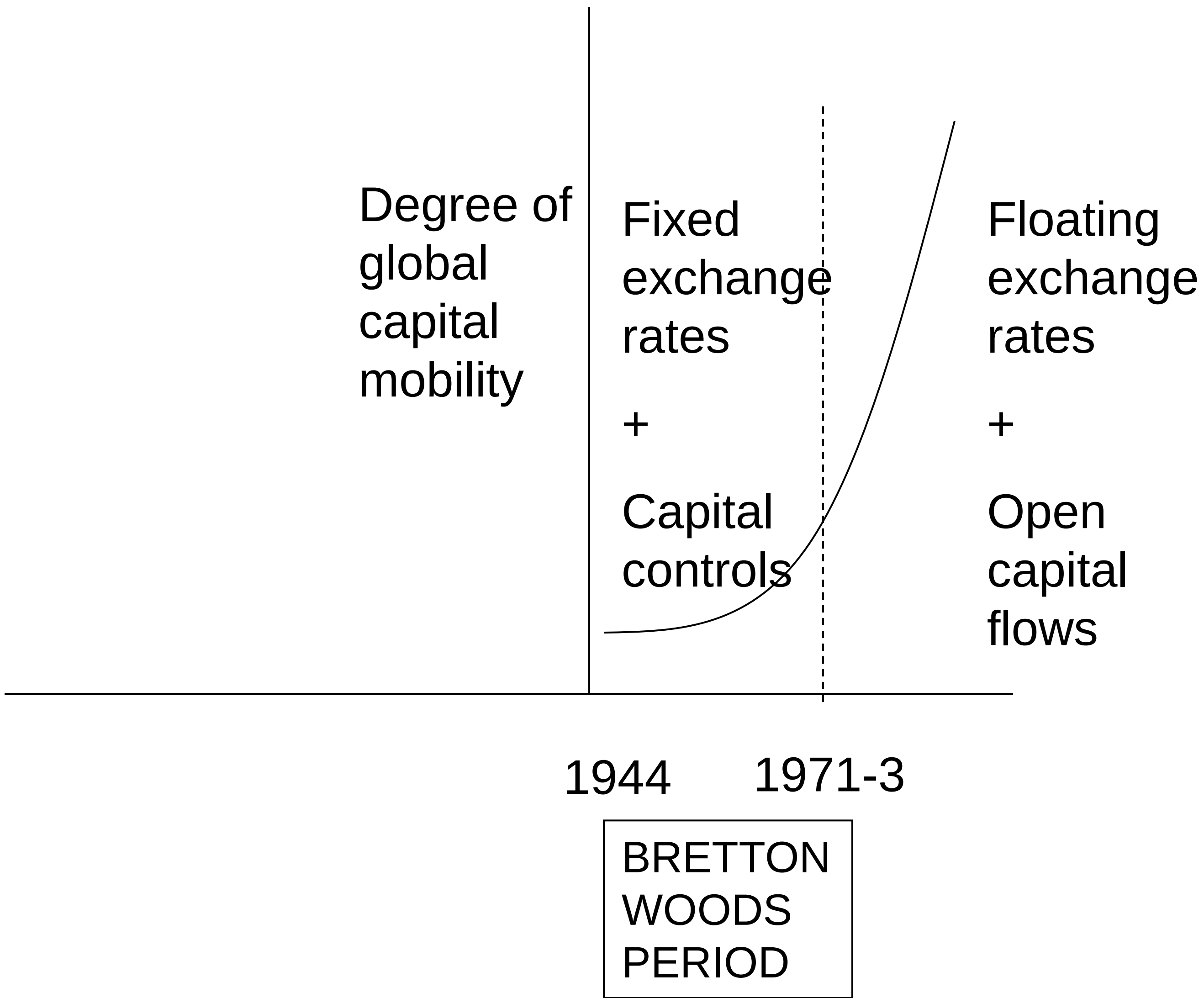
Consequences of XR volatility?

- Uncertainty hurts international transactions?
- Suppose you work on a profit margin of 5%-9% and the XR changes 5% between the time you ship an export and the time it arrives…
- But businesses can purchase options to buy a foreign currency 30, 60, or 90 days in the future at today’s XR, thereby insuring themselves against short-term XR volatility
- Nevertheless, a reduction in investment is one possible consequence of currency misalignments

Fixed Exchange Rate

- A kind of commitment
- To avoid SPECULATATION governments try to make a ***credible*** commitment to a fixed XR
- If the commitment is not credible, speculation can be disastrous
- Argentine Currency Board (1991-2002)
  - Pegged the Argentine peso to the U.S. dollar in an attempt to eliminate hyperinflation
  - Credibility? Required legislative vote to change the value of the currency (public discussion undermines the point of a devaluation!)
  - But deficit spending ultimately undermined confidence
  - And tied hands prevented the government from acting
  - Run on the currency in 2002 ➔ disaster!!

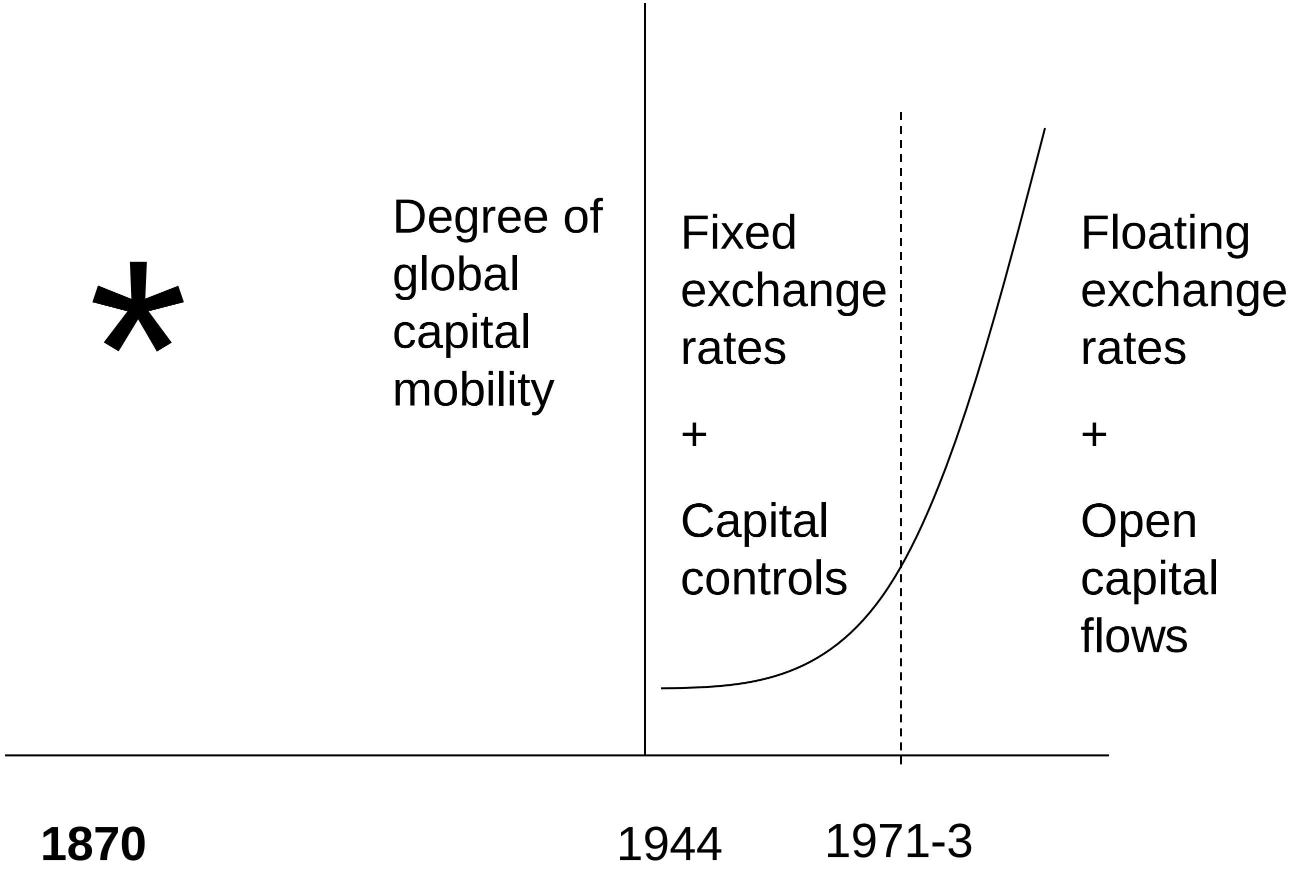
The Rise and Fall of Bretton Woods



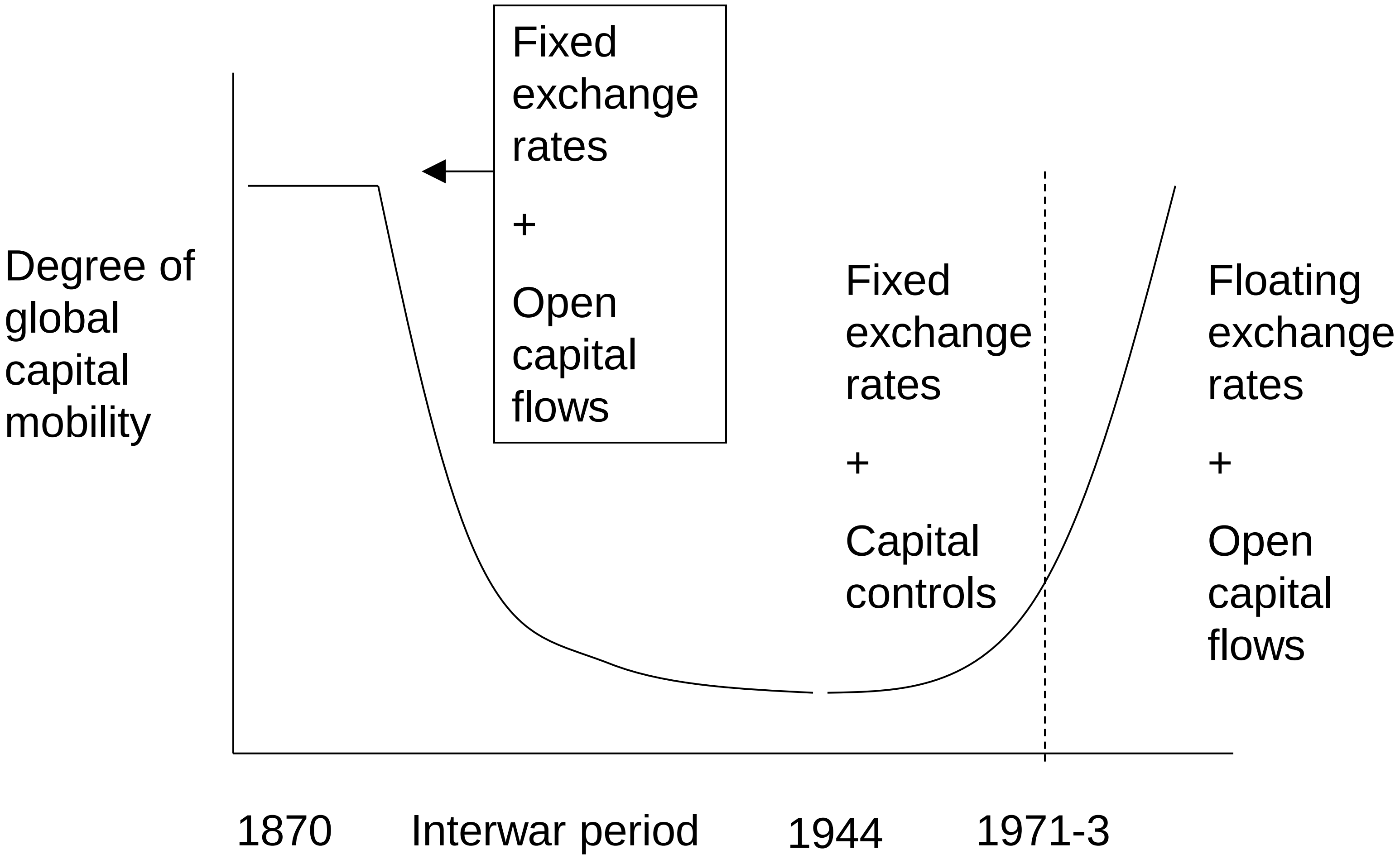
Conclusion:

- Cannot maintain (global) fixed exchange rates in the presence of high capital mobility…?

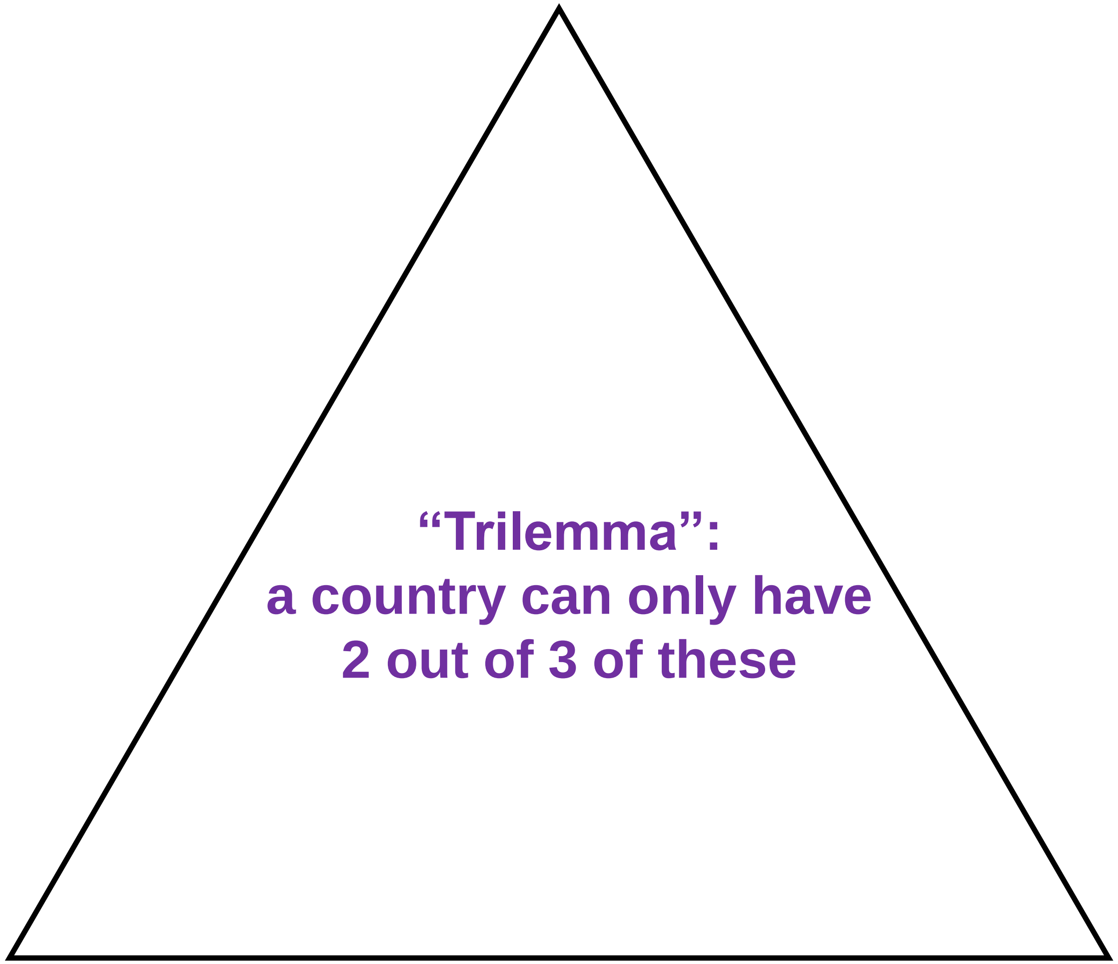
The Rise and Fall of Bretton Woods: A Puzzle



A Puzzle: Why were countries able to maintain fixed exchange rates with high capital mobility in the late 19th century?



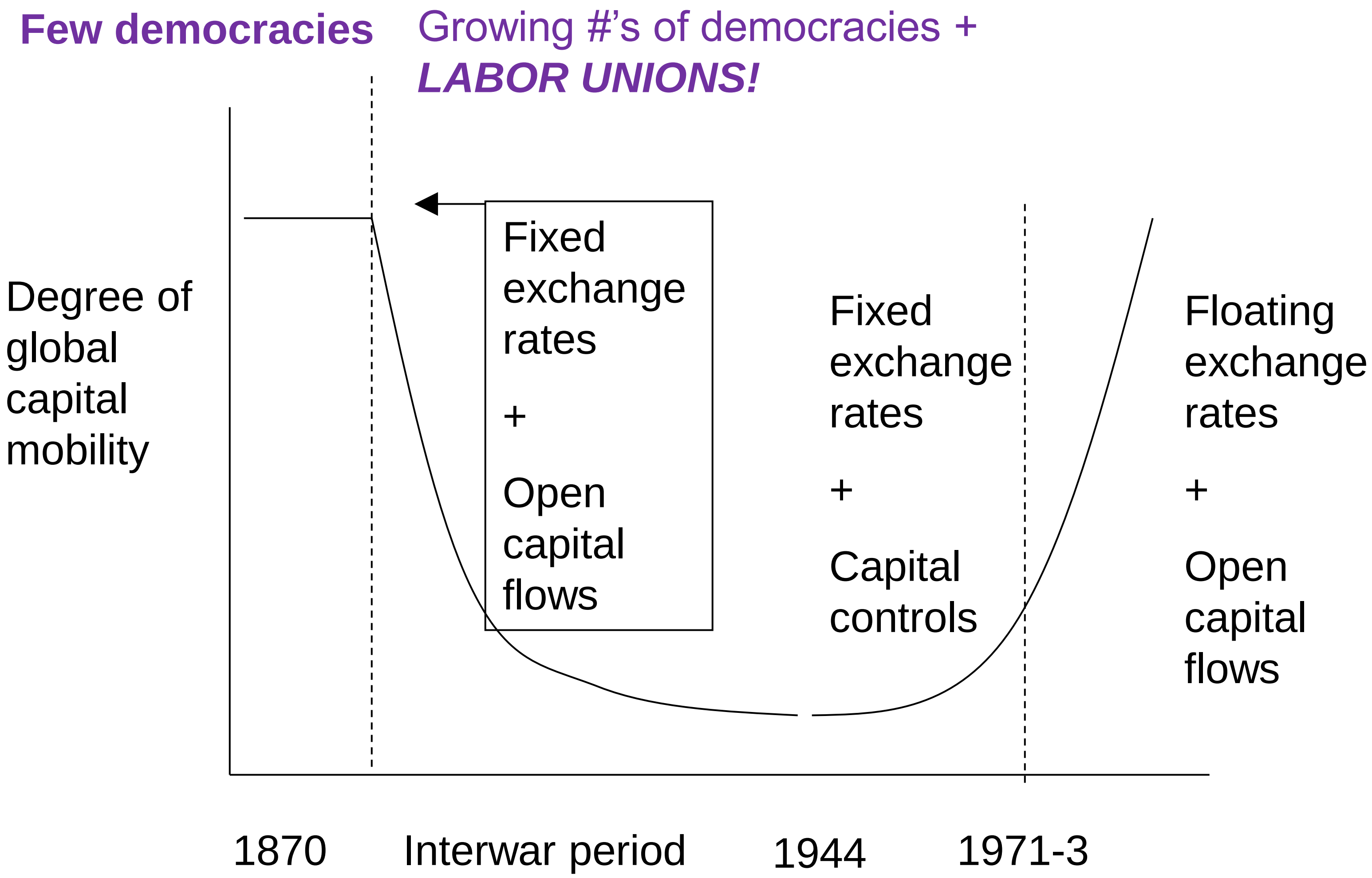
Free Capital Flow



Fixed Exchange Rate

Sovereign Monetary Policy

Answer: Democracy

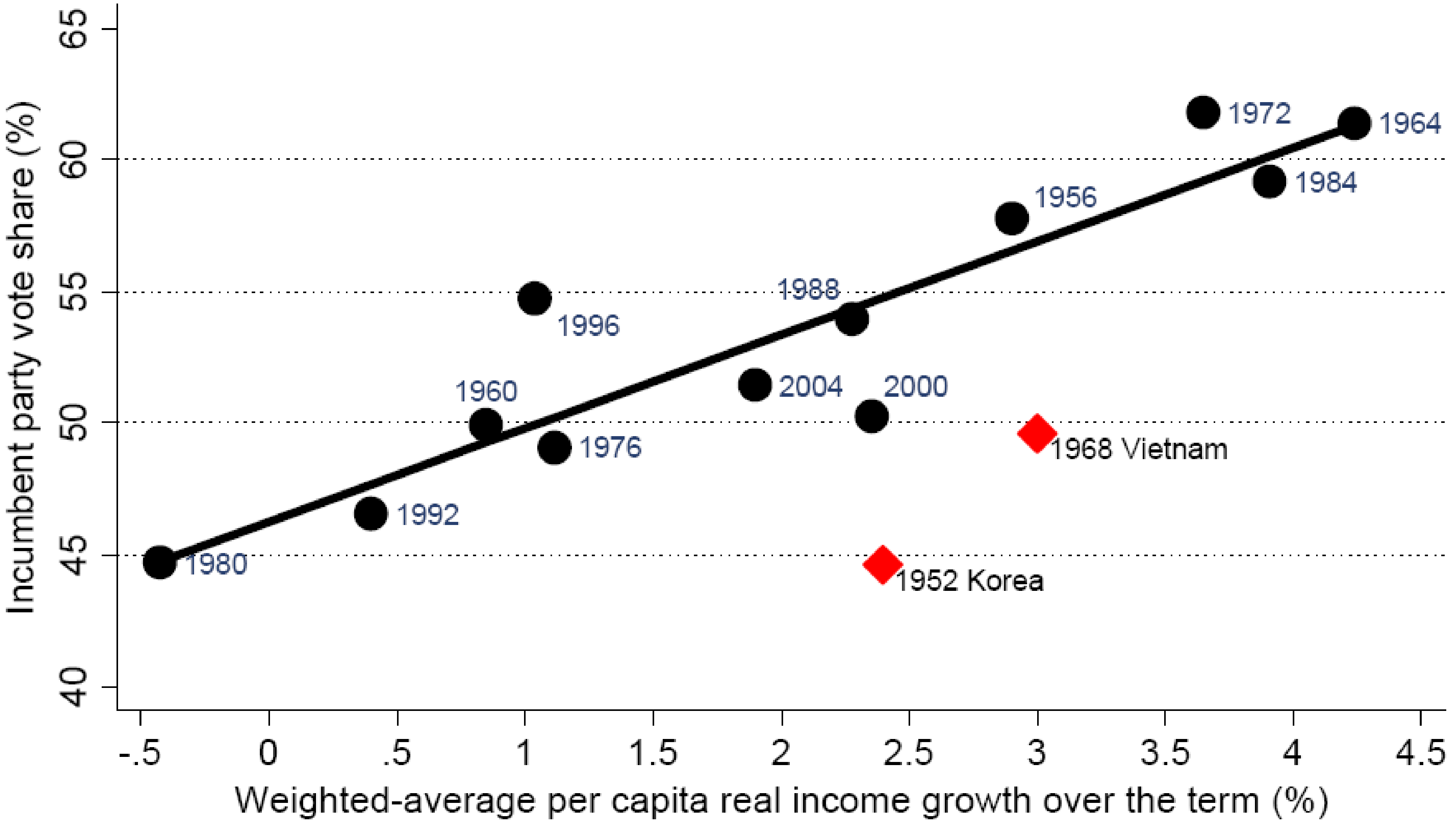


Under democracy,

The “pocketbook voter model”

- people vote according to changes in their income
- http://www.youtube.com/watch?v=loBe0WXtts8

Figure 1. Bread and Peace Voting in US Presidential Elections



Why?

- So, why do fixed exchange rates pose a problem for democracies in the face of highly mobile capital?

Pure Gold Standard

- Country A imports from Country B
- Gold moves from A to B (re-coined/minted)
- Less money in A ➔ lower prices
- More money in B ➔ higher prices
- ➔ Country B imports from Country A
- Balance is restored

With Paper Money

- Central Banks intervene by adjusting interest rates
- So gold doesn’t actually flow
- Gold Standard ➔ strict discipline!

What is “discipline”?

- What do “lower prices in Country A” mean?
- Supply of money down
- More expensive to borrow
- Jobs cut!
- People don’t eat!


Are you better off than you were four

Stylized History

- Late 19^{th} century:
  - Mobile capital, authoritarian governments

- Interwar years:
  - Mobile capital + democracy ➔ beggar-thy-neighbor
  - http://www.youtube.com/watch?v=3_ex0sTsb_I&feature=channel

GOLD STANDARD DROPPED

TO LIFT PRICES AND AID OU

PLANS FOR CONTROLLED

ALL MARKETS BOOSTED

Stocks Rise 1 to 9½ and Commodities Spurt as Bonds Move Lower.

Dollar D

https://www.youtube.com/watch?v=3_ex0sTsb_I

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- Bretton Woods (1944-1971/3):
  - Capital controls + democracy
  - http://www.youtube.com/watch?v=GVytOtfPZe8

What were the goals of Bretton Woods?

- Attempted to establish a system of fixed XR in a world where governments where governments were unwilling to sacrifice employment to address imbalances
- 4 INNOVATIONS:

1. Some XR flexibility (fixed-but-adjustable “snake”)
2. Capital controls
3. A stabilization fund (held on reserve at the IMF)
4. The International Monetary Fund – authority over XR changes + conditionality attached to loans

Bretton Woods failed for several reasons

- IMF lacked true authority over XR – governments did as they saw fit
- Governments did not like IMF conditionality
- The stabilization fund was never large enough to deal with the potentially massive imbalances that come with growing globalized economic integration
- Straws that broke the BW back:
  - USA: VIETNAM + SOCIAL SPENDING + INTERNATIONAL RESERVE CURRENCY
  - ➔ SPECULATION that the US cannot maintain the fixed convertibility to gold + the French – regularly demanded American gold from the US for the $’s they accumulated
- http://www.youtube.com/watch?v=iRzr1QU6K1o

Stylized History

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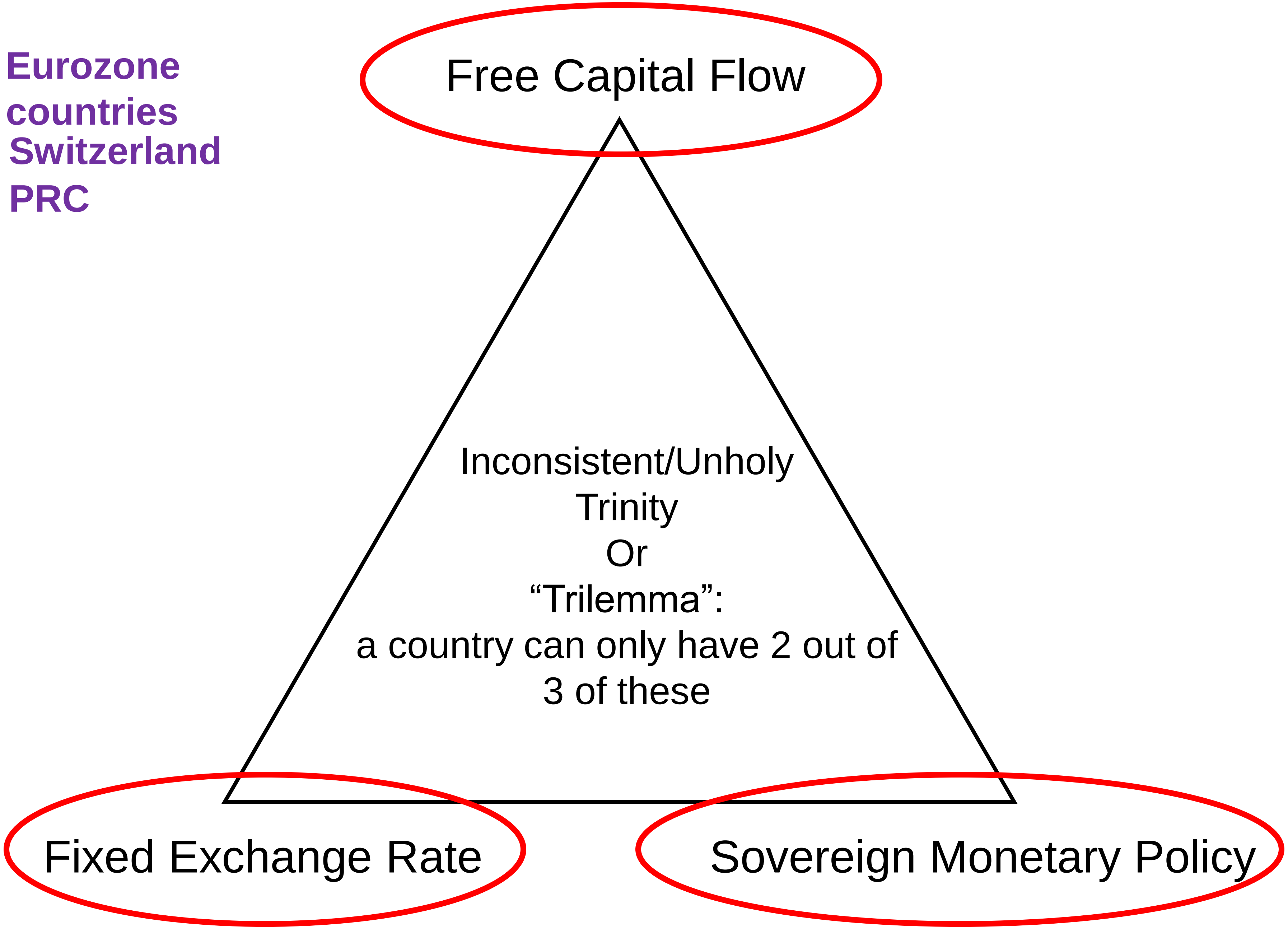
- Post Bretton Woods:
  - Floating exchange rates
  - http://www.youtube.com/watch?v=iRzr1QU6K1o

Eurozone countries
Switzerland
PRC



Monetary Policy

Policies to adjust the supply of money in the economy

Expansionary

- ↓ Interest rates ~ ↑ Money supply
- ↑ Borrowing, ↓ Savings
- ↑ Investment and consumption
- ↓ Unemployment
- Risks of inflation

Contractionary

- ↑ Interest rates ~ ↓ Money supply
- ↓ Borrowing, ↑ Savings
- ↓ Investment and consumption
- ↑ Unemployment
- Contorl inflation

Thank You!

Take-away

1. The Trilemma (choose 2 out of 3)
   - Free Capital Flow
     - Draw on the savings of the rest of the world
     - Investment opportunities abroad
   - Fixed Exchange Rate
     - Reduce uncertainty in trade
   - Sovereign Monetary Policy
     - Address inflation/unemployment
2. Democracy → Fall of the gold standard
3. Fall of Bretton Woods replaced with floating XR
4. The Trilemma
5. Floating XR allows for flexibility in monetary policy