International Monetary System

8

Unit Highlights:

- Types of international monetary system.
- Characteristics of good international monetary system.
- Types of monetary standard.

Lesson-1 : **Types of International Monetary System**

Lesson Objectives

After studying this lesson, you will be able to :

- tell the meaning of international monetary system;
- understand why there are different types of international monetary system and
- explain the characteristics of a good international monetary system.

International Monetary System

Movement of goods across national borders requires movement of money in the opposite direction. For example when the US buys coffee from Brazil, it must send money to the Brazilians. When Japan purchases petroleum from Saudi Arabia, it must send money to the Saudis, and so on . For these payment to go on smoothly, there must be certain rules and conventions governing the international financial conduct of nations.

The international monetary system is based on rules and conventions governing the financial conduct of nations.

The international monetary system refers to the body of rules, regulations, customs, conventions and organizations for effecting international payments. The financial relations among nations may be organized in different ways. Not surprisingly, the international monetary system has historically evolved in different ways and has assumed different forms. All international monetary system have some core characteristics in common, though they vary in other respects.

Types of International Monetary System

International monetary systems are usually classified by two criteria (or along two dimensions) : (i) the role of the exchange rate, and (ii) the nature of the reserve asset(s).

Exchange Rate Regimes (System)

The need for converting one country's currency into those of others gives the exchange rate regime a prominent place in the international monetary system. It is indeed possible to classify the international monetary system on the basis of the degree of flexibility (or rigidity) of foreign exchange rates.

The degree of flexibility of the exchange rate is one basis of classifying the international monetary systems.

We are already familiar with the permanently fixed and absolutely flexible exchange rates (Unit-6, Lesson-2). These are polar extremes in between which there are various mixes of rigidity and flexibility. Sometimes nations stand ready to change the fixed par value of their currencies, if so demanded by the need to correct fundamental disequilibrium in the balance of payments. This system is known as the adjustable peg. And when the exchange rate is made flexible within wide limits, but not beyond them, we have a wide-band regime. Under the crawling peg system, exchange rates are allowed to vary by small bits at a time (justifying the qualifier 'crawling'). A managed float exchange rate regime is one in which there are no fixed par values, but the monetary authority does intervene in the foreign exchange market so as to prevent the exchange rate from moving far away from its long term trend. Finally, we have the recent new approach known as the

target zone approach. It involves the setting up of a set of mutually consistent targets for (trade-weighted) real exchange rates by major economies (such as US, Germany and Japan). Since the targets are for real rates, the nominal rates are free to vary continuously to reflect differences in interest rates. With targets given, the participating countries remain committed to keep the exchange rate within a band (or zone) of 10 per cent on either side of the targets. At the same time, the limits are kept soft by permitting countries to exceed the limits in exceptional circumstances.

Monetary Standard

The nature of the reserve asset(s) is the second way of characterizing the international monetary system.

A second way of characterizing the international monetary system is in terms of the nature of the reserve asset(s). Two major types of international reserve assets are: (a) commodity reserves, and (b) fiduciary (or fiat) reserves. The essential difference between the two lies in the intrinsic value of the relevant reserve asset. While the commodity reserves (like gold) have some intrinsic value (other than their value as money) fiduciary reserves (such as special Drawing Rights, and national currencies which are not convertible into commodity reserves) have none.

On the basis of the nature of reserves held by the monetary authority, a three fold classification of the international monetary system is possible.

1. Pure Commodity Standards, Where all reserves consist of commodity reserves (as in the case of gold standard)

2. Pure Fudiciary Standards, in which the entire reserve consists of fiduciary reserves (e.g. the inconvertible paper standard)

3. Mixed Standards in which the reserves are partly commodity reserves and partly fiduciary reserves (e.g. the gold exchange standard)

It should be noted that either criterion (type of exchange rate regime or the nature of reserve assets) can be used to characterize the entire (not just part of it) international monetary system. This allows one to use different names to refer to the same international monetary system, so as to put emphasis on one criterion or the other. For instance, the gold standard may be referred to as the fixed exchange rate system (with emphasis on the fixity of the exchange rate) or, as a pure commodity standard (with emphasis on gold as a commodity reserve asset.

Characteristics of a Good International Monetary System

What is a good international monetary system ?

An ideal international monetary system should be able to ensure maximization of world output and its equitable distribution.

How do we know that a given international monetary system is satisfactory or not? To answer these important questions, we must know what to expect from a good international monetary system.

As already mentioned, a basic function of the international monetary system is to facilitate international payments arising from the flow of goods and services across nations. A free trade makes possible an international specialization in production and move towards maximization of world output and welfare. But then there is the thorny question of sharing in the gains in welfare. Therefore, the international monetary system should be such that it helps in

(i) Maximization of total world output, and

(ii) Achievement of equitable distribution of welfare gains among nations and among groups within each nation.

Maximization of world output presupposes free trade in goods, services and factors of production. Ensuring this is clearly not easy. Nations do have incentives to cooperate among themselves in order to maximize world output. But this co-operation may not be forthcoming, if there are disagreements over the distribution of gains from free trade. If each nation (or groups within a nation) tries to get a bigger slice of the pie than justified by some reasonable criteria (which themselves could be the bone of contention) international co-operation may break down. The optional tariff is a case in point. When this sets off competitive retaliation among trading nations, in the end all may be worse off. Therefore, a good international monetary system should aim at fostering co-operation among trading nations and at minimizing their potential policy conflicts.

Disagreements over the distribution of gains from trade may come in the way of necessary co-operation.

Obviously there would be no rivalries or conflicts over gains from international trade, if nations do not engage in trade at all. In contrast, a complete anarchy will prevail if trading nations could do whatever they liked. Both these extremes are undesirable and absurd. This points to the need for a good international monetary system that would allow an orderly evolution and growth of world trade and welfare.

Performance Tests

Given the broad objectives of a good international monetary system, we need a set of criteria with which to evaluate whether a system is functioning satisfactorily or not. Economists have developed these tests for the evaluative purpose: adjustment, liquidity and confidence. The meaning and significance of these criteria are explained below.

Performance tests are intended to evaluate the international monetary system on the basis of certain desirable traits.

Adjustment : Balance of payments call for adjustment in the national economy. This involves changes in national incomes, relative prices, or exchange rates, leading to marginal reallocation of resources. Obviously these changes have their economic costs, which may take the form of deflating the economy and accepting unemployment (in the case of the deficit country), or accepting higher inflation (in the case of surplus country). Therefore, a good monetary system would be one which facilitates the adoption of such policies as can (i) minimize the total costs of adjustment internationally, and (ii) equitably distribute these costs among nations.

Devising such a system is not an easy matter as the history of international monetary relations would indicate. There are a number of reasons for this difficulty. First, it is often difficult to accurately predict the consequences (and hence costs) of following alternative adjustment policies. Secondly, each nation is apt to be more concerned about its own costs of adjustment than about the aggregate costs for the whole world. Acceptance of unemployment (in the deficit country) or inflation (in the surplus country) may be unpalatable on political, economic or prestige grounds. Each nation would like the other(s) to take the initiative to remove the imbalance, leading to a policy stalemate. Finally, there are often groups within a given country which perceive the adjustment policies as detrimental to their interests, prompting them to launch vigorous campaigns against those policies. For example, labour unions may resist unemployment

generating measures, or the import competing industries may not like exchange rate adjustments that tend to cheapen imports.

Liquidity : International monetary reserves consist of total official holding of gold, convertible foreign currencies, special drawing rights, and net reserve position at the International Monetary Fund. Liquidity, in the parlance of international finance, refers to the availability of international reserve assets to settle temporary balance of payments disequilibrium without deflating the home economy or being inflationary for the world as a whole.

Liquidity is usually aimed at financing temporary disequilibrium in the balance of payments. But it can also help cope with fundamental disequilibria (which call for adjustment, not just financing) by allowing the country to choose those adjustment policies which have lower adjustment costs (but are slow-acting) than their alternatives.

Adjustment, liquidity and confidence are the major desirable characteristics.

Confidence: When countries hold international reserve assets of different kinds, there is the danger that destabilizing shifts from one asset to another can take place. This can happen if the holder's confidence in the stability of assets' absolute and relative values are shaken. A good monetary system should have mechanisms to prevent any such crisis from arising. At the vary least , it should be capable of coping with such crises, should they arise. As we shall see later on, such crisis of confidence has been responsible for undermining the Bretton Woods System.

Questions for review

MCQ's (Pick the correct answer)

1. The international monetary systems are usually classified on the basis of
   a. the role of the exchange rate only
   b. the nature of the reserve assets only
   c. both (a) and (b)
   d. none.
2. Under the system of adjustable peg, the exchange rate
   a. can be changed by the authority
   b. cannot be changed
   c. can be truly float
   d. none of the above
3. Commodity reserves have
   a. no intrinsic value
   b. some intrinsic value
   c. unlimited intrinsic value
   d. none of the above
4. The gold standard may be referred to as
   a. as the fixed exchange rate
   b. as a pure commodity standard
   c. as a flexible exchange rate
   d. as both (a) and (b)
5. It is difficult to desire a good monetary system because
   a. it is difficult to accurately predict the consequences of different adjustment policies
   b. each nation is likely to be more concerned about its own costs rather than the costs to the whole world
   c. both of the above
   d. none of the above.

Short Questions

1. "The monetary system is about the rules and conventions governing the financial conduct of nations." Explain.
2. State the two criteria usually used to classify the international monetary systems. Why are they useful?
3. "Between the permanently fixed and absolutely flexible exchange rates there are various mixes of rigidity and flexibility." What does this statement mean? Discuss.
4. Explain how monetary reserves may be used to classify the international monetary system.
5. "Conflicts over the distribution of gain from trade stand in the way of profitable co-operation among trading nations." Do you agree? Can you cite an historical example?

Essay-type Questions

1. What is meant by an international monetary system? Describe the various types of international monetary systems bringing out their distinguishing features.
2. What are the characteristics of a good international monetary system? Describe them fully.

3. How is the actual performance of a good monetary system tested? What purpose can it serve?

Lesson-2 : **Types of Monetary Standard**

Lesson Objectives

After studying this lesson, you will be able to:

- Describe the international gold standard;
- Understand the reasons for the collapse of the international gold standard;
- Describe the Bretton Woods System and
- Explain the collapse of the Bretton Woods System.

Introduction

The world has witnessed a number of monetary standards at various periods of its monetary history. Each evolved from the preceding one(s) trying to cope with problems faced by its predecessors. Historically the most important, and perhaps most highly cherished by many, is the gold standard discussed below.

The International Gold Standard

The use of gold coins dates back to antiquity. The international gold standard, however, flourished in a brief period of history, emerging the 1870s and collapsing with the outbreak of World War I in 1914. The pure gold standard provides the clearest example of the fixed exchange rate system. It has the following three distinguishing features:

(i) The government fixes the price of gold and then fixes the value of its money in terms of gold.

Three nguishing res of the standard.

(ii) The government is committed to ensure convertibility of the currency. In other words, the government will, on demand, buy and sell gold at the official rate. If you have gold, you can get it converted into the domestic currency at the fixed rate. Or, if you want gold, you can walk into the central bank, buy gold at the fixed rate, and walk away with gold.

(iii) The government provides a 100% gold backing (or 100% cover). It creates money when it buys gold and destroys money only by selling gold. For instance, under 100% cover if the public buys $100 worth of gold from the central bank, there is a one-for-one reduction in the stock of money outstanding. A one-for-one increase in money supply takes place when the central bank buys gold for currency.

Balance of Payment Adjustment Under the Gold Standard

exchange rate is tely fixed the Gold Standard.

Under the pure gold standard, the exchange rate is absolutely fixed. Suppose that US and Britain follow the gold standard rules - a fixed par value, convertibility and 100 percent cover. Now if the pure value of gold in US is $20.00 per ounce and that in Britain is £5 per ounce, the exchange rate between the pound sterling and the US dollar is thereby fixed at $4 per pound ($20/£5). Why is this so?

Suppose that the price of a pound sterling is more than $4. Instead of buying pounds directly, I can buy one-fifth of an ounce of gold in US for $4, ship it to Britain, and get one pound from the Bank of England. For the same reason, the price of a pound cannot fall below $4. If I have £1, I can buy one-fifth of an ounce of gold from the Bank of England, ship it to US and get $4 from the Federal

Reserve. The exchange rate calculated from the relative price of gold is called the gold parity.

The gold standard has a built-in mechanism for correcting any imbalance in the international balance of payment. For simplicity, assume that US trades only with Britain and Britain trades only with US. If US has a payments deficit, there will be a net outflow of gold from US into Britain. The deficit is thus temporarily financed by movement of gold between the two countries. Since the domestic money supply is based on gold, the quantity of money will fall in US and rise in Britain. The change in money supply would affect spending. Monetary decline in US would cause interests rate to rise and spending to fall. The opposite should happen in Britain. These changes will have their impact in the foreign exchange market. The US import demand schedule will continuously shift to the left and its export schedule to the right until the deficit is totally eliminated. Thus the process which started with financing the deficit has ultimately ended in its adjustment (elimination).

It is clear now that under the pure gold standard no nation has control over its domestic monetary policy and, therefore, no country can control its economy well. One other problem is that the growth of international commerce is linked to new gold discoveries and mining. If the supply of gold cannot keep pace with growth of the world economy, prices have to fall in the long run and employment has to fall in the short run.

Automatic adjustment under the gold standard does not imply instantaneous adjustment. The process takes time to be operative and work itself out, and it is automatic only in the sense that if nations faithfully followed the three gold standard rules, any imbalance (deficit or surplus) in the balance of payments will eventually be removed.

The gold standard described above is an idealized system. In practice the players (trading nations) did not always play according to all three rules of the game. Particularly the correspondence between changes in gold reserves and changes in money supply has not been faithfully maintained. The system, however, did work automatically; the exchange rate stayed at the gold parity level and the convertibility of the currency was maintained.

On the other hand, the average unemployment and the year-to-year variability of the price level was higher in this period than they have been since the World War II.

Many economists are skeptical about the success claimed for the pre-1914 gold standard. They argue that the success is in fact a myth. During the gold standard period the world economy was tranquil and did not experience any dramatic shocks (such as World Wars I and II, the Great Depression of the 1930s or the oil price shocks in the 1970s). Therefore, the apparent successes, it is argued, are more due to the fortuitous combination of circumstances than to the inherent strength of the gold standard.

Collapse of the Gold Standard and the Inter-War Period

During World War I, most countries departed from the gold standard. European governments needed gold to finance war. Belligerent nations suspended convertibility of their currencies into gold and imposed embargo on gold exports. Governments made it illegal for individuals to hold gold and required that they sell

their gold to the government at the official gold price (or gold parity). The classical gold standard thus came to an end.

What happened to the foreign exchange market? Private individuals freely traded one paper currency for another at prices determined by the forces of demand and supply. As a result, in fact a purely floating exchange rate regime took the place of the fixed exchange rate system of the gold standard, and this led to wild fluctuations in the exchange rates.

industrial tries tried eceive the standard ter World with little success.

After the First World War major industrial countries tried hard to revive the pre-war gold standard. However, attempts to value gold at the pre-war parity despite rapid price inflation in the intervening years led to trouble : a shortage of gold as a reserve asset. As a device for economizing on old, the Financial Committee of the Genoa Conference of 1922 recommended the adoption of the Gold Exchange standard. It required only the willingness of some countries to hold as international reserves the currencies of nations that held reserves of gold. The reserve currency countries, whose currencies were held by others, continued to follow the rules of the gold standard ready to exchange gold for their own currencies. This economized on the use of gold as the ultimate reserve asset.

The gold exchange standard broke down during the Great Depression as one country after another abandoned its commitment to fix the price of its currency against the US dollar. For example, in the late 1920s and early 1930s Britain struggled to maintain the pound at $4.80, but gave up in September 1931, because its stock of gold and foreign exchange was running out and it was unwilling to depress its economy any further.

The great ression of rly 1930s ed and the eak of the rld War II finally troyed the ernational standard.

In the decade of the Great Depression of the early 1930s various governments were trying to outdo each other in the game of competitive depreciations. These desperate attempts were aimed at eliminating domestic unemployment and restoring external balance. The foreign trade became seriously disorganized and fragmented during the period 1931-35. The Tripartite Agreement of cooperation between Britain, France and the United States signed in 1936 raised some hope of restoring order in the international economic scene, But the hope was dashed by the outbreak of World War II in 1939. Any serious attempt at comprehensive reform of the international monetary system was not undertaken until after the end of the second World War.

The Bretton Woods System (1944-1971)

Leaders from 44 non-communist countries met in New Hampshire, USA in 1944 with the aim of evolving a plan for regulating the international financial system (the first attempt at concerted action in international monetary history). The economic and social turmoil were still fresh in their minds. The British delegation was led by J.M. Keynes, while at the head of the US delegation was H.D. Dexter, an American diplomat. Two proposals for reforms were tabled by the two delegations.

Keynes' proposal centred on the creation of a clearing union with overdraft facilities and the power to create reserves. A new unit of account called Bancor was proposed and a need for bearing at least a part of the adjustment burden by the surplus country was emphasized. The agreement that was finally hammered out by the conference was, however, closer to the Dexter plan. The treaty was

negotiated at a resort hotel at Bretton Woods, and so came to be known as the Bretton Woods System. The important features of the agreement were the following: (i) establishment of the Adjustable Peg System (ii) Augmentation of International Reserves and Liquidity, and (iii) Currency convertibility and Multilateral Trade.

Adjustable Peg System

As we have seen, in the inter-war period the attempts to keep the exchange rate fixed by pegging the currency to gold failed, and the free floating that ensued brought enormous chaos and confusion. This experience prompted the delegates at the Bretton Woods to devise a system which combined the desirable features of the fixed exchange rates (stability, automaticity) and that of floating exchange rates (adaptability).

In the short run, the adjustable peg system was to operate like a gold standard. The price of gold was initially fixed at $35 an ounce, and the dollars held by central banks and official monetary institutions were to be freely convertible into gold. The US stood ready to buy and sell unlimited amounts of gold at the official rate, making the dollar the key currency.

The monetary authorities of the rest of the world could define their currencies either in terms of US dollars or gold, and to ensure fixed exchange rates among currencies, they were to buy and sell their currencies at the declared parity. Any country facing temporary disequilibria in the balance of payments could defend its parity by borrowing from the International Monetary Fund (discussed below) . But if the disequilibria appeared to be fundamental (caused by structural factors), it could, with the approval of the Fund, change the parity. The system was thus pegged as well as adjustable.

Augmentation of International Reserves and Liquidity

The slow growth in the supply of gold was a bane of the gold standard system. The currency exchange standard that followed tried to economize on gold reserves, but could not sustain itself. All this highlighted the need for augmenting reserves, more so because of the pegging under the proposed system.

To cope with this and other problems, the delegates at the Bretton Woods meet agreed to create a permanent institution with sufficient powers and responsibilities to facilitate cooperation and coordination among nations and to impose discipline in the conduct of international financial transactions. Thus the International Monetary Fund (IMF) came into being. It would help deficit (in the balance of payment) countries by lending additional reserves, encouraging the removal of restrictions on international payments and promoting orderly adjustment of the exchange rate. Each country was assigned its quota with the IMF. The quota equalled its subscription 25% of which was in gold (or currency convertible into gold), the rest being the member country's own currency.

The functions of the IMF and its methods of operation have significantly changed since its establishment, especially after the collapse of the Bretton Woods system in the early 1970s, but its principal mission has remained largely the same.

Currency Convertibility and Multilateral Trade

This feature of the Bretton Woods system is related to the requirements of the adjustable peg. The countries agreed to ensure free convertibility of their currencies at the declared rates in order to facilitate multilateral trade and payments. There were to be no restrictions on current international transactions, no discriminatory currency arrangements or exchange controls.

Collapse of the Bretton Woods System

The Bretton Woods system lacked an effective adjustment mechanism that was commensurate with its objective of multilateral trade and currency convertibility. Frequent (and really needed) change in the exchange rates were made difficult. A member country facing a balance of payments deficit was encouraged to finance it by using its own reserves or by using its automatic borrowing rights with the International Monetary Fund. Even for persistent deficits the Fund policy seemed to favour expenditure reducing (fiscal and monetary) policies. Only in cases of (genuine) fundamental imbalance, exchange rate adjustment though devaluation was approved (but fundamental disequilibrium was not vary clearly defined); and, generally the need for devaluation was taken as a sign of failure to manage the economy well. As a result, the real needs for exchange rate adjustment were not timely recognized, and the country concerned had to take the unpopular step of deflating the economy.

The system of pegging, combined with the need for prior approval of the IMF for devaluation, made the weak currencies easy victims of destabilizing currency speculation. The speculator could easily detect whether a country had been running persistent and unsustainable deficits. Seeking IMF approval for devaluation would further strengthen their perceptions about the possibility of devaluation. They would then sell the devaluation-suspect currency in the hope of buying it cheaper after a possible devaluation. If their expectation proved true, they made handsome profits but if the parity is somehow successfully defended, they stood to lose very little. Speculation was then just a one-way gamble. The most sinister aspect of the situation was that the speculators could precipitate a devaluation by their own actions which could otherwise be avoided. Their expectation could be self-fulfilling. This would not be true, if the exchange rates were flexible, because the actual exchange rates could be higher or lower than what the speculator expected them to be.

There was another problem in the liquidity creation mechanism of the Bretton Woods system which finally hastened its downfall. In the post-war period, Europe and Japan experienced rapid growth and gained competitive strength relative to US firms. As a result, the US balance of payments position moved into large deficits. The US deficits in fact represented a growing demand by the international economy for dollar reserves to meet the monetary needs of international transactions. The so-called 'redundancy problem' arose, because the US could not devalue its dollar in terms of gold. The only way this could come about was by revaluation of currencies of the surplus countries such as Japan and Germany. By building up deficits continuously, the US tried to ensure consistency among national policies because all countries could not run surpluses at the same time. But this build-up could not continue indefinitely without raising doubts about the US ability to convert dollars into gold at the fixed parity. This problem surfaced and intensified in the 1960s; people began lose confidence in the dollar. Here in lay the dilemma. For supplying the needed liquidity, US deficit needed to grow; but if it grew the confidence in the convertibility of the dollar could not be sustained. To

put it in another way, as the quantity of the reserves grew, the quality deteriorated. Finally the problem become so acute that President Nixon of the United States broke the link between the dollar and gold in August 1971, thus bringing the Bretton Woods era to an end.

Questions for Review

MCQ's (Pick the correct answer)

1. Which of the following was not a feature of the international gold standard?
   a. fixed value of money in terms of gold
   b. free convertibility of the currencies
   c. A non-for-one increase in money supply takes place when the central bank buys gold for currency.
   d. both gold and silver were used as money.
2. The gold standard had to cope with imbalance in the balance of payments. If
   a. had no built-in mechanism to deal with it
   b. had a build -in mechanism to deal with it
   c. had a built-in mechanism that could he depended upon only it the players played by the rules of the gold standard.
   d. both (a) & (b)
3. The gold standard collapsed because
   a. no country liked its features
   b. all played by the rules
   c. many did not play by the rules, forcing other to do the same
   d. its design was inherently fundly.
4. The Bretton Woods System tried to keep
   a. all the features of the gold standard
   b. some features of the gold standard
   c. no feature of the gold standard
   d. US supply by granting it a unique place in the international money scene
5. The Bretton Woods System failed because
   a. it lacked a proper adjustment mechanism
   b. it had a proper adjustment mechanism
   c. other countries grew jealous of the US's portion
   d. keyless original plan was not accepted.

Short Questions

1. Explain briefly the built-in mechanism of the gold standard for correcting any imbalance in the international balance of payments.
2. "Under the pure gold standard no country had control over its domestic monetary policy." Can you explain why?
3. "Automatic adjustment under the gold standard did not imply instantaneous adjustment." What does this statement mean?
4. Why are some economists skeptical about the claimed success of the gold standard? Elaborate.
5. The adjustable peg system was designed to operate like the gold standard in the short run. Did it finally succeed in this respect? Can you suggest what went wrong?

6. For what specific purposes was the IMF brought into being under the Bretton Woods System? Has IMF's character changed a lot since its inception? If so, why?
7. Describe the dilemma that haunted the liquidity creation mechanism of the Bretton woods system. Could it finally overcome it? If not, why?

Essay-type Questions

1. Describe the salient features of the international gold standard. Explain why this system finally collapsed?
2. Describe the Bretton Woods System. What were its main features? What led to the collapse of the Bretton Woods System?

Lesson-3 : The present International Monetary System: Managed Flexibility

Lesson Objectives

After studying this lesson, you will be able to:

- Understand the concept of managed floating;
- Describe the characteristics of the managed floating system and
- Understand the purpose and the functions of the GATT and the WTO

Introduction

Failure to fix exchange rates makes the system, by default, one of floating rates. Therefore, for quite sometime since the dramatic event of 1971, this is what happened to the major currencies of the world. Major financial nations did not, however, take enforced exchange rate flexibility as an interim arrangement to be replaced by some kind of fixed exchange rate system. Some of these countries met several times with this aim in mind, but failed to evolve a comprehensive new system. This almost inevitably meant that major industrial nations slowly drifted toward a managed floating regime with several variations. The present system may be described in terms of the flowing characteristics:

(i) Managed Floating

Most industrial and financial nations such as US, Japan and U.K. intervene in the foreign exchange market to reduce the day-to-day volatility of the exchange rates. Otherwise the rates are allowed to fluctuate freely around their long-term trend. But there have been exceptions. In many instances, central banks have tried to oppose the basic trends in exchange ratcs. Deficit nations have bought their own currencies to prevent them from depreciating, while the surplus nations have sold their currencies to prevent them from appreciating. This mongrel system is widely known as the 'dirty' float or the 'managed' float.

(ii) Target Zones

Some countries follow the policy of flexible rates with target zones. Their currencies are pegged against one another and then allowed to float against other currencies (e.g. the dollar). Such an attempt by the European Community countries has been called the 'snake' within the 'tunnel'. The reason is that the movement of jointly floating currencies (compared with a snake) is restricted by intervention within a narrow band (compared with a tunnel). This arrangement, however, did not last long.

(iii) Crawling Peg

Many small countries peg their currencies to one major currency (such as the dollar) or a basket of currencies. They follow a system of intervention called crawling peg in which the par value is adjusted upward or downward in small doses or bits. One reason for this preference for slowly adjusting the pegged rate is that in the absence of established forward exchange markets they can insure against exchange risk in trade only by tying their exchange rates to a major

currency. Another motive is to guard against destabilizing speculation of the absolutely flexible exchange rates.

An Evaluation of the Current System of Managed Float

managed
ystem too
t difficult
attain the
cherished
f stability
short run
flexibility
long run.

The post-Bretton Woods system of managed floating has not been a resounding success. The twin goals of stability in the short run and flexibility in the long run have continually eluded the international monetary system. When there were no external balance problems, nations used to employ in the 1960s both monetary and fiscal instruments for the attainment of internal balance (full employment and price stability). But when the problem of external balance loomed large, there was a tendency to assign monetary policy to external balance, saving the fiscal policy for internal balance. In fact, since countries did not have sufficient policy instruments for the attainment of both internal and external balance, the abandonment of fixed rates in 1973 was seen as a boon. It relieved, or so it was supposed, the pursuit of internal balance from the constraints of balance of payments, and indeed, allowed exchange rates to serve as a policy instrument. But the newly found independence has not been (or could not be) wisely used: exchange rates have been manipulated to serve many purposes- to promote external balance, to control domestic inflation and so on.

The general presumption was that a flexible exchange rate regime would enable national economies to concentrate on national economic policies without having to worry about the balance of payments (the so-called policy autonomy). But this proved misleading, though essentially correct. Important linkages between trading countries could exist quite independently of the exchange rate regimes. Because of these linkages between trading countries, national policies that are independently pursued to take care of the domestic economy could cause inflation or unemployment abroad through trade and capital flows. For example, if the United States tightened the monetary policy, the US interest rate would go up. This would tend to higher capital inflow from abroad. As the demand for dollars grew, the dollar would appreciate. US imports would rise and foreign countries would experience inflation. If the foreigners saw this as incompatible with their domestic economic objectives, they too might be tempted to resort to monetary contraction to fight the 'imported' inflation (since they are not bound by any agreement not to do so). The simultaneous monetary contraction could precipitate a global recession as seemed to have happened during 1981-82.

e flexible
nge rates
managed
and
nipulated,
t failed to
countries
shocks of
gn origin.

The possibility of national policies being internationally incompatible in a global economy of increasing interdependence may even be the cause of protectionist sentiments at home or abroad. For instance, a decline in real net exports caused by appreciating dollar can have a contractionary multiplier effect upon US output and employment. Under these circumstances the US labourers in the affected industries could raise demand for tariffs or other forms of protection to save their jobs which the politicians may find difficult to resist.

The flexible exchange rates, despite management and manipulation, seem to have failed to isolate countries from shocks that originate abroad. Therefore, large fluctuations in exchange rates which may result from national policies unless fully synchronized could prove to be serious threats to an open trading system.

International Cooperation: From the Plaza to the Louvre

As mentioned before, the two major problems that have been afflicting the present international system of managed flexibility are excessive volatility of the exchange rates and persistent large disequilibrium in the foreign exchange markets In the decade of the 1980s, the US dollar rose and fell sharply in external value. In 1980, the US followed a tight money policy which led to higher interest rates and appreciation of the dollar. The real interest rate (the nominal rate minus the rate of inflation) rose to an average of 4% during the 1980-84 period . Between 1979s and 1985, the dollar rose by about 80%. But over the next three years, the dollar fell by more than it gained in the early 1980s. This had serious implications for inflation and unemployment not only for the US but also for the entire world economy. Fortunately, the chaos brought home the point that interdependence of national economies through trade and capital flows was unavoidable, even when the exchange rates are allowed to find their own levels freely in the foreign open economies because domestic actions could not be insulated from spilling over national or regional boundaries.

This appreciation of the need for international co-operation led to several attempts by major industrial nations to evolve a framework of co-ordinated national policies for harmonious growth of the world economy. For instance in September 22, 1985, the finance ministers of the United States, Japan, West Germany and Britain (the so-called Group of Five) met at the Plaza Hotel in New York and signed the famous Plaza Accord. These countries pledged to push down the value of the dollar by co-ordinated intervention in the foreign exchange market so as to reduce global trade imbalance and to stem the rising tide of protectionist sentiments in the United States.

In fact, the US dollar began its downward slide even before the Plaza Accord of September, 1985. In November 1986, the US and Japan agreed that the dollar had fallen enough relative to the yen, but in the absence of clear commitments in the new agreement dollars decline continued. The US thought this was caused by the tight fiscal policies pursued by Japan and West Germany in their own domestic interest. The US wanted Japan and West Germany to absorb more US exports through faster growth, while the latter wanted the US to remedy the situation by cutting its own budget deficits. The quarrel that ensued over who should bear the burden of international adjustment and by how much finally led to a meeting of the Group of Five plus Canada and Italy (also known as the Group of Seven) at Palais du Louvre in Paris in February, 1987. It was agreed that the prevailing external value of the dollar was nearly right and that the US would take steps to reduce its deficits. In the Venice Summit (June, 1987) the Group of Seven reaffirmed the Louvre Accord.

Despite these attempts at macroeconomic policy co-ordinations, it is doubtful how far nations can progress towards the goal of effective and substantial co-operation and co-ordination. The reason for the doubt is that nations are often unwilling to surrender their policy autonomy as long as they have different inflation-unemployment trade-offs. But the search for major institutional innovation to ensure coordination of economic policies will go on.

The Uruguay Round and the World Trade Organization (WTO)

Serious attempts at harmonization of macroeconomic policies of major financial nations are a feature of the period following the breakdown of the BrettonWoods system in the early 1970s. Trade liberalization attempts, however, go back to the

early post-war years and are still continuing. During the Great Depression years countries vied with one another to check rising unemployment by curbing imports and encouraging exports. The most favourite method was devaluation of the currency which tended to make imports dearer to domestic users and exports cheaper to foreigners. But these beggar-thy-neighbour policies were doomed to fail (and they did). All countries could not hope to simultaneously succeed in increasing exports or curbing imports (since one country's exports are imports of another). So all ended up worse in the wake of shrinking world trade, but slowly came round to the view that monetary and fiscal policies (not manipulated commercial policies) could do the job at lower economic costs.

ATT was
d with the
reducing
e barriers
through
ultilateral
trade
otiations.

With the aim of lowering trade barriers among nations through multilateral negotiations the world leaders who met at the Bretton woods created, along with the International Monetary Fund referred to earlier, another institution called the General Agreement on tariffs and Trade (GATT) in 1947 with headquarters in Geneva (Switzerland). The agreement was intended to uphold and implement three fundamental principles in trade relations namely (i) nondiscrimination (called the most Favoured Nation, MFN, principle according to which any trade concession bilaterally negotiated should automatically be extended to all participating nations) (ii) elimination of non-tariff barriers and (iii) consultation among nations for settling trade disputes within the GATT framework.

The participating countries, meeting in various rounds of negotiations (such as the Kennedy Round (1964-67), the Tokyo Round (1973-79), have substantially brought down the tariff and non-tariff barriers (with liberal exceptions for extra-ordinary circumstances). In spite of the major achievements of the various rounds of negotiations including the Tokyo Round many unresolved issues remained. These were taken up in the Uruguay Round, the eighth and the most ambitious attempt in the history of multilateral trade negotiations. This round began at Punta del Este in Uruguay in 1986 in which 117 countries took part. After seven years of protracted and complex bargaining (in which the US economic clout and diplomatic pressure played a significant role) the negotiations were concluded in December 1993. Several of the notable features of the Uruguay Round were the following :

Uruguay
ound that
n in 1986
the most
bitious of
ultilateral
trade
iations in
trades in
ulture and
es proved
quite
ntentions.

i. curbing new protectionist tendencies;

ii. bringing trades in agriculture and services into negotiations;

iii. obtaining agreements with respect to trade related investment measures (TRIMS);

iv. devising rules for the amendment of the patent regime to cover trades in intellectual property rights (TRIPs);

v. setting up of a new institution to be called The World Trade Organization (WTO) replacing the GATT.

Among the issues, trades in agriculture and services, TRIPs and TRIMs were quite controversial and largely account for the long time taken to conclude the negotiations (the round was supposed to be completed by December, 1990).

In several countries, especially those of the European Union, agriculture is highly subsidized (under the Common Agricultural Policy (CAB)) ostensibly on self-sufficiency grounds. This puts American grain exporters at a disadvantage by enabling European grain exporters to penetrate US export markets. After

negotiations, it was agreed that the volume of subsidized agricultural exports were to be reduced by 21% over a six-year period. As for trade in services, the European countries could not be persuaded to open their markets of US service exports such as banking, insurance and US films and TV Programmes.

An important aspect of the Marakesh Agreement of April 1994 following trade negotiations under the Uruguay Round relates to provisions concerning Trade Related Investment Measures (TRIMs). Many countries, among them some LDCs, previously attempted to head off competition from multinational corporations (MNCs) by invoking the so-called 'local content requirements' under which foreign enterprises were obliged to deploy local manpower or raw materials, and/or to export a certain percentage of the enterprise output. The Marakesh Agreement rules out these discriminatory measures by requiring countries to give 'national treatment' to foreign producers or goods. After goods from abroad enter a country, they must enjoy the same facilities or face the same restrictions (with respect to tax, for example) as goods produced within the country. The existing impediments are required to be phased out.

The Uruguay Round negotiations concerning the intellectual property rights (IPR) met with objections from many developing countries led by India and Brazil. But they came to nothing with the signing of the Marakesh Agreement. What is an intellectual property? Intellectual property refers to creations requiring mental exertions such as a song, a music, a poem, a film, a computer software package and is to be distinguished from assets like land, cars, machines and equipment which have physical existence. Intellectual property right (IPR) is a right to such property and is usually protected by laws relating to copyrights, trade marks and patents. Until the creation of the World Trade Organization in January, 1995, the intellectual property right used to be protected by the World Intellectual Property Rights Organization (WIPO), based in Geneva and established in 1974.

The negotiations from the US and other Western countries felt very strongly that their countries were being deprived on a large scale of the benefits of technological breakthroughs brought about by their huge investment in research and development (R&D) by unauthorized copying of their intellectual property. They demanded (and received) a globalized patent regime extending up to twenty years as a guarantee against such illegal piracy. The TRIPs agreement at Marakesh provides for a comprehensive set of global trade rules of the protection of copyrights, patents, trademarks, industrial designs that apply to all member countries irrespective of the levels of development, natural and human endowments, and history. Evrery member country has been asked by the WTO to amend its national patent laws to conform to that universal, globilized format within a given time frame. The least deveoped countries have been asked for make these changes by 2005 AD. Many signatory countries resented the denial of opportunity to opt out of some of the provisions of the TRIPs rules. More surprisingly, one provision of TRIPs (in Article 34) proposes the reversal of the burden of proof : the defendant country has to prove that an identical product has been produced by a process other than the patented one, thus violating one of the basic conons of Anglo-Saxon jurisprudence.

The Uruguay Round of Negotiation also led to the establishment of a new institution to be called the World Trade Organization (WTO) replacing the GATT since January,1995. The WTO has been invested with authority over matters relating to trade not only in industrial products, but also in agricultural products

and services. For decisions regarding trade disputes it is now enough to have votes of two-thirds or three-quarters of the nations (in contrast to the unanimity required under the GATT rules). Despite wide powers given to the WTO to discipline the erring members, many observers are skeptical about its ability to proceed against major trade powers when they try to abuse the system.

Questions for Review

MCQ's (Pick the correct answer)

1. Under managed floating, authorities intervene
   a. to reduce day-to-day volatility of the exchange rates.
   b. to reduce annual volatility of the exchange rates
   c. to allow the exchange rate to rise slowly over time
   d. to achieve none of the above.
2. Under the Target Zones system, the member countries
   a. keep their currencies pegged against one another
   b. allow there currencies to float against other currencies
   c. adopt both (a) and (b)
   d. adopt none.
3. The crawling peg system is one
   a. which is usually adopted by small countries
   b. in which the national currency is pegged to one major
   c. in which the country intervenes currency to adjust the pegged rate upward or downward in small bits
   d. in which all the above features are found.
4. Many countries saw the abandonment of the fixed exchange rate regime as a boon because
   a. they lacked sufficient policy instruments for both internal and external balance
   b. they had more than enough instruments
   c. whatever instruments they had were rendered ineffective by the fixed exchange rate
   d. the fixed exchange rate tended to favour the foreigners
5. GATT was formed to
   a. relieve balance of payments problems faced by many countries
   b. cure inflationary pressures imported from abroad
   c. help bring down trade barriers through multilateral negotiations
   d. achieve none of the above.

Short-type Questions

1. Examine how the following systems operate: (a) Managed floating (b) Target Zones (c) Crawling Peg
2. What is meant by policy autonomy? Was the objective of policy autonomy attained under the flexible exchange rates? If not, can you explain why?
3. "The incompatibility of national economic objectives with those of a globalized world has always been a serious problem for unhindered multilateral trade." Do you agree? Illustrate your answer from the experiences of the managed floating system.

4. The Uruguay Round provisions with respect to TRIPs and TRIMs are widely regarded as unfair to the developing countries. Do you think so? Explain.
5. What does the provision of 'local content requirements' mean? Who support it and who oppose? Examine the pros and cons and say whether the provision is overtly protectionist?
6. "While the first post-Bretton Woods decade has been a tough time for policy makers, the managed float apparently eased policy co-ordination rather than complicated it." Evaluate the statement.

Essay-type Questions

1. Outline the principal features of the system of managed floating. Examine its different variants.
2. Provide a general evaluation of the current system of managed floating of the exchange rate.
3. Examine the background of the Uruguay Round of multilateral trade negotiations under the GATT.
4. What are intellectual property rights? Why did they prove to be controversial during the Uruguay Round?

Answer: key for MCQ's

Lesson-1: 1.c, 2.a, 3.b, 4.d, 5.c

Lesson-2: 1.d, 2.d, 3.c, 4.b, 5.a

Lesson-3: 1.a, 2.c, 3.d, 4.a, 5.c