

International Financial System

- **Multinational economic organizations**
- **Ministries of finance and central banks**
- **Foreign-exchange markets**
- **International money & capital markets**

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Bretton Woods Conference

- ***International Monetary Conference***
- **1944**
- **Bretton Woods, NH**
- **To design the international economy of post-World War II**

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Bretton Woods Conference

- **1st major goal: To foster, strengthen & support free & efficient FX markets**

*International Monetary Fund
(IMF)*

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Bretton Woods Conference

- **2d major goal: To foster reconstruction & development**
 - *International Bank for Reconstruction & Development (IBRD)*
 - = *World Bank*

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Bretton Woods Conference

- **3d major goal: To combat trade protectionism**
 - *General Agreement on Tariffs & Trade (GATT)*
 - *World Trade Organization (WTO)*

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International Monetary Fund (IMF)

- **An international organization for promoting free & efficient FX markets**
 - **Founded: 1946**
- **Open to any government that:**
 - **Agrees to abide by the rules & practices of the IMF, and**
 - **Accepts its assigned *quota*.**

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Goals of the IMF

- **Foster, strengthen & support free & efficient FX markets by:**
 - **Providing a permanent forum for FX cooperation between governments**
 - **HQ: Washington, D.C.**
- **Create & maintain a stable system of exchange rates, and**
- **Discourage exchange & capital controls**
- **Accumulate large pool of funds**

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IMF Quotas

- **Assessed against all members**
- **The quota determines:**
 - **The *subscription* to be paid to the IMF**
 - **Voting rights in the IMF**
 - **Borrowing rights from the IMF**
 - **The allocation of *SDRs***

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Resources of the IMF

- ***Subscription quotas* of its members**
 - **Increased periodically (see 1st table)**
- **Interest is earned on loans to its members & other investments.**
- **The IMF has chosen not to borrow from the private money & capital markets.**

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IMF Subscription Quotas

	Quota		Value	
	\$	SDRs	\$	
1947	\$ 7.9		\$ 7.9	
1959	\$14.0		\$ 14.0	
1966	\$20.6		\$ 20.6	
1970	\$28.4		\$ 28.4	
1978		SDR 39.0	\$ 51.0	
1980		SDR 59.6	\$ 76.0	
1983		SDR 88.5	\$ 93.0	
1990		SDR146.0	\$200.0	
1998		SDR212.0	\$290.0	

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- ### Special Drawing Rights (SDRs)
- Only form of worldwide money
 - Created by the IMF in 1969
 - Used only by governments
 - Exists only in electronic form
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Composition of SDRs (Changes every 5 years)

	1981-5	1986-90	1991-5	1996-00	2001-5	2006-10
\$	42%	42%	40%	39%	45%	44%
¥	13%	15%	17%	18%	15%	11%
£	13%	12%	11%	11%	11%	11%
€					29%	34%
DM	19%	19%	21%	21%		
FF	13%	12%	11%	11%		

Source: International Financial Statistics (IMF)
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Activities of the IMF

- **Advises member countries**
- **Lends to member countries**
 - **To help them maintain free & efficient FX markets**
- **Does not *intervene* directly in FX markets**

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Loans to IMF Members

- **Available to any member**
- **Automatic credit lines**
 - *Reserve tranche*
 - **Special drawing rights**
- **Conditional credit lines**
 - *Conditionality*
 - **Credit tranches (5)**

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European Monetary Union

- **Unification of the currencies of 12 members of the European Union**
 - **Voluntary – 3 EU members “opted out”**
 - ***European Central Bank (ECB)***
 - **12 national currencies replaced by one common currency: *euro (€)***

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Treasuries / Ministries of Finance

- **Responsible for *fiscal policy***
[What is fiscal policy?]
- **The ministry of finance (or treasury) is an arm of the administration in power.**

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Central Banks

- **Responsible for *monetary policy***
[What is monetary policy?]
- *Open-market operations*
- **Intervention**
- **Central banks differ in their degree of independence.**

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- *"There is no sphere of human thought in which it is easier to show superficial cleverness & the appearance of superior wisdom than in...currency & exchange."*

- Winston Churchill
- British House of Commons
- (September 28, 1949)

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Government Actions Affecting the FX Markets

- **Actions to *directly* affect the FX markets: *intervening in the FX markets***
 - ***Selling the local currency (LC)***

[For what purpose?]

[What does the central bank receive in exchange?]

[Where does the central bank get the LC that it sells in the FX markets?] ¹⁹

FX-Market *Intervention*

- ***Buying the local currency, using international reserves***
 - **Foreign-currency (investments)**
 - **(Monetary) gold**
 - ***Reserve position in the Fund (IMF)***
 - ***Special drawing rights***
- ***Intervention is very difficult to accomplish successfully.*** ²⁰

Government Actions *Indirectly* Affecting the FX Markets

- ***Changing interest rates***
 - **A very quick, & generally predictable, impact**
 - **The most powerful tool for affecting XRs**

Current World FX System

- **A mixture of fixed & floating exchange rates (XRs).**
- **Fixed exchange-rate system**
 - **Government *fiat***
 - ***Par value* [= *parity*]**
 - **Action by the government (e.g., intervention or interest-rate**

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Current World FX System

- **Government action is:**
 - **Mandatory under a fixed-rate FX system.**
 - **Voluntary under a floating-rate FX system**

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Varieties of *Fixed Exchange-Rate* Systems

- **"Old" IMF system**
 - ***Gold-exchange standard***
- **Monetary union (e.g., EMU)**
- **Unilateral**
 - **Tied to a single currency**
 - **Tied to *currency*, "*cocktail*" (e.g., SDR)²⁴**

Change in Value of Fixed XRs

- *Devaluation*
- *Revaluation*

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Floating Exchange-Rate System

- **Determined by market forces**
- **No par value**
- **Intervention, if any, is voluntary.**
- **Governments often attempt to manipulate floating exchange rates.**

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Change in Value of a Floating XR

- *Depreciation*
- *Appreciation*

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Change in Currency Value

	<u>Increase</u>	<u>Decrease</u>
Fixed	Revaluation	Devaluation
Floating	Appreciation	Depreciation

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Change in Currency Value

- **Increase or decrease????**

$[(EV - BV) \div BV] * 100 = \% \Delta$

or

$[(BV - EV) \div EV] * 100 = \% \Delta$

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What Impact Does a *Decrease* in a Currency's Value Have upon a Country's:

- **Exports?**
- **Imports?**
- **Inflation?**
- **Earnings of foreign subsidiaries?**
- **The value of investments in FC-denominated stocks & bonds?**³⁰
