Lecture 4

The evolution of the international and monetary system

- Global institutions play important role in shaping international financial and monetary systems; thereby shaping the global system
- The international financial and monetary systems, has undergone several changes in response to certain developments in political and economic events at domestic or international level
- Generates pressure for these changes
- We can identify several historical stages
    - Establishment of international finance and monetary order before WWI
    - Collapse of the international monetary and financial system during WWI
    - Bretton Wood Order
    - Financial crisis of 1970's
    - Transformation from floating exchange rates to monetary unions
    - Globalization of financial markets

    - **Establishment of the international finance and monetary order before World War I**

        - Most international transactions during this period were one of two types
            - Short term capital movement; generated by interest rate differential between countries or between institutions.
            - Long term capital export; from major lending European financial institutions to the different

borrowers all around the world. London the main source of capital export during this period. Percentage of capital exports to the GDP in London was extremely high.

- System was highly integrated; by 1914 most currencies were linked to the same gold standard. This linkage led to establishment of a fixed exchange rate system.
- Several monetary zones were established. In each zone, the currency in that region could be circulated among one another.
- 2 major monetary unions:
    - Scandinavian Monetary Union (1873): Sweden, Denmark, Norway
    - Latin Monetary Union (1865): France, Switzerland, Belgium, Italy
- There was a serious attempt to integrate international monetary system; international conference of 1867 which was held to examine the possibility of establishing an integrated world monetary union; to create a single currency for the whole world.
- Increasing ambitions by the world powers to control as many colonies as possible.
    - Accompanied by the attempt to encourage the circulation of their own currencies in the newly occupied territories.

- **Collapse of the international monetary and finance system during WWI**

    - Capital movements and financial transactions were stopped

- Many nations abandoned the gold standard
- After WWI, financial institutions and world powers really tried to restore the pre-1914 international financial and monetary order.
- All of these attempts were defeated by the 1930's: the great depression
- The whole system collapsed; led to a very unique system where it broke off into several closed currency blocs. Within each bloc, currency was fixed in relation to each other; their value fluctuated
- Financial transaction between blocs was highly regulated and limited

- Bretton Woods agreement

  - First serious attempt to create new financial and monetary order.
  - After WWII
  - Headed by US and UK; planned to organize the post-war international monetary and financial system.
  - Policymakers wanted a more open liberal order; felt the prior order led to great depression and the second world war itself.
  - Philosophy based on a system which can reconcile multi level of transactions with the new domestically oriented priorities. Issues such as unemployment, social welfare and prosperity.
  - New system to satisfy both domestic and international needs.

        - Allows government to promote social welfare of society and prosperity, but at the same time, it will allow free flow of capital, less restrictions as possible.
- Proposed at Bretton Woods conference in 1945
- Major objectives
    - Establish and maintain the state of international currencies and its stability
    - Each country must determine and declare a par value of its national currency; determined by their relation to the value of US dollars which was tied to gold. (at the time $35USD/ounce)
        - By fixing currencies in this form, an international gold standard was established.
        - The gold-dollar standard is created.
    - Countries , as an option of adjusting the value of their currency and when their economy experiences a severe disequilibrium, the countries would be allowed to adjust the value of their currencies
        - They were allowed to adjust by a margin of 10% without approval of the IMF; any larger, and approval is needed
    - Countries were given the right to controlling all capital movements or all international capital transactions
    - Control was based on two justifications
        - Reduce effects of speculation; Maintain a stable exchange rate, maintain national economic autonomy
        - Enable the governments to conduct a sound or stable microeconomic policy through an independent control on interest rates.

- Two public financial institutions were created
    - International Bank for Reconstruction and Development (World Bank)
        - Objective: to promote long term loans for reconstruction and development following the war.
    - International Monetary Fund
        - Mandate: created to promote global and financial cooperation; they were given a power of international lending which were prior left to private institutions.
        - Provide short term loans and financial assistance to help member countries to finance their balance of payment problems and debt.

The gold standard

- Element of self correcting itself
- Any external shock or imbalances can be automatically corrected
- If any country experiences an imbalance in balance of payments (deficit), they can correct it through domestic policy
- Can export gold, reserves of gold goes down; money supply goes down
- Interest rates go up -> capital inflow, more investment in the economy. Interest rate of country is higher than international interest rates.
- Foreign currency goes up, balance of payment deficit goes down.

If balance of payment is deficit because there is excess foreign currency; therefore must buy gold.

- System offered domestic stability