Lecture 5

Financial Crisis (1970s)

- By early 1970s, Bretton Woods agreement began to collapse

- Led to 2 major impacts
    - Fixed exchange rate system was no longer in effect
    - Gold exchange standard broke down as well

- First major sign of the collapse was in August 1971; Nixon administration ended the convertibility of US dollars into gold.
    - Creates situation in which gold as a standard for other currencies ceased
    - Other currencies were no longer tied to the US dollar.

- Collapse was expected; to some US policy makers, it was very desirable
    - Fundamental problem of the gold standard was that it made the US dollar a central reserve currency; hence, the international liquidity could not be increased without increasing amount of US dollar issued
    - Would cause balance of payments deficit

- Prior to 1971, quantity of US dollars in the international market grew larger than amount of gold held by the US government.
    - Beneficial to the US economy, because the economy was capable of financing the increasing external debt
    - It was exporting inflation in the world by flooding the world with US dollars

- Diminishing of world confidence in US economy
  - Generated the question on whether the US dollar should be linked to gold
  - If all countries holding US dollars wanted to convert their money to gold, there would not be enough in the US' reserve.

- Justification for de-linking the US dollar to Gold
  - Fixing the dollar value to gold was negatively affecting the US corporations' competitiveness internationally
  - Became a problem for the government; pressure on other countries to revaluate their currencies. Many refused to do so.
  - Tried to postpone problem; Japan and Germany agreed they would not attempt to convert their US dollar reserves into gold.
  - Because of the lost confidence in the US economy, they faced pressure from private speculators in the global market; against the US dollar

- 2 choices
  - Reduce quantity of US dollars printed; reduce money supply and increase domestic interest rate to improve value
  - End relationship between US dollars and gold

- Some economists believe despite this action, US control over financial and monetary system ended,
- Others believe that it was nothing more than changing style of leadership role; US still has large effect on international financial and monetary market.

- De-linking the dollar and gold also affected the Bretton Woods agreement by eliminating the fixed exchange rate system

- Starting in 1973, most of the world's major currencies start fluctuating in value versus each other.
- The IMF legalized the new style floating exchange rate in 1976, and gave the countries the responsibility to determine the value and the stability of its currencies.
- Accompanied by large growth in speculative international financial flows.
- Large part of these speculative demands and flows were initiated by the governments themselves. Governments would influence flows by buying and selling their own currencies and foreign currencies.

- Reason: New system can and will play important role in adjusting the external imbalances, deficits in the balance of payments. Can provide the proper environment and mechanisms which will allow countries to address problems of deficits with less control and without having to change their monetary and fiscal policies. Leads to stabilize world economy.
- Argument: this system will discourage global and international trade and finance.
- But floating exchange rate had no effect on global trade and finance; on the contrary, governments avoid using capital controls, trade barriers, to correct BOP deficits. By doing so, they increase the size of international trade and financial transactions. It also helped the process of creating an international economic integration.

- Other criticisms of floating exchange rate system
  - New regime the destabilizing speculative financial transactions and generates very unstable currency market.
  - Encourages a kind of casino capitalism in which speculators become the dominant figure in the foreign exchange market; these speculations usually affect value of currencies negatively. Price of major commodities are affected; affects level of exports, etc.

- Size of daily foreign exchange trading increased from 15US billion in 1973 to 1650 billion by 2001.
- Total value of exports of all countries in 1997 reached 6.6 trillion; 25 billion a day
- Some positive effects on international trade and finance
- Some disruptive effects on US economy
    - Some mismanagement of the money market during the period
        - Created deficits in the US; substantial decline in level of exports.
    - Created demands for more effective exchange rate system

- 1985, G5 signs agreement to work together to encourage the depreciation of the US dollar vis-à-vis other currencies in order to boost their level of exports. (Plaza agreement?)
- US urged Japan and Germany to increase value of their currencies and to encourage US imports to these countries. Pressured them by using 'the dollar weapon'; reducing the value of the US dollar. This action left the Japanese and Germans with 2 options; one was to intervene when the US would sell US dollars and buy Japanese and German currency, they would do the opposite to keep the US dollar high. However, this created problems for them; led to continual increase in money supply in both Germany and Japan; affected interest rates and create unstable monetary system. The other option was to accept the US dollar appreciation and accept all the consequences of that. Would have an impact on domestic economies of both countries; reduce competitiveness of their industries and level of exports.
- Restored the US dollar as the key world currency.
- But these conflicts created an unstable world economic environment; which were more negative for poorer countries.

- Needed to create stable system
    - One solution was to make stable regional monetary zones
    - Not new: when Bretton woods broke down, several European countries attempted to stabilize exchange rates among themselves.
        - Establishment of European Monetary system in 1979
        - The new system advocated an adjustable fixed exchange rate regime; both capital controls and financial support were provided to protect each country's currency's position versus the others.
    - 1991: the Maastricht Treaty was signed; European Union.
        - Members committed themselves to a full monetary union whose rules would be finalized in 1999