THE CONSEQUENCES OF GLOBAL VOLATILITY REFLECTED IN THE EVOLUTION OF INTERNATIONAL MONETARY SYSTEM

Daea Alexandra Renate

University of Craiova, Faculty of Economics and Business Administration, Drobeta Turnu Severin, Adrian Street No.174, Romania, alexandradaea@yahoo.com, 0723610537

The international financial system is unstable and subject to serious crises. The crises are a recurrent feature of the international economy and they represent market failures that not only imply some resource misallocations, much more, shocking setbacks in the growth prospects for the emerging economies, with serious implications for income distribution and living standards for their citizens. The founders of the Bretton Woods System 60 years ago were primarily concerned with orderly exchange rate adjustment in a world economy that was characterized by widespread restrictions on international capital mobility. In contrast, the rapid pace of financial globalization during recent years poses new challenges for the international monetary system.

Key words: international financial system, crises, Bretton Woods system

International monetary system – subject of international crises

Integration of global financial markets and increased monetary and financial interdependence of national economies had a significant impact on domestic as well as international economics. Increased interdependence also has integrated such once-isolated policy issues as trade flows and exchange determination, thus immensely complicating the task of managing the world economy and raising important questions about the adequacy of the rules governing international economic affaires.

The international financial system is unstable and subject to serious crises. The crises are a recurrent feature of the international economy and they represent market failures that not only imply some resource misallocations, much more, shocking setbacks in the growth prospects for the emerging economies, with serious implications for income distribution and living standards for their citizens.

The founders of the Bretton Woods System 60 years ago were primarily concerned with orderly exchange rate adjustment in a world economy that was characterized by widespread restrictions on international capital mobility.

In contrast, the rapid pace of financial globalization during recent years poses new challenges for the international monetary system. In particular, large gross cross-holdings of foreign assets and liabilities mean that the valuation channel of exchange rate adjustment has grown in importance, relative to the traditional trade balance channel.

The financial system is complex in structure and function throughout the world. The volatility of global financial markets culminated in the East Asian crisis and the global economic turmoil of the late 1990s, which began in Thailand in July 1997, reflected the growing impact of global economic forces on international economic affaires

The Bretton Woods rules-based international monetary system was replaced by a shaky political agreement among the dominant economic powers G-7; this change made the central banks of the major economic powers de facto managers of the international monetary system.

The last two decades have seen changes in the structure of the international monetary system. Creation of the European Monetary System and the common currency (euro) pose a serious threat to the unity of the international monetary system. The most important questions are whether or not the euro displaces the dollar, what the consequences for the United States would be if it did, and how the euro would affect the functioning and management of the international monetary and economic system.

Throughout the postwar era, the international role of the dollar has been an important feature of the world economy. Somewhere between 40 and 60 percent of international financial transactions are denominated in dollars. For decades, the dollar has also been the world's principal reserve currency; the international role of the dollar has conferred a number of economic and political benefits on United States, and if the dollar were to lose its status as the world's key currency, the United States would forfeit these benefits.

The international demand for dollars has meant that the United States has been able to finance its huge and continuing trade/payments deficits since the early 1980s at a minimal cost. Moreover, the United States has been able to borrow in its own currency and thus avoid exchange-rate risks. In addition, American prestige is certainly enhanced by the international role of the dollar.

Emerging markets passed through a series of crises, leading some to adopt regimes of greater exchange rate flexibility and others to rethink the pace of capital account liberalization. Interpreting these developments is no easy task: some observers conclude that recent trends are confirmation of the bipolar view that intermediate exchange rate arrangements are disappearing, while members of the fear of floating school conclude precisely the opposite.

We show that the two views can be reconciled if one distinguishes countries by their stage of economic and financial development. Among the advanced countries, intermediate regimes have essentially disappeared; this supports the bipolar view for the group of countries for which it was first developed. Within this subgroup, the dominant movement has been toward hard pegs, reflecting monetary unification in Europe. Here the majority of the evacuees have moved to floats rather than fixes, reflecting the absence of EMU-like arrangements in other parts of the world. Among developing countries, the prevalence of intermediate regimes has again declined, but less dramatically. As with emerging markets, the majority of those abandoning the middle have moved to floats rather than hard pegs.

The gradual nature of these trends does not suggest that intermediate regimes will disappear outside the advanced countries anytime soon. At some level, the literature on the bipolar view builds on classic studies of the pre-World War I gold standard. The miracle of the gold standard was that it somehow managed to successfully reconcile stable exchange rates with high capital mobility.

Before World War I, the gold standard was predominant. Currencies were convertible into gold, thus fixing exchange rates between countries. After World War II, the Bretton Woods system and the International Monetary Fund were established to promote a fixed exchange rate system in which U.S. dollar was convertible into gold. The Bretton Woods system collapsed in 1971. We now have an international system that has elements of a managed float and a fixed exchange rate system.

The modern literature attributes this success to the hegemony of a model of monetary policy in which central banks attached priority to exchange rate stability, to the absence of a theory linking monetary policy to the business cycle, and to the fact that the public was not organized or enfranchised in a way that might enable it to apply pressure for the pursuit of alternative goals of policy. Thus, Keynes (1930) modelled the prewar gold standard as a stable intermediate regime – essentially, as a credible target zone. All this changed with the extension of the franchise and the politicization of monetary policy in the 1920s. The result was intense speculative pressure leading to the final collapse of the gold standard in the early 1930s. Disenchantment with open capital markets followed. Capital controls were widely imposed. Their maintenance allowed countries to operate a wide variety of different exchange rate regimes after 1931. Restrictions on transactions on capital account were maintained for many years – in some countries into the 1990s. Thus, while the Articles of the Agreement of the International Monetary Fund required members to make their currencies convertible for purposes of current account transactions after a short transitional period, there was no obligation to make currencies convertible for transactions on capital account.

The architects of Bretton Woods essentially took for granted the indefinite maintenance of capital controls when designing the new post-World War II system of pegged-but-adjustable rates. With the gradual postwar recovery of financial markets and transactions, investors found a growing number of ways around these controls; the development of the Eurodollar market starting in the 1960s was only the most graphic case in point. Policy makers responded in two ways. One was by widening the bands around their exchange rate parities.

Thus, the Smithsonian Agreement in 1971 that sought to salvage the Bretton Woods System expanded fluctuation bands against the dollar from +/−1 to +/−2.25%. European policy makers adopted this convention of 2.25% bands after Bretton Woods collapsed and they substituted the European Monetary System in 1979.

The other response was to elaborate and further tighten controls in order to prevent capital flows from destabilizing currency pegs. What is striking in retrospect is that there seem to have been so few analyses acknowledging that the rise in capital mobility was ineluctable and that it posed a challenge to the maintenance of intermediate regimes – that countries would ultimately be forced to move either to hard pegs (in Europe, in the form of monetary union) or freer floats (in other parts of the world).

Since the collapse of the Bretton Woods architecture, the world monetary system has been affected by two conflicting forces. The more powerful of the two forces is the concept of flexible exchange rates, which established itself in the ideological climate of economic liberalism. The other source of conflict originates in the belief that total exchange-rate flexibility is harmful to economic growth and free trade; it has led to the creation of the euro. This unsettled debate between the two rival concepts has acquired a new intensity because of globalization.

International monetary stability and global financial integration

Moreover, there is another problem that must be solved: Can a globalized economy function in the long run without a global currency? The economists must decide between two alternatives: Will the dynamics of globalization lead to the establishment of a world monetary system or will monetary fragmentation eventually trigger a reversal of globalization? This debate seems to be more an academic controversial because, in reality, monetary calm is an illusion: somewhere, there is always an imbalance that needs clearing.

The crisis in the emerging economies illustrates the harmful consequences of the present shortage of international monetary cooperation. But it depends to the world states (especially United States and European Union) to remedy that deficiency. The advent of the euro creates ideal conditions for a revival of global monetary cooperation. It is a historic opportunity that a revamped G-7 should seize in order to establish financial stability. Without the latter, the gains of globalization may be jeopardized by rising protectionism-a phenomenon whose sporadic manifestations are already visible. The G-7 has not sufficiently adapted to the new global economic environment, in particular the explosion of international capital flows and the rise of the emerging economies.

The G-7 has a special responsibility in the playing field without rules, constraints, or sanctions that has been built on the ruins of the Bretton Woods system. The G-7 must now fill this gap by contributing rapidly and decisively to the development of a new international financial architecture.

First, the G-7 must define a more coherent set of operating rules for the IMF. It must give the Fund the means to act, particularly by granting it broader authority to negotiate with countries that come to it for help; the G-7 also must increase the IMF's financial resources. After the quota increases now under discussion, IMF resources measured against international trade volume will stand at only 11 percent of their 1945 level: this does not make sense.

Second, the G-7 must reform itself in order to take better account of the interests of the emerging economies and to achieve the flexibility needed to adjust to global change without being paralyzed by short-term conflicts of interest. In particular, the G-7 structure needs revamping in order to separate the activities concerning relationships between the two or three main currencies (euro, dollar, and the yen) from broader initiatives requiring an adequate representation of small and emerging countries.

The establishment of these new ground rules must rest on close cooperation between the main industrialized countries, at government and central-bank level. Indeed, their governments and central banks must be fully aware that their international responsibilities, in an open economy, are simply an extension of their domestic obligations. Under such conditions, the international monetary system will be able to gain strength and meet the challenges of the years ahead.

The decline of the G-7 and of monetary cooperation bears a special responsibility in the development; the decline has substantially weakened the scope of preventive action by the multilateral financial institutions in response to governments' economic policies and to unstable investor behavior. Countries whose financial systems had not been adjusted were allowed to lift all controls on capital movements with the rest of the world, and in some cases they were actually encouraged to do so. The world's rising monetary and financial instability is due to fixed exchange rates and the support they have received from the international community, notably the International Monetary Fund.

In a universe in which all agents were perfectly informed, we might assume that this recipe would ensure international monetary and financial stability-provided that economic policies converged. In practice, policy convergence-whether in the monetary or the fiscal sphere-has not proved to be a sufficient guarantee of monetary stability.

In my view, international financial integration and the state of the international financial system are far less abstract topics than one might think at first glance. They reflect one of the most complex, intriguing and powerful aspects of the phenomenon that is generally referred to as globalization. This phenomenon represents a key issue that policy-makers in Europe and beyond have to deal with. Policy-makers often face very specific concerns about economic uncertainty and the risk of instability. There is also a more recent phenomenon that is less visible, but even more dynamic, namely global financial integration. By this, I mean the integration of local and national financial markets into a more unified international financial market. Only a few decades ago, the realization of an investment project was largely contingent on the availability of capital in the local economy. Today the opportunities to raise finance as well as to invest capital are truly global. The substantial number of bilateral investment treaties and the liberalization of capital accounts have further encouraged cross-border investment.

The benefits of this integration are obvious – a greater variety of goods and downward pressure on prices benefiting consumers and households. But the benefits are even more substantial, as production requires both human and financial capital. A skilled workforce cannot unleash its full potential without financial capital. Europe's impressive economic recovery after World War II would have been inconceivable without its integration into the global economy and its concentration on high-quality exports.

Today, many Asian economies are benefiting from global economic integration. Investment in the appropriate technologies enables these countries to compete on the world market and increase welfare substantially. This is by no means a phenomenon which only appears in national accounts. Income disparities across the world have declined significantly. Not surprisingly, the benefits of this financial integration are particularly clear for open economies, which have recorded higher average growth rates in recent years.

How should we assess these recent developments in the international financial system? We realize that the benefits outweigh the costs. But there are costs of adjustment, often front-loaded and concentrated on specific regions and sectors, which need to be taken into consideration.

The change in the structure of the global economy also requires structural adjustments to be made in local economies. We know that the ability of a country to benefit from global financial integration very much depends on the quality of its institutional and structural environment. All economies, including advanced ones, such as the euro area, have to adapt to the changing needs of the world economy.

The European economy has undergone and will continue to undergo substantial structural changes, which are necessary and beneficial because they will secure Europe's place in the global economy. This structural adjustment has been and will continue to be a major phenomenon in the coming years. As the world's largest exporter, Europe clearly has a major interest in global economic integration and is well placed to benefit from it. Sceptics are concerned about the sustainability of global financial integration; they argue that financial integration has gone too far, that market turnover has reached levels that are unhealthy.

The world economy has entered a particularly difficult phase, with the financial turmoil spreading, across borders, across sectors, and to the real economy. Indeed, one of the key lessons has been the importance of international policy cooperation and coordination. Such a collaborative approach offers the best hope for ensuring the stability of the global economy.

References

1. Lee, Kiefer, Carter, Steve, Global Marketing Management, Oxford, Oxford University Press, 2005
2. Gilpin, Robert, Global Political Economy - Understanding the International Economic Order, Princeton University Press, Princeton and Oxford, 2001
3. Mishkin Frederic, The Economics of Money, Banking and Financial Markets, 6th edition, Addison Wesley, New York, 2000