

# International Political Economy (SOCS-SHU 222)

## THE INTERNATIONAL MONETARY SYSTEM

Instructor: JING QIAN



# Quiz 1 Recap

# Question 1

The purpose of this exam is to solve

- A tragedy of the commons problem
- A collective action problem
- A moral hazard problem
- ✓ ○ A commitment problem
- A coordination problem

→ Class 1 slide

# Exams

## What's the point?

- CREDIBLE COMMITMENT
- Designed to help you to do your work
- Emphasizes a key point of the class:

## *The Importance of Incentives*

## Why choosing your own weight?

- PRIORITIES
- *Commitment and Ownership*

# Question 11-13

Player 2		
Player 1	Cooperate w/friend	Defect (rat)
Cooperate w/friend	<b>-3, -3</b>	<b>-25, -1</b>
Defect (rat)	<b>-1, -25</b>	<b>-10, -10</b>

What is the one-shot equilibrium of this game?

→ Defect – Defect

What is collectively optimal (Pareto optimal) outcome in the above game?

→ Cooperate – Cooperate

In a repeated setting, which of the following is an equilibrium?\*

→ Cooperate – Cooperate (infinitely repeated)

→ Defect – Defect (finitely repeated)

# Question 15

According to the “factor model,” trade causes

- ☐ the income of the abundant factor to fall
- ☐ the income of the scarce factor to rise
- ☐ the income of the import-competing sector to fall
- ☐ the income of the export-oriented sector to rise
- ☒ none of the above

# Question 18-19

		Land-Labor Ratio	
		High	Low
Advanced Economy		Abundant: Capital Land  Scarce: Labor  A	Abundant: Capital Labor  Scarce: Land  B
		Abundant: Land  Scarce: Capital Labor  C	Abundant: Labor  Scarce: Capital Land  D

Class Conflict:

- Capital & Land vs.
- Labor

Urban-Rural Conflict:

- Capital & Labor vs.
  - Land
- 
- Scarce factor oppose free trade
  - Abundant factor support free trade

# Question 33

Regarding multinational corporations, horizontal integration is associated with which type of problem?

- Fixed asset
- Mobile asset
- Specific asset
- Monopoly
- ✓ ○ Intangible asset

→ Class 13 slide



# Horizontal Integration

- How much is the Coca Cola formula worth? How about the inner workings of Windows? Or the details of management at a firm like Kia?
- Intangible asset:
  - The value is derived from knowledge or from a set of skills/routines possessed by a firm's workforce
- “know-how”
- It is difficult to sell or license intangible assets
- Paradox of information:
  - The value of the information for the purchaser is not known until she has the information... but then she has acquired it without cost
- The owner of the information is unwilling to share info, the purchaser unwilling to buy
- Rather than sell the information, the firm can simply set up shop in a new location

# Vertical Integration

- Specific assets – dedicated to a particular long-term economic relationship
- Difficult to enforce long-term contracts
- One party in the long-term relationship can take advantage of the specific nature of the asset to extract a larger share of the value from the transaction
- Vertical integration eliminates this problem arising from specific assets

# Additional Office Hour

Sign-up to go through the quiz with me

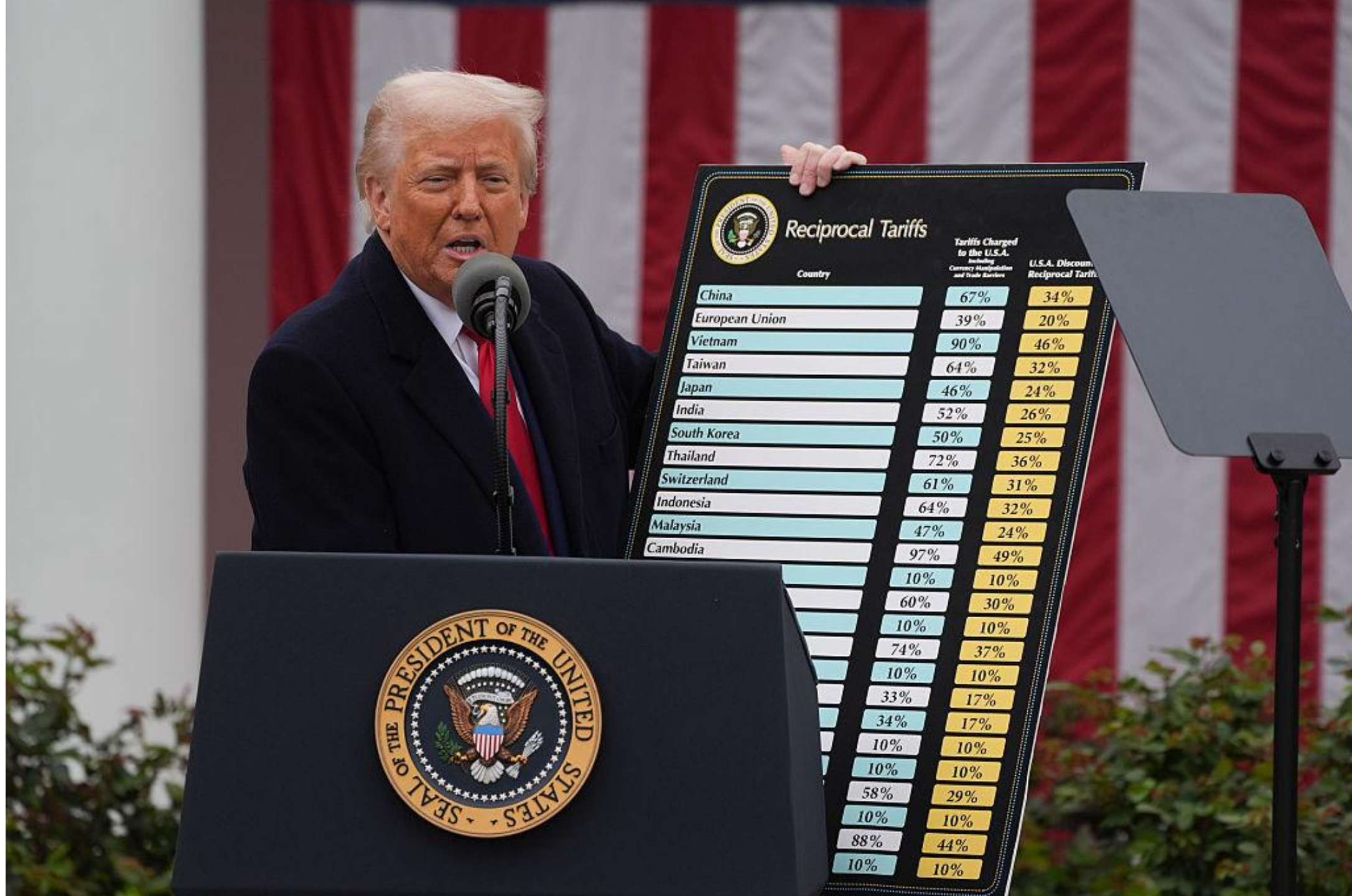
[jingqian.org/IPEclass/officehour](http://jingqian.org/IPEclass/officehour)

**Thoughts?**

# Quiz 1 – Follow Up

## GOOD NEWS!

- Quiz 1 weight reassignment: due April 11 at 11:59pm on Brightspace
- EXTRA CREDITS (all due May 15 at 11:59pm on Brightspace)
  - ✓ Watch a related movie/documentary & submit a short memo (2pts)
  - ✓ 1:1 consultation with ARC or library (1.5pts)
  - ✓ Attend a workshop or academic talk (1.5pts)
  - ✓ Up to 5 total extra credits!



# Trade and Prices



US distributors import Switch 2 from Japan

- Say selling price by Nintendo is JPY 60,000 (~ \$400)

Trump's Reciprocal Tariff

- With the 24% tariff, the cost would be JPY 74,400 (~\$500)

Exchange-Rate Fluctuation

- If USD-JPY exchange rate increases to 1:200
- The cost would be ~\$300 instead



# The International Monetary System

READING ASSIGNMENT:

Oatley Chapter 10

NYU  
上海



SHANGHAI  
纽约大学



# 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**

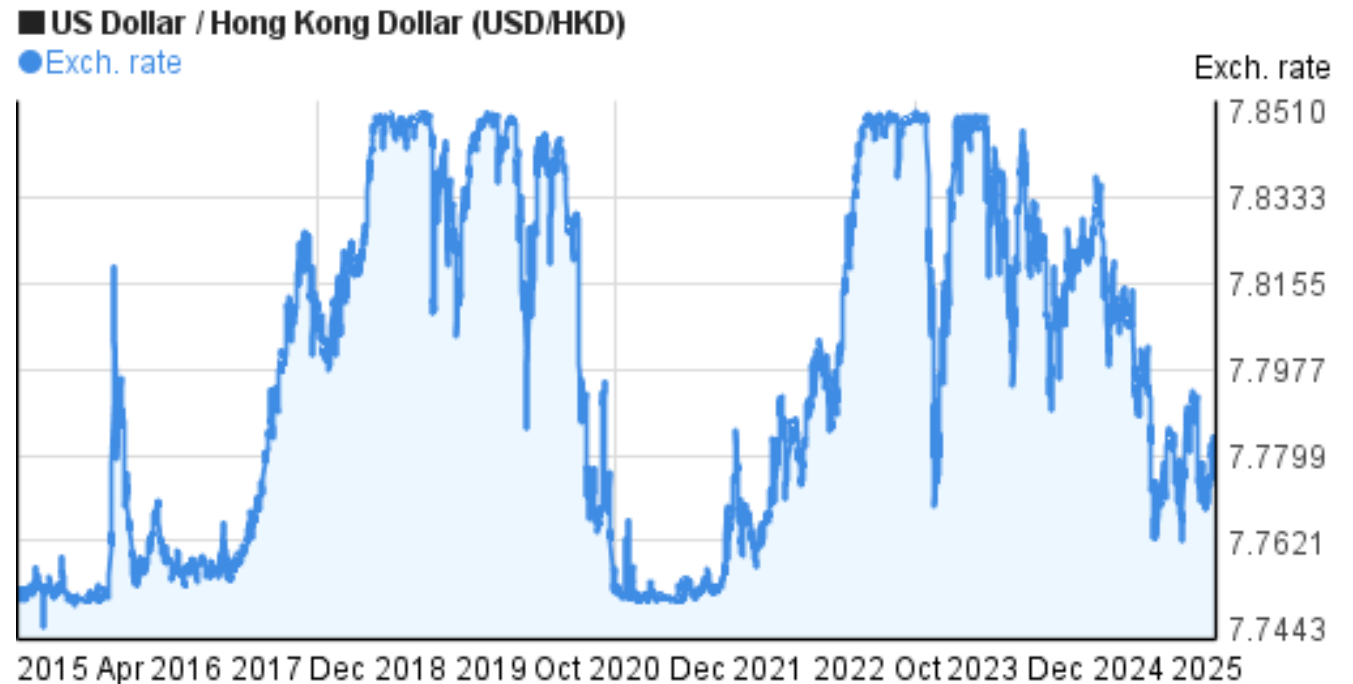
# The Exchange Rate System

**FIXED:** governments allow for only very small changes. The government maintains this fixed price by buying & selling currencies in the foreign exchange market.



HONG KONG MONETARY AUTHORITY  
香港金融管理局

The Linked Exchange Rate System (LERS) has been implemented in Hong Kong since 17 October 1983. Through a rigorous, robust and transparent Currency Board system, the LERS ensures that **the Hong Kong dollar exchange rate remains stable within a band of HK\$7.75-7.85 to one US dollar.**



© Chartoasis.com

# The Exchange Rate System

**FIXED:** governments allow for only very small changes. The government maintains this fixed price by buying & selling currencies in the foreign exchange market.



HONG KONG MONETARY AUTHORITY  
香港金融管理局

The Linked Exchange Rate System (LERS) has been implemented in Hong Kong since 17 October 1983. Through a rigorous, robust and transparent Currency Board system, the LERS ensures that **the Hong Kong dollar exchange rate remains stable within a band of HK\$7.75-7.85 to one US dollar.**

## USD:HKD > 7.85?

- The HK government would:
- Sell USD reserves
- Purchase HKD
- *Price of HKD goes up*
- *USD:HKD ↓*

## USD:HKD < 7.75?

- The HK government would:
- Purchase USD
- Sell HKD
- *Price of HKD goes down*
- *USD:HKD ↑*

# The Exchange Rate System

FLOATING: governments do not intervene. There are no limits on how much the XR can move up or down (e.g., US\$)



# The Exchange Rate System

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

- **FIXED:** governments allow for only very small changes. The government maintains this fixed price by buying & selling currencies in the foreign exchange.
- **FLOATING:** governments do not intervene. There are no limits on how much the XR can move up or down (e.g., US\$)
- **FIXED-BUT-ADJUSTABLE:** Governments intervene under a set of well defined circumstances (e.g., Bretton Woods... note: well defined circumstances can be devastating with speculators – surprise is important when it comes to monetary policy!)
- **MANAGED FLOAT:** Governments intervene but there are no rules (surprise!) – these days most governments do this...

# Balance of Payments

An accounting device that records all international transactions between a particular country and the rest of the world for a given period.

## Three main components of the BoP

- **Current Account: non-financial transactions**
  - Imports & exports of goods & services, royalties, fees, interest payments, profits, remittances, foreign aid grants
- **Capital Account: capital transfers**
  - Capital transfers (e.g. debt forgiveness, migrant transfers); Non-produced, non-financial assets (e.g. rights to natural resources, patents, leases)
- **Financial Account: transactions in financial assets and liabilities**
  - Foreign direct investment, portfolio investment (stocks & bonds), & other investments (such as changes in holdings in loans, bank accounts, and currencies)

Current Account Balance + Capital Account Balance + Financial Account Balance + *Statistical Discrepancy* = 0

U.S. 2024 BoP: <https://jingqian.org/IPEclass/BoP> (p7-8)

# Adjusting the BoP

$$\text{Current Account Balance} + \text{Capital Account Balance} + \text{Financial Account Balance} + \textit{Statistical Discrepancy} = 0$$

- But with millions of international transactions there is no assurance will produce a perfect balance. When they don't, the country faces an imbalance of payments
- Adjusting the BOP under Fixed XR -> Price Changes
- Adjusting the BOP under Floating XR -> Exchange Rate Movements

# Adjusting the BoP under Fixed XR

- The adjustment occurs through PRICE CHANGES
- Deficit countries see a reduction in the money supply
  - So prices fall
- Surplus countries see an increase in the money supply
  - So prices rise
- The prices of goods (and services... wages?) actually rise and fall!
- The government maintains the fixed XR by using monetary policy
  - Interest rates go up in deficit countries, they go down in surplus countries
- Monetary policy cannot be used to manage domestic economic activity (*unless there are **strict** capital controls*)



# Adjusting the BoP under Fixed XR

- In early 1990s, fixed XR between Argentine Peso and US Dollar
- Say Argentina runs a trade deficit with US, it
  - Imports = \$10 billion
  - Exports = \$6 billion
  - Current account deficit = -\$4 billion
- So Argentina pays 10 billion USD but only receives 6 billion pesos
  - Demand for USD is higher ( $10 > 6$ )
  - Depreciation pressure on peso
- **To maintain fixed XR, Argentine sells \$4 billion to buy back pesos**
  - That is 4 billion less pesos from circulation
  - So less money supply
- With money supply falls
  - Less spending
  - Less lending
  - Falling wages and prices (deflation)

# Adjusting the BoP under Floating XR

- The adjustment occurs through EXCHANGE RATE MOVEMENTS
- Deficit countries see a depreciation in their currency (excess supply of the currency lowers the “price” or XR of the currency)
  - So, in terms of other currencies,
  - Prices of exports fall – Accordingly, demand for exports goes up
  - Prices of imports rise – Accordingly, demand for imports goes down
- Surplus countries see an appreciation in their currency (excess demand for the currency increases the “price” or XR of the currency)
  - So, in terms of other currencies,
  - Prices of exports rise – Accordingly, demand for exports goes down
  - Prices of imports fall – Accordingly, demand for imports goes up
- Balance is restored as deficit countries see imports go down & exports go up while surplus countries see imports go up and exports go down
- Prices of domestic goods (& services... **wages**) remain relatively stable
- The government is free to pursue domestic policy goals (employment, for example) by using monetary policy
  - E.g., lower interest rates to stimulate demand... economic growth; raise interest rates to fight inflation

# Adjusting the BoP under Floating XR

- ~~In early 1990s, fixed XR between Argentine Peso and US Dollar~~
- Say Argentina runs a trade deficit with US, it
  - Imports = \$10 billion
  - Exports = \$6 billion
  - Current account deficit = -\$4 billion
- So Argentina pays 10 billion USD but only receives 6 billion pesos
  - Demand for USD is higher ( $10 > 6$ )
  - Depreciation pressure on peso
- **With floating XR, peso depreciates**
  - USD:Peso  $> 1:1$ , say 1:2
- With depreciated Pesos, for Argentina
  - Imports from US become more expensive -> import demand drops
  - Export become cheaper for Americans -> export demand rises
  - Gradually, current account deficit shrinks

# What were the goals of Bretton Woods?

- Attempted to establish a system of fixed XR in a world 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>

# Thank You!



# Take-away

- XRs: (1) Fixed, (2) Adjustable, (3) Managed, (4) Float
- Adjusting the BoP under fixed exchange rates
  - Monetary policy raises/lowers money supply to deal with surplus/deficit
- Adjusting the BoP under floating exchange rates
  - XR appreciates/depreciates to deal with surplus/deficit