CHAPTER 2 INTERNATIONAL MONETARY SYSTEM

SUGGESTED ANSWERS AND SOLUTIONS TO END-OF-CHAPTER QUESTIONS AND PROBLEMS

QUESTIONS

1. Explain Gresham's Law.

Answer: Gresham's law refers to the phenomenon that bad (abundant) money drives good (scarce) money out of circulation. This kind of phenomenon was often observed under the bimetallic standard under which both gold and silver were used as means of payments, with the exchange rate between the two metals fixed.

2. Explain the mechanism which restores the balance of payments equilibrium when it is disturbed under the gold standard.

Answer: The adjustment mechanism under the gold standard is referred to as the price-specie-flow mechanism expounded by David Hume. Under the gold standard, a balance of payment disequilibrium will be corrected by a counter-flow of gold. Suppose that the U.S. imports more from the U.K. than it exports to the latter. Under the classical gold standard, gold, which is the only means of international payments, will flow from the U.S. to the U.K. As a result, the U.S. (U.K.) will experience a decrease (increase) in money supply. This means that the price level will tend to fall in the U.S. and rise in the U.K. Consequently, the U.S. products become more competitive in the export market, while U.K. products become less competitive. This change will improve U.S. balance of payments and at the same time hurt the U.K. balance of payments, eventually eliminating the initial BOP disequilibrium.

3. Suppose that the pound is pegged to gold at 6 pounds per ounce, whereas the franc is pegged to gold at 12 francs per ounce. This, of course, implies that the equilibrium exchange rate should be two francs per pound. If the current market exchange rate is 2.2 francs per pound, how would you take advantage of this situation? What would be the effect of shipping costs?

Answer: Suppose that you need to buy 6 pounds using French francs. If you buy 6 pounds directly in the foreign exchange market, it will cost you 13.2 francs. Alternatively, you can first buy an ounce of gold for 12 francs in France and then ship it to England and sell it for 6 pounds. In this case, it only costs you 12 francs to buy 6 pounds. It is thus beneficial to ship gold due to the overpricing of the pound. Of course, you can make an arbitrage profit by selling 6 pounds for 13.2 francs in the foreign exchange market. The arbitrage profit will be 1.2 francs. So far, we assumed that shipping costs do not exist. If it costs more than 1.2 francs to ship an ounce of gold, there will be no arbitrage profit.

4. Discuss the advantages and disadvantages of the gold standard.

Answer: The advantages of the gold standard include: (I) since the supply of gold is restricted, countries cannot have high inflation; (2) any BOP disequilibrium can be corrected automatically through cross-border flows of gold. On the other hand, the main disadvantages of the gold standard are: (I) the world economy can be subject to deflationary pressure due to restricted supply of gold; (ii) the gold standard itself has no mechanism to enforce the rules of the game, and, as a result, countries may pursue economic policies (like de-monetization of gold) that are incompatible with the gold standard.

5. What were the main objectives of the Bretton Woods system?

Answer: The main objectives of the Bretton Woods system are to achieve exchange rate stability and promote international trade and development.

6. Comment on the proposition that the Bretton Woods system was programmed to an eventual demise. Comment on this proposition.

Answer: The answer to this question is related to the Triffin paradox. Under the gold-exchange system, the reserve-currency country should run BOP deficits to supply reserves to the world economy, but if the deficits are large and persistent, they can lead to a crisis of confidence in the reserve currency itself, eventually causing the downfall of the system.

7. Explain how the special drawing rights (SDR) is constructed. Also, discuss the circumstances under which the SDR was created.

Answer: SDR was created by the IMF in 1970 as a new reserve asset, partially to alleviate the pressure on the U.S. dollar as the key reserve currency. The SDR is a basket currency comprised of five major currencies, i.e., U.S. dollar, German mark, Japanese yen, French franc, and British pound. Currently, the dollar receives a 40% weight, mark 21%, yen 17%, franc 11%, and pound 11%. The weights for different currencies tend to change over time, reflecting the relative importance of each currency in international trade and finance.

8. Explain the arrangements and workings of the European Monetary System (EMS).

Answer: EMS was launched in 1979 in order to (I) establish a zone of monetary stability in Europe, (ii) coordinate exchange rate policies against the non-EMS currencies, and (iii) pave the way for the eventual European monetary union. The main instruments of EMS are the European Currency Unit (ECU) and the Exchange Rate Mechanism (ERM). Like SDR, the ECU is a basket currency constructed as a weighted average of currencies of EU member countries. The ECU works as the accounting unit of EMS and plays an important role in the workings of the ERM. The ERM is the procedure by which EMS member countries manage their exchange rates. The ERM is based on a parity grid system, with parity grids first computed by defining the par values of EMS currencies in terms of the ECU. If a country's ECU market exchange rate diverges from the central rate by as much as the maximum allowable deviation, the country has to adjust its policies to maintain its par values relative to other currencies. EMS achieved a complete monetary union in 1999 when the common European currency, the euro, was adopted.

9. There are arguments for and against the alternative exchange rate regimes.

a. List the advantages of the flexible exchange rate regime.

b. Criticize the flexible exchange rate regime from the viewpoint of the proponents of the fixed exchange rate regime.

c. Rebut the above criticism from the viewpoint of the proponents of the flexible exchange rate regime.

Answer: a. The advantages of the flexible exchange rate system include: (I) automatic achievement of balance of payments equilibrium and (ii) maintenance of national policy autonomy.
b. If exchange rates are fluctuating randomly, that may discourage international trade and encourage market segmentation. This, in turn, may lead to suboptimal allocation of resources.
c. Economic agents can hedge exchange risk by means of forward contracts and other techniques. They don’t have to bear it if they choose not to. In addition, under a fixed exchange rate regime, governments often restrict international trade in order to maintain the exchange rate. This is a self-defeating measure. What’s good about the fixed exchange rate if international trade need to be restricted?

10. In an integrated world financial market, a financial crisis in a country can be quickly transmitted to other countries, causing a global crisis. What kind of measures would you propose to prevent the recurrence of a Asia-type crisis.

Answer: First, there should be a multinational safety net to safeguard the world financial system from the Asia-type crisis. Second, international institutions like IMF and the World Bank should monitor problematic countries more closely and provide timely advice to those countries. Countries should be required to fully disclose economic and financial information so that devaluation surprises can be prevented. Third, countries should depend more on domestic savings and long-term foreign investments, rather than short-term portfolio capital. There can be other suggestions.

11. Discuss the criteria for a ‘good’ international monetary system.

Answer: A good international monetary system should provide (i) sufficient liquidity to the world economy, (ii) smooth adjustments to BOP disequilibrium as it arises, and (iii) safeguard against the crisis of confidence in the system.

12. Once capital markets are integrated, it is difficult for a country to maintain a fixed exchange rate. Explain why this may be so.

Answer: Once capital markets are integrated internationally, vast amounts of money may flow in and out of a country in a short time period. This will make it very difficult for the country to maintain a fixed exchange rate.

13. Assess the possibility for the euro to become another global currency rivaling the U.S. dollar. If the euro really becomes a global currency, what impact will it have on the U.S. dollar and the world economy?

Answer: In light of the large transactions domain of the euro, which is comparable to that of the U.S. dollar, and the mandate for the European Central Bank (ECB) to guarantee the monetary stability in Europe, the euro is likely to become another global currency over time. A major uncertainty about this prospect is the lack of political integration of Europe. If Europe becomes politically more integrated, the euro is more likely to become a global currency. If the euro becomes a global currency, it will come at the expense of the dollar. Currently, the U.S. derives substantial benefits from the dollar's status as the dominant global currency – for instance, the U.S. can run trade deficits without having to maintain substantial foreign exchange reserves, can carry out international commercial and financial transactions in dollars without bearing exchange risk, etc. If the euro is to be used as a major denomination, reserve, and invoice currency in the world economy, dollar-based agents will start to bear more exchange risk, among other things.

MINI CASE: WILL THE UNITED KINGDOM JOIN THE EURO CLUB?

When the euro was introduced in January 1999, the United Kingdom was conspicuously absent from the list of European countries adopting the common currency. Although the current Labor government led by Prime Minister Tony Blair appears to be in favor of joining the euro club, it is not clear at the moment if that will actually happen. The opposition Tory party is not in favor of adopting the euro and thus giving up monetary sovereignty of the country. The public opinion is also divided on the issue.

Whether the United Kingdom will eventually join the euro club is a matter of considerable importance for the future of European Union as well as that of the United Kingdom. The joining of the United Kingdom with its sophisticated finance industry will most certainly help propel the euro into a global currency status rivaling the U.S. dollar. The United Kingdom on its part will firmly join the process of economic and political unionization of Europe, abandoning its traditional balancing role.

Investigate the political, economic and historical situations surrounding the British participation in the European economic and monetary integration and write your own assessment of the prospect of British joining the euro club. In dong so, assess from the British perspective, among other things, (1) potential benefits and costs of adopting the euro, (2) economic and political constraints facing the country, and (3) the potential impact of British adoption of the euro on the international financial system, including the role of the U.S. dollar.

Suggested Solution to Will the United Kingdom Join the Euro Club?

Whether the U.K. will join the euro club will be a political as much as economic decision. Recently, the U.K. economy was converging with those of euro-zone countries. Economic conditions in terms of government budgets, interest rates, and inflation rate are becoming similar to those in euro-zone countries. On an economic ground, this convergence is creating a condition that is conducive to U.K.'s joining the euro club. As recently pointed out by Wim Duisenberg, the President of the European Central Bank, British opposition to joining the euro club is more "psycho-political" than justified on economic grounds. Since many political leaders in France and Germany consider adoption of the euro as a step toward the European political union, the U.K. is likely to join the euro-zone if it is prepared to join the European political union as well. Once the U.K. joins the euro-zone, the euro will no doubt become a global currency rivaling the U.S. dollar.