Unit Six: Global Politics of Money

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Outline:

- Introduction - International Monetary System
- Central mechanisms
- Breton Woods System
- Breakdown of the Breton Woods System
- Contemporary System
- Current Controversies
- Further Reading

Required Reading:
- Cohn, Ch. 6.

Class Discussion Reading:
1) Introduction - International Monetary System

- Why is it important to study this???
  - Key to facilitating all international exchange
  - Important domestic politics ramifications
  - Major site of theoretical debate
    - Liberals emphasize role of markets in monetary system
    - Realists and Historical Structuralists emphasize role of states in creating/managing system

- Current debates?
  - Should exchange rates float (liberals) or be “Pegged” (anti-liberals and Keynesians)
2) Three Central Mechanisms:

A) Exchange Rate System:
- Exchange Rates/Foreign Exchange Markets
- Based on price of one currency in terms of another
  - “Price” determined by:
    - Floating System – supply and demand of currency
    - Fixed system – state intervention

B) Balance of Payments

C) Balance of Payments Adjustment
“Ideal Types” of Exchange Rate System:

i) Fixed or “pegged” system: currency pegged in relation to key (or “benchmark”) currencies or gold

- E.g. Gold Standard (19th Century) - states guarantee value of currency against gold = *convertibility*
- *Currencies should not fluctuate in value . . .*

- Non-Gold standard “pegged” systems
- *Currencies “fixed” in value against other currencies*
  - States defend currency value through *market intervention*
  - Without *convertibility* speculators may not accept official exchange rates
Market Interventions in a Fixed Exchange Rate System:
1) Capital controls - Prevent currency trading and speculation
2) Trading of State reserve currencies
3) Domestic policy adjustment
   - E.g. Lower or raise interest rates

ii) Floating System/Free-Floating System: States allow exchange rates to change
   - Markets determine daily value of currency
   - Supply and demand
Modern “real world” systems:

i) “Fixed, but Adjustable” exchange rate systems:
- States peg rates but can adjust them if necessary
- Requires international cooperation to prevent “beggar thy neighbor” policies

ii) “Managed Floating”: (Current “non system”)
- Exchange rates float in theory, but, states intervene to reduce exchange rate changes bad for economy
  - i.e. Canada 2005 to 2007
- No agreed rates, states make own choices . . .
  - Can lead to “Manipulative or Dirty Floating” – States artificially reduce exchange rate through “pegs” etc. for export advantage
    - Requires Considerable political coordination
      - E.g. China/US

Key Point: In modern system - states pursue different approaches, some fix, some float etc.
Why do states choose to “fix” or “float”? 

- Economic Theory: “The Unholy Trinity”

- States have three potential monetary goals:
  - Fixed exchange rate = Good for firms and international trade
  - Autonomy over domestic monetary and fiscal policies = Good for domestic politics . . .
  - Capital mobility = Access to foreign investment

- Economists say you can only have two at once
  - E.g. Fixed exchange rates and autonomy only if capital mobility is low
    - State must controls short term “Portfolio Investment” capital flows (Breton Woods System)
  - E.g. Autonomy and capital mobility, but exchange rates must float (Theoretically, the current “non system”)
    - However do states have autonomy in current system?
      - Only if they are unconcerned about exchange rates . . .
Three Central Mechanisms:

- “Current Account” and “Capital Account” →

**Implications:**
- US is borrowing capital to finance imports
  - Over long term this will further hurt “Current Account”
  - US becomes “debtor nation” and foreigners own more US assets

**Key Points:**
- US account balances, but reveals potential long term problem.
- Situation is only sustainable as long as foreigners perceive the health of the US economy which makes it an attractive place to invest.
  - Or as long as people perceive the health of the US dollar . . .
Three Central Mechanisms:

C) Balance of Payments Adjustment:

- If “Current Account” and “Capital Account” don’t balance – country has an “imbalance of payments”
  - E.g. If no one wants to lend to or invest in US = Downward pressure on US dollar

- States must *adjust* policies to remedy situation
  - Adjustment limited by *Exchange Rate System*
Balance of Payments Adjustment:

- In a Fixed Exchange Rate System:
  - Imbalance creates pressure on exchange rate = States must intervene in market to offset imbalance
    - E.g. US problem – current account deficit – leads to declining interest in US dollar
  - Options:
    1. “Financing” - Use reserves and IMF lending
      - Can exceed capacity – under fixed Breton Woods system states helped one other through IMF lending
    2. Adjust domestic “Monetary Policy” and “Fiscal Policy”
    3. Impose tariffs
Balance of Payments Adjustment:

- In a Floating Exchange Rate System:
  - Imbalance creates pressure on exchange rate, but adjustment occurs through exchange rate changes
    - I.e. US dollar falls relative to other currencies
      - “Depreciation” vs. “Appreciation”
  - Resolves current account deficit – makes:
    - US exports cheaper
    - foreign imports more expensive

- Is this occurring?
3) Breton Woods System:

="Fixed but Adjustable" gold exchange standard: Most currencies fixed to US dollar which was fixed to gold (35$ an ounce). US guaranteed convertibility

- “Holy trinity” = Capital controls

- Balance of payments problems fixed by:
  A) “Financing” (IMF increased reserves available)
  B) Agreed exchange rate adjustments
    - “Devaluation” and “Revaluation”

- Option for all states - except the US!
4) Breakdown of Breton Woods:

System worked well for a time . . .
- Restarted economic globalization (good for liberals)
- High growth rates, rapid increases in standards of living
- Good for US allies
- Also, good for US as hegemon?

“Seignorage”: Benefits that go to the issuer of currency
- Under system US $ is “global reserve currency”
  - Benefits . . . ?
Problems:

1) Central role of US dollar:
   a) “Liquidity” versus “confidence” – “Triffin Dilemma”
      – one currency can’t do both
   b) No adjustment for US:
      - US could not reduce value of currency - Other countries take advantage
        - Trade
        - Convertibility

2) Globalization:
   A) Growth of short term financial flows/eroding of capital controls (1970s)
      - E.g. “Eurocurrencies”/“Euromarkets”/Eurodollars
        - Increased pressure on fixed exchange rates
Collapse:

“Evil” French . . .

1970s = US balance of trade deficit – US needed to adjust

“Nixon Shocks” (1971)
- Ends convertibility to gold
- Imposes tariffs to restore trade surplus
- Devalues US dollar

OECD states began to abandon capital controls and float exchange rates
5) Contemporary System:

Current “Managed Floating” System is confused = management problems

- Major countries “float” currencies (US, EU, UK, Japan, Canada)
- Smaller European states, East Asia, developing nations peg currencies
- US $ remains key currency of exchange but world is subjected to challenges caused by US policies
Problems:

- Financial flows bigger than expected
- Speculation
- Volatility
- Privatization of the costs of volatility - “Hedging”
- Not all states float and manipulative or “Dirty Floating”
- Misalignment and irrationality
  - E.g. US dollar often overvalued - role as key currency
  - E.g. Canadian dollar often undervalued - Not clear why

- Problems require state management and international cooperation

- *Despite floating system states remain important actors in monetary system*
6) Current Controversies:

a) Speculation and exchange rates:

- Particular problem for small economies and developing nations

- Solutions?
  
  i) Tobin Taxes - restore some autonomy
  
  ii) World Bank and IMF Reform
  
  iii) "Currency Unions": (E.g. Euro)

- "Optimal Currency Area"
  
  Match the coverage of the currency to the area of economic integration – less “trade” in foreign currency
b) “Euro” vs. the USD:

c) China/US Financial Relations:

- US argues Chinese RMB/Yuan pegged too low relative to US $
  - Massive trade deficit with China and outsourcing debate
  - China holding huge US dollar reserves
    - Inflating value of US dollar?
    - Large pool of FDI – China becoming a huge capital exporter

- Arguments:
  - Use US power to force revaluation
  - US benefits from situation
D) “Sovereign Wealth Funds (SWF)”:  
- State controlled investment vehicles  
- Control large amounts of global finance, but may not behave like market participants  
  - Transparency  
  - Political agendas
Further Reading:


For Next Time:

Unit Seven: Money Problems - The “Debt Crisis” and Financial Crises (November 3 & 5)

- **Required Reading:**
  - Cohn, Ch. 11.

- **Class Discussion Readings:**