

Chapter 2 World Trade and the International Monetary System

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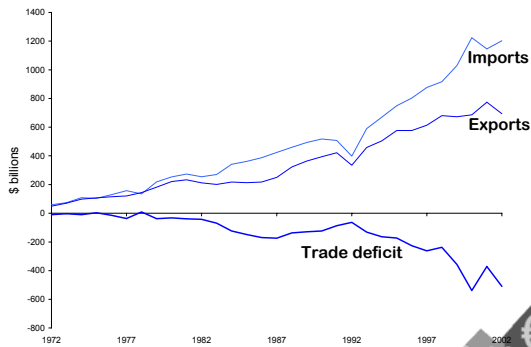
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Integration of the world's markets for goods and services

- Creation of the World Trade Organization (WTO)
- Emergence of China as a major trading partner
- Global trend toward free-market economies
- Industrialization of the Far East and Pacific Rim
- Emergence of central and eastern Europe
- Reunification of East and West Germany
- Hong Kong's 1997 return to China
- Introduction of the euro

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U.S. merchandise trade



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Integration of financial markets

- An increase in cross-border financing
- Increasingly interdependent national financial markets
- An increasing number of cross-border mergers, acquisitions, and joint ventures
- An increasing number of cooperative linkages among securities exchanges

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The Bretton Woods Agreement

- **World Bank** which now includes
 - International Bank for Reconstruction and Development
 - International Development Association
 - International Finance Corporation
 - Multilateral Investment Guarantee Agency
 - International Centre for Settlement of Investment Disputes
- **International Monetary Fund (IMF)**
 - Responsible for ensuring the stability of the international financial system
 - Compiles balance-of-payments statistics

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The U.S. balance of payments

	1992	2002
Goods: Exports	440	683
Goods: Imports	-537	-1167
Trade Balance	-97	-484
Services: Credit	177	289
Services: Debit	-116	-240
Balance on Goods & Services	-36	-436
Income: Credit	132	245
Income: Debit	-109	-257
Balance on Goods, Services, & Income	-14	-447
Current transfers: Net	-35	-56
Current Account	-49	-503

Source: U.S. Bureau of Economic Analysis (www.bea.gov)

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The U.S. balance of payments

	1992	2002
Capital Account: Net	1	1
Direct Investment Abroad	-48	-124
Direct Invest from Abroad	20	30
Portfolio Investment Assets	-50	-26
Portfolio Invest Liabilities	81	388
Other Investment Assets	23	-6
Other Investment Liabilities	70	213
Financial Account	96	474

Source: U.S. Bureau of Economic Analysis (www.bea.gov)

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Exchange rate systems

- **Pegged or fixed exchange rate systems**
 - Forges a direct link between inflation differentials and employment levels
 - Can result in large adjustments
- **Floating exchange rate systems**
 - Allows exchange rates to adjust for inflation differences
 - Allows employment levels and wages to equalize through the exchange rate mechanism

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Recent exchange rate arrangements

FX regime	Africa	Asia/Pacific	Europe/Mid East	Americas
No separate legal tender	WAEMU, CAEMC	Marshall Is, Micronesia	Euro Area	Ecuador, Panama
Currency board or fixed peg	Libya, Sudan, Zimbabwe	China, HK, Malaysia, Taiwan	Iran, Kuwait, Saudi Arabia, Syria	Argentina, Bahamas, Suriname
Crawling peg or horiz band	Egypt		Denmark, Egypt, Israel	Bolivia, Venezuela
Managed float	Algeria, Ethiopia, Kenya, Nigeria	India, Indonesia, Singapore, Thailand	Croatia, Iraq, Russian Fed., Yugoslavia	Dom. Rep, Guatemala, Jamaica, Trinidad
Independent float	Mozambique, S. Africa, Uganda	Afghanistan, Australia, S. Korea	Czech Rep, Norway, Poland, Sweden, Turkey, Switzerland, United Kingdom	Brazil, Canada, Chile, Colombia, Mexico, Peru, United States

Source: *International Financial Statistics*, April 2003 (as of Dec 2001)

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Major exchange rate agreements

- 1946 Bretton Woods Conference
- 1971 Smithsonian Agreement
- 1972 European Joint Float Agreement
- 1976 Jamaica Agreement
- 1979 European Monetary System (EMS) created
- 1985 Plaza Accord
- 1987 Louvre Accord
- 1991 Treaty of Maastricht
- 1999 Introduction of the euro
- 2002 Euro begins public circulation

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History of the international monetary system

- **1946 Bretton Woods Conference**
 - The U.S. dollar is convertible into gold at \$35/ounce
 - Other currencies are pegged to the dollar
 - Created the IMF and the World Bank

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History of the international monetary system

- **1971 - Exchange rate turmoil**
 - Dollar falls off the gold standard
 - Most currencies float on world markets
- **1971 - Smithsonian Agreement (G-10)**
 - dollar devalued to \$38/oz of gold
 - other currencies revalued against the dollar
 - 4.5% band adopted
- **1972 - European Joint Float Agreement**
 - "The snake" adopted by EEC

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History of the international monetary system

- > **1976 - Jamaica Agreement**
 - Floating rates are declared “acceptable”
- > **1979 - European Monetary System (EMS)**
 - European Exchange Rate Mechanism (ERM) established to maintain EEC currencies within a 2.25% band around central rates
 - European currency unit (ECU) created

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History of the international monetary system

- > **1985 - Plaza Accord (G-10)**
 - The Group of Ten agree to cooperate in controlling exchange rate volatility and bringing down the value of the dollar
- > **1987 - Louvre Accord (G-5)**
 - The Group of Five agree to maintain current exchange rate levels

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History of the international monetary system

- > **1991 - Treaty of Maastricht**
 - EC members agree to a broad agenda of economic, financial and monetary reforms
 - A single European currency is proposed as the ultimate goal of monetary union
- > **1999 - Introduction of the euro**
 - Emu-zone currencies pegged to the euro
 - European bonds convert to the euro
- > **2002 - Euro begins public circulation**

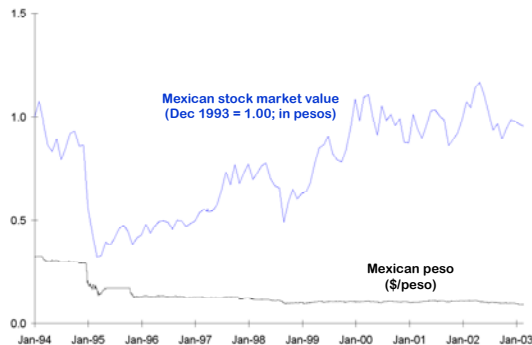
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Currency crises

- > **Recent currency crises**
 - **Mexican** peso crisis of 1995
 - **Asian** contagion of 1997
 - **Russian** ruble crisis in 1998
 - **Argentinian** peso crisis of 1998
- > **Contributing factors in each crisis**
 - A fixed or pegged exchange rate system that overvalued the local currency
 - A large amount of foreign currency debt

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Mexican peso crisis

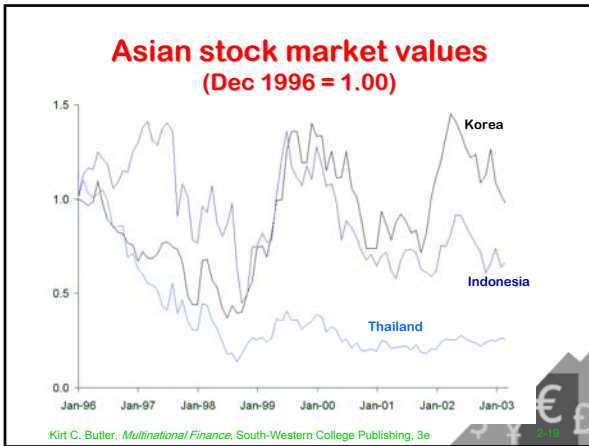


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Asian currency values: \$/unit (Dec 1996 = 1.00)



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- ### The debate over IMF lending
- > **Proponents of IMF lending policies believe**
 - Short term loans help countries overcome temporary crises
 - > **Critics of IMF lending believe**
 - Belt-tightening is counterproductive
 - Capital market liberalizations increase risks
 - Loans are often spent supporting unsustainable exchange rates
 - IMF loans last for decades
 - IMF remedies benefit developed countries
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- ### IMF lending and moral hazard
- > **Moral hazard**
 - The existence of a contract can change the behaviors of parties to the contract
 - > **The IMF's challenge**
 - develop policies that promote economic stability
 - and ensure that the consequences of poor investment decisions are borne by investors and not taxpayers
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