

International Finance

International Finance

Module Introduction and Overview

Contents

1	Introduction to the Module	2
2	Study Resources	3
3	Learning Outcomes	4
4	Study Advice	4
5	Module Overview	5

1 Introduction to the Module

The emergence of an open, liberal international financial order has been one of most notable developments in the global economy in the last 20 years. The growth of a more open international economy since the Second World War produced an international environment in which markets have bypassed national regulations, and financial flows have seriously questioned the Keynesian demand management policies. The study of trade and production cannot, therefore, satisfactorily explain the behaviour of the international economy; finance and the institutions through which it flows should also be examined. In a world where consumption, production and investment are globalised, international finance has become an integral part of any serious academic study of international economics.

The main objective of this module is to study the economists' perspective on international finance, which is a policy-oriented perspective. The examination of the institutions of international finance and the key policy problems that have arisen in recent decades are the main concern of this module. In other words, it is the perspective that an economist would use when advising governments on how to work within the modern international financial system and how to overcome its problems.

In order to explore problems of policy within the international financial system, you need to learn three principal types of material:

- the institutional structure of the modern international financial system
- the principles of financial policy analysis for an open economy
- the principles affecting some current policy issues in international finance.

The institutional structure of the modern international financial system is discussed in Units 1 and 2. Unit 1 is concerned with the *Bretton Woods* system, the *Eurodollar* system, and the new institutional development arising from the *international debt crisis* of the 1980s. Unit 2 deals with foreign exchange markets as the foundation for all operations in international finance, and its relation to money markets. That unit presents an overview of the basic nature of foreign exchange markets, the distinction between spot and forward exchange rates, the different types of transaction that take place in the market and the policy relationships.

The principles of financial policy analysis for an open economy are presented in Units 3, 4 and 5. In Unit 3, you will study the concept of balance of payments and examine one important element of the balance of payments, the *current account*. Methods used to analyse the effects of different policies upon the current account, and their complementary nature are also explained in that unit. The methods analysed are the *multiplier framework*, the *elasticities framework*, and the *absorption framework*. Unit 4 will introduce the Mundell–Fleming Approach to the balance of payments, and Unit 5 considers the monetary approach to balance of payments policies. The monetarist analysis of the balance of payments and the evaluation of

the monetary approach to balance of payments are the most important topics in that unit.

The principles affecting some current policy issues in international finance comprise the subject matter of Units 6, 7 and 8. An examination of the policy debates on fixed, flexible and managed exchange rate systems are the central theme of these units. In Unit 6, you will study the arguments in favour of, and the arguments against fixed, floating and managed rates. Unit 7 is about the policy implications resulting from fixed versus floating exchange rate systems at an international level. You will also learn how some countries, such as the EU members, have agreed to maintain fixed exchange rates among themselves (*currency blocs*), which some others have exercised to co-ordinate their exchange rate policies (*international macro co-ordination*). The evolution and objectives of the European Monetary Union are also discussed in this unit.

Unit 8 is concerned with problems of international finance faced by developing countries. In this unit, the validity of assumptions used in the standard economic models studied in this module, and the logic of abstraction employed in constructing simple models to represent the actuality of developing countries, are questioned.

2 Study Resources

This study guide is your central learning resource, it structures your learning unit by unit. Each unit should be studied within a week. It is designed in the expectation that studying each unit and the associated readings will require 15 to 20 hours per week, but this will vary according to your background knowledge and experience of studying.



Key text

The key text for this module is:

Keith Pilbeam (2013) *International Finance*. 4th Edition. Basingstoke UK: Palgrave Macmillan.

This is a standard, good, modern textbook that gives a clear exposition of the main theoretical, institutional and policy issues taught in this module. I will refer to it simply as Pilbeam from now on.

Throughout this module, I will introduce you to the topic of each unit, set out the main questions and direct you to the sections and chapters of Pilbeam that deal with the material you are studying. I will explain concepts in Pilbeam that appear difficult, and discuss with you the conclusions you could draw from your reading. In some units, I will refer to articles instead of Pilbeam or in addition to that text.

Module readings

You are also provided with some academic articles and other reports, which are assigned as readings in the study guide. You are expected to read them as an essential part of the module although you will find that some academic articles range more widely than the study guide or use more advanced techniques and have a greater level of conceptual difficulty than the textbook. That is the nature of academic articles, but I have selected articles and reports whose main arguments can be understood and appreciated at the level appropriate to this module.

3 Learning Outcomes

When you have completed this module, you will be able to do the following:

- outline the decline of Bretton Woods and the rise of the Flexible Exchange Rate Regime, 1973 to the present
- analyse and discuss fixed versus flexible exchange rate regimes
- explain the difference between hedging, arbitrage and speculation and the interaction of hedgers, arbitrageurs and speculators
- discuss the parity relationships between spot and future exchange rates
- demonstrate how a balance of payments is constructed with a series of transactions, and show how transactions are recorded
- explain how the national income framework and elasticities framework can be linked to the absorption framework.
- discuss the policy problem the Mundell–Fleming model is designed to address, and the historical circumstances that made it relevant
- differentiate between the assumptions of the Polak model and those of the Mundell–Fleming model
- assess the strengths and weaknesses of the monetary approach
- relate the traditional arguments for and against fixed and floating exchange rates
- explain the rationale behind discretionary intervention in the foreign exchange market
- give an account of the development of the European Monetary System and the European Monetary Union.

4 Study Advice

The module units (or ‘study guide’) serve much as a lecture in a conventional university setting, introducing you to the literature of the subject under study and helping you to identify the core message of each reading you are assigned. As you work through the units, you should study the readings as suggested and answer the questions set. Where you are already

familiar with the particular topic introduced, you may find that skim-reading is sufficient, as long as you can answer the relevant questions.

The objectives of each unit are set out in the introductory section of each unit, and it's a good idea to review these when you have finished that unit's work to make sure that you can indeed complete each task suggested. These are the sorts of issues you are likely to meet in examination questions and your ability to write on them should set you up well for success in the module.

You should always read your module materials critically and evaluate carefully the strengths and weaknesses of economic models that are being presented. Remember that no model is perfect in its attempt to explain a particular aspect of economic behaviour. Train yourself, therefore, to adopt a critical approach to all your module material, including these units.

During the scheduled weeks of the module, you must complete two assignments in which you will be asked to write essays. The essays will be marked by your tutor in London, who will send you detailed comments and advice. The grades on your two assignments will account for 30% of your final module grade. To complete the module, you will take an examination, according to the University of London examination schedule, which will account for the remaining 70% of your total module grade.

Please keep in mind that your essays, examination and study of the module should reflect its principal themes and ways of reasoning. I hope that, by the end of your study of the module, you will be able to

- identify and clearly define significant policy problems
- use an appropriate theoretical model to analyse policy problems
- and, when necessary, place the argument in the context of the institutional setting.

The best marks will be awarded for essays and examination answers that include these elements. Moreover, we will give great weight to the use you make of theoretical models in your essays. Recall that models presented in diagrams or equations are usually the clearest. Your work in each unit will be organised around one or two thematic questions relating to that unit.

The overall, broad question, which runs through the module as a whole, is:

- What policies and strategies can countries adopt to solve international financial problems, and what are their strengths and weaknesses?

5 Module Overview

Unit 1 Evolution of International Financial Systems

- 1.1 Introduction to Unit 1
- 1.2 Bimetallism – before 1879
- 1.3 Classical Gold Standard – 1879–1914
- 1.4 The Interwar Period – 1914–1944
- 1.5 The Bretton Woods System – 1945–1972

- 1.6 The Flexible Exchange Rate Regime – 1973 Onwards
- 1.7 The Rise of the Eurodollar
- 1.8 The International Debt Crisis
- 1.9 Summary

Unit 2 Foreign Exchange Markets

- 2.1 Introduction
- 2.2 Economic Models and Institutions
- 2.3 Market Institutions and Exchange Rates
- 2.4 A Simple Model of the Spot Exchange Rate
- 2.5 A Theory of Spot Exchange Rates: Purchasing Power Parity
- 2.6 Forward and Spot Exchange Rates: Covered Interest Parity
- 2.7 Parity Conditions Linking Spot and Forward Exchange Markets
- 2.8 Foreign Exchange and Other Financial Markets

Unit 3 The Balance of Payments

- 3.1 Introduction
- 3.2 Measures of the Balance of Payments
- 3.3 The Multiplier Approach
- 3.4 The Elasticities Approach
- 3.5 The Absorption Approach
- 3.6 Summary

Unit 4 Balance of Payments: the Mundell–Fleming Approach

- 4.1 Introduction
- 4.2 The Internal-and-External-Equilibrium Approach to Policy
- 4.3 The Mundell–Fleming Approach: the IS-LM-BP Model
- 4.4 Policies and Events: Shifts of the Three Curves
- 4.5 Policies under Fixed and Floating Exchange Rates
- 4.6 Perfect Capital Mobility
- 4.7 Evaluations of the Mundell–Fleming Model
- 4.8 Evaluation of Perfect Capital Mobility

Unit 5 Balance of Payments: the Monetary Approach

- 5.1 Introduction
- 5.2 Background to the Monetary Approach
- 5.3 Three Assumptions of the Monetarist Theory
- 5.4 The Money Supply Identity
- 5.5 Monetarist Analysis of the Balance of Payments
- 5.6 Evaluation of the Monetary Approach
- 5.7 Conclusion

Unit 6 Fixed and Flexible Exchange Rate Systems

- 6.1 Introduction
- 6.2 The Case for Fixed Exchange Rates
- 6.3 The Case for Floating Exchange Rates
- 6.4 The Modern Evaluation of Fixed and Flexible Exchange Rate Regimes
- 6.5 The Case for Managed Exchange Rates
- 6.6 Finance and the Choice of Exchange Rate Systems

Unit 7 Currency Blocs, Financial Integration and International Co-ordination

- 7.1 Introduction
- 7.2 Types of Financial Co-operation
- 7.3 Macroeconomic Policy Co-ordination
- 7.4 European Monetary Union

Unit 8 Currency and Financial Crises and the International Financial System

- 8.1 Introduction
- 8.2 Modelling Currency Crises
- 8.3 The East Asian Financial Crisis
- 8.4 The 2007–08 Financial Crisis
- 8.5 Financial Innovations before the Credit Crunch
- 8.6 Dimensions and Causes of the Credit Crunch
- 8.7 Policy Responses to the 2007–08 Crisis

Assessment

Your performance on each module is assessed through two written assignments and one examination. The assignments are written after Unit 4 and Unit 8 of the module session. Please see the VLE for submission deadlines. The examination is taken at a local examination centre in September/October.

Preparing for assignments and exams

The examinations you will sit are designed to evaluate your knowledge and skills in the subjects you have studied; they are not designed to trick you. If you have studied the module thoroughly, you will pass the exam.

Understanding assessment questions

Examination and assignment questions are set to test your knowledge and skills. Sometimes a question will contain more than one part, each part testing a different aspect of your skills and knowledge. You need to spot the key words to know what is being asked of you. Here we categorise the types of things that are asked for in assignments and exams, and the words used. All the examples are from the Centre for Financial and Management Studies examination papers and assignment questions.

Definitions

Some questions mainly require you to show that you have learned some concepts by setting out their precise meanings. Such questions are likely to be preliminary and will be supplemented by more analytical questions. Generally, 'Pass marks' are awarded if the answer only contains definitions. These questions will contain words such as:

- describe
- define
- examine
- distinguish between
- compare
- contrast
- write notes on
- outline
- what is meant by
- list.

Reasoning

Other questions are designed to test your reasoning, by asking you to explain cause and effect. Convincing explanations generally carry more marks than basic definitions. These questions will include words such as:

- interpret
- explain
- what conditions influence
- what are the consequences of
- what are the implications of.

Judgement

Others ask you to make a judgement, perhaps of a policy or a course of action. They will include words like:

- evaluate
- critically examine

- assess
- do you agree that
- to what extent does.

Calculation

Sometimes you are asked to make a calculation using a specified technique; these questions begin:

- use indifference curve analysis to
- using any economic model you know
- calculate the standard deviation
- test whether.

It is most likely that questions that ask you to make a calculation will also ask for an application or interpretation of the result.

Advice

Other questions ask you to provide advice in a particular situation. This applies to law questions and to policy papers where advice is asked in relation to a policy problem. Your advice should be based on relevant law, applicable principles, and evidence of what actions are likely to be effective. The questions may begin:

- advise
- provide advice on
- explain how you would advise.

Critique

In many cases the question will include the word 'critically'. This means that you are expected to look at the question from at least two points of view, offering a critique of each view and your judgement. You are expected to be critical of what you have read.

The questions may begin:

- critically analyse
- critically consider
- critically assess
- critically discuss the argument that.

Examine by argument

Questions that begin with 'discuss' are similar; they ask you to examine by argument, to debate and give reasons for and against a variety of options. For example:

- discuss the advantages and disadvantages of
- discuss this statement
- discuss the view that
- discuss the arguments and debates concerning.

The grading scheme: assignments

The assignment questions contain fairly detailed guidance about what is required. All assignments are marked using marking guidelines. When you receive your grade, it is accompanied by comments on your paper, including advice about how you might improve, and any clarifications about matters you may not have

understood. These comments are designed to help you master the subject and to improve your skills as you progress through your programme.

Postgraduate assignment marking criteria

The marking scheme for your programme draws upon these minimum core criteria, which are applicable to the assessment of all assignments:

- understanding of the subject
- utilisation of proper academic or other style (*eg* citation of references, or use of proper legal style for court reports)
- relevance of material selected and arguments proposed
- planning and organisation
- logical coherence
- critical evaluation
- comprehensiveness of research
- evidence of synthesis
- innovation/creativity/originality.

The language used must be of a sufficient standard to permit assessment of these aspects.

The guidelines below reflect the standards of work expected at postgraduate level. All assessed work is marked by your tutor or a member of academic staff, and a sample is then moderated by another member of academic staff. Any assignment may be made available to the external examiner(s).

80+ (Distinction). A mark of 80+ will fulfil the following criteria:

- very significant ability to plan, organise and execute independently a research project or coursework assignment
- very significant ability to evaluate literature and theory critically and make informed judgements
- very high levels of creativity, originality and independence of thought
- very significant ability to critically evaluate existing methodologies and suggest new approaches to current research or professional practice
- very significant ability to analyse data critically
- outstanding levels of accuracy, technical competence, organisation and expression.

70–79 (Distinction). A mark in the range 70–79 will fulfil the following criteria:

- significant ability to plan, organise and execute independently a research project or coursework assignment
- clear evidence of wide and relevant reading, referencing and an engagement with the conceptual issues
- capacity to develop a sophisticated and intelligent argument
- rigorous use and a sophisticated understanding of relevant source materials, balancing appropriately between factual detail and key theoretical issues. Materials are evaluated directly, and their assumptions and arguments challenged and/or appraised

- correct referencing
- significant ability to analyse data critically
- original thinking and a willingness to take risks.

60–69 (Merit). A mark in the 60–69 range will fulfil the following criteria:

- ability to plan, organise and execute independently a research project or coursework assignment
- strong evidence of critical insight and thinking
- a detailed understanding of the major factual and/or theoretical issues and direct engagement with the relevant literature on the topic
- clear evidence of planning and appropriate choice of sources and methodology with correct referencing
- ability to analyse data critically
- capacity to develop a focused and clear argument and articulate clearly and convincingly a sustained train of logical thought.

50–59 (Pass). A mark in the range 50–59 will fulfil the following criteria:

- ability to plan, organise and execute a research project or coursework assignment
- a reasonable understanding of the major factual and/or theoretical issues involved
- evidence of some knowledge of the literature with correct referencing
- ability to analyse data
- examples of a clear train of thought or argument
- the text is introduced and concludes appropriately.

40–49 (Fail). A Fail will be awarded in cases in which there is:

- limited ability to plan, organise and execute a research project or coursework assignment
- some awareness and understanding of the literature and of factual or theoretical issues, but with little development
- limited ability to analyse data
- incomplete referencing
- limited ability to present a clear and coherent argument.

20–39 (Fail). A Fail will be awarded in cases in which there is:

- very limited ability to plan, organise and execute a research project or coursework assignment
- failure to develop a coherent argument that relates to the research project or assignment
- no engagement with the relevant literature or demonstrable knowledge of the key issues
- incomplete referencing
- clear conceptual or factual errors or misunderstandings
- only fragmentary evidence of critical thought or data analysis.

0–19 (Fail). A Fail will be awarded in cases in which there is:

- no demonstrable ability to plan, organise and execute a research project or coursework assignment
- little or no knowledge or understanding related to the research project or assignment
- little or no knowledge of the relevant literature
- major errors in referencing
- no evidence of critical thought or data analysis
- incoherent argument.

The grading scheme: examinations

The written examinations are 'unseen' (you will only see the paper in the exam centre) and written by hand over a three-hour period. We advise that you practise writing exams in these conditions as part of your examination preparation, as it is not something you would normally do.

You are not allowed to take in books or notes to the exam room. This means that you need to revise thoroughly in preparation for each exam. This is especially important if you have completed the module in the early part of the year, or in a previous year.

Details of the general definitions of what is expected in order to obtain a particular grade are shown below. These guidelines take account of the fact that examination conditions are less conducive to polished work than the conditions in which you write your assignments. Note that as the criteria for each grade rise, they accumulate the elements of the grade below. Assignments awarded better marks will therefore have become comprehensive in both their depth of core skills and advanced skills.

Postgraduate unseen written examinations marking criteria

80+ (Distinction). A mark of 80+ will fulfil the following criteria:

- very significant ability to evaluate literature and theory critically and make informed judgements
- very high levels of creativity, originality and independence of thought
- outstanding levels of accuracy, technical competence, organisation and expression
- outstanding ability of synthesis under exam pressure.

70–79 (Distinction). A mark in the 70–79 range will fulfil the following criteria:

- clear evidence of wide and relevant reading and an engagement with the conceptual issues
- development of a sophisticated and intelligent argument
- rigorous use and a sophisticated understanding of relevant source materials, balancing appropriately between factual detail and key theoretical issues

- direct evaluation of materials, and challenging and/or appraisal of their assumptions and arguments
- original thinking and a willingness to take risks
- significant ability of synthesis under exam pressure.

60–69 (Merit). A mark in the 60–69 range will fulfil the following criteria:

- strong evidence of critical insight and critical thinking
- a detailed understanding of the major factual and/or theoretical issues and direct engagement with the relevant literature on the topic
- development of a focused and clear argument, with clear and convincing articulation of a sustained train of logical thought
- clear evidence of planning and appropriate choice of sources and methodology, and ability of synthesis under exam pressure.

50–59 (Pass). A mark in the 50–59 range will fulfil the following criteria:

- a reasonable understanding of the major factual and/or theoretical issues involved
- evidence of planning and selection from appropriate sources
- some demonstrable knowledge of the literature
- the text shows, in places, examples of a clear train of thought or argument
- the text is introduced and concludes appropriately.

40–49 (Fail). A Fail will be awarded in cases in which:

- there is some awareness and understanding of the factual or theoretical issues, but with little development
- misunderstandings are evident
- there is some evidence of planning, although irrelevant/unrelated material or arguments are included.

20–39 (Fail). A Fail will be awarded in cases which:

- fail to answer the question or to develop an argument that relates to the question set
- do not engage with the relevant literature or demonstrate a knowledge of the key issues
- contain clear conceptual or factual errors or misunderstandings.

0–19 (Fail). A Fail will be awarded in cases which:

- show no knowledge or understanding related to the question set
- show no evidence of critical thought or analysis
- contain short answers and incoherent argument.

DO NOT REMOVE THE QUESTION PAPER FROM THE EXAMINATION HALL

UNIVERSITY OF LONDON

CENTRE FOR FINANCIAL AND MANAGEMENT STUDIES

MSc Examination

Postgraduate Diploma Examination

for External Students

91DFM C229

91DFM C329

FINANCE (BANKING)

FINANCE (ECONOMIC POLICY)

FINANCE (FINANCIAL SECTOR MANAGEMENT)

FINANCE (QUANTITATIVE FINANCE)

International Finance

Specimen Examination

*This is a specimen examination paper designed to show you the type of examination you will have at the end of the year for **International Finance**. The number of questions and the structure of the examination will be the same but the wording and the requirements of each question will be different. Best wishes for success in your final examination.*

The examination must be completed in **THREE** hours.

Answer **THREE** questions, at least **ONE** from **EACH** section.

The examiners give equal weight to each question; therefore, you are advised to distribute your time approximately equally over three questions. The examiners wish to see evidence of your ability to use technical models and of your ability to critically discuss their mechanisms and application.

PLEASE TURN OVER

Answer **THREE** questions, *at least ONE* from **EACH** section.

Section A

Answer at least ONE question from this section.

1. 'To understand the 1990s system of international finance, it is necessary to examine how the debt crisis evolved in the 1980s.' Discuss this statement in the context of the following questions:
 - a) What were the main mechanisms and arrangements through which the debt crisis was managed and ameliorated?
 - b) What were the main effects on the international financial system of the debt crisis?
2. Explain the concept of arbitrage. In your answer, show how it relates to the purchasing power parity theory of exchange rates *and* how it relates to links between the spot and forward exchange rates.
3. 'The implication of the Marshall-Lerner condition is that devaluation may be a cure for some countries' balance of payments deficits, but not for others.' Critically discuss this statement.
4. Using the Mundell–Fleming model, explain the effect on internal and external equilibrium of a change in exchange rates. Explain and discuss the role of capital mobility in the model.

Section B

Answer at least **ONE** question from this section.

5. The Polak model is sometimes described as a version of the monetary approach to the balance of payments. Explain and discuss the main assumptions and conclusions of each theory.

6. 'Since both fixed and flexible exchange rate systems have weaknesses, the optimum would be an intermediate system of managed exchange rates.' Explain and discuss that statement.

7. Explain and discuss the principles of monetary unions in the light of European experience.

8. Answer *either*
In the light of a theory of capital flight from less developed countries, discuss policies that could reverse it.

or
'The absorption approach assumes that expenditure switching policies such as devaluation cause an expansion of national output, but in less developed countries devaluation may cause a contraction.' Explain and discuss that statement.

[END OF EXAMINATION]

International Finance

Unit 1 Evolution of International Financial Systems

Contents

Unit Overview	2
1.1 Introduction	3
1.2 Bimetallism: before 1879	4
1.3 Classical Gold Standard: 1879–1914	4
1.4 The Interwar Period: 1914–1944	6
1.5 The Bretton Woods System: 1945–1972	7
1.6 The Flexible Exchange Rate Regime: 1973 Onwards	12
1.7 The Rise of the Eurodollar	13
1.8 The Latin American Debt Crisis	14
1.9 Conclusion	18
References	18

Unit Overview

One of the main learning objectives in this unit is to begin to analyse the evolution of today's international monetary system. In Unit 1, you will examine the major operating principles, or 'rules of the game', of alternative international monetary agreements and arrangements. You will see how the rules of the game for the classical gold standard and the Bretton Woods system for pegged exchange rates have operated in practice, whereby the Bretton Woods system evolved into a US dollar standard. You will also study the reasons advanced for the decline of Bretton Woods, and the emergence of the Latin American debt crisis of the 1980s. Later in the module, in Unit 8, you will return to the analysis of the evolution of the international financial system following two major crises – the Asian Financial Crisis of 1997 and the severe global financial crisis beginning in 2007–08. However, this first unit introduces and contextualises basic concepts and issues relevant to the international monetary system and thus sets the scene for your understanding of the models and approaches to analysing its elements and its operation, in subsequent units.

Meantime, the overall question, which is the main learning objective of this unit, may be expressed as follows:

- Under the Bretton Woods system, was international finance regulated by public institutions rather than markets, and did the development of the Eurodollar system reverse the situation to one in which markets operated without regulation?

Learning outcomes

When you have completed your study of this unit and its readings, you will be able to:

- relate how the international economy fared under bimetallism, before 1879
- account for the establishment of the classical gold standard, 1879–1914
- discuss the decline of world trade during the Interwar Period, 1915–44
- detail the creation of the Bretton Woods System, 1945–1972
- outline the decline of Bretton Woods and the rise of the Flexible Exchange Rate Regime, 1973 to the present
- assess the influence of the Floating-Rate Dollar Standard, 1973–1984
- explain and discuss the Plaza-Louvre International Accords and the Floating-Rate Dollar Standard, 1985–1996
- discuss the current exchange rate arrangements
- explain the international response to the Mexican Peso Crisis
- analyse and discuss fixed versus flexible exchange rate regimes.



Reading for Unit 1

Keith Pilbeam (2013) *International Finance*. 4th Edition. Basingstoke UK: Palgrave Macmillan. Chapters 11, 12 and 15.

1.1 Introduction

As noted in the introduction to this module, in exploring problems of policy within the international financial system, you need to understand the institutional structure of modern international finance. In Unit 1, you will learn about specific institutional structures and organisations such as the International Monetary Fund (IMF), which is a highly specific executive organisation that has been at the centre of the system.



Reading 1.1

To put Unit 1 in context, please stop now and read quickly pages xxvi–xxviii of the key text by Pilbeam, which gives a brief overview of the subject matter of international finance.

Pilbeam (2013)
'Introduction: The subject matter of international finance' in *International Finance*. pp. xxvi–xxviii.

Foreign exchange markets and institutions, such as the IMF, are the framework within which most of today's policy problems in international finance have to be considered. However, their present character is not accidental, nor it is unchanging; but it is, instead, the result of historical developments. Consequently, in order to fully understand the system, its problems and policy options, we have to consider how it was formed and how it has developed. This is the subject matter of this unit – the development of the modern system of international finance from 1944 to the present (though we shall return to consider further how crises in the late 20th and early 21st century may have affected international monetary arrangements). Unit 2 then examines the system's universal, basic, market institution – the foreign exchange market – in general terms.

In this unit you will be introduced to the following main concepts:

- the Bretton Woods system
- the Eurodollar system (and other Eurocurrencies)
- the Latin American debt crisis
- fixed exchange rate system
- floating exchange rate system.

At the end of the unit, you should pause to check whether you have understood all of them.

The unit summary page, which appears at the beginning of this text, shows a more complete list of topics and issues that you will be learning during your study of this unit. However, you are not expected to learn only by absorbing information; instead, I expect you to *question* the ideas presented to you and to read the module materials critically. At the start of each unit, I will set out the

main questions posed in it; keep these questions in mind as you read the material and, at the end, consider your own answers to them.

However, let me reiterate the overall question, which is the main learning objective of this unit:

- Under the Bretton Woods system, was international finance regulated by public institutions rather than markets, and did the development of the Eurodollar system reverse the situation to one in which markets operated without regulation?

1.2 Bimetallism: before 1879

The international monetary system prior to the 1870s can be characterised as based on *bimetallism*, in the sense that both gold and silver were used as international means of payment. This does not, however, imply that each individual country was on a bimetallic standard; many countries accepted *either* a gold standard *or* a silver standard. For example, China, India, Germany and Holland were on the silver standard while in the UK, bimetallism was maintained until 1816 when Parliament abolished the free coinage of silver. In the United States, bimetallism was maintained until 1873, when Congress adopted the gold standard only. Similarly, France introduced bimetallism from the French Revolution to 1878, when the franc effectively became a gold currency.

Note that the exchange rates among currencies were determined by their gold or silver contents, and sometimes by their exchange rates against another currency. For example, the exchange rate between the British pound (gold standard) and German mark (silver standard) was determined by their exchange rates against the French franc (bimetallic standard).

1.3 Classical Gold Standard: 1879–1914

By 1879, all major industrial countries and most smaller countries had adopted the gold standard, which lasted until the First World War in 1914, when European governments ceased convertibility of their currencies either into gold or other currencies. The United States, however, remained on the gold standard until 1933.

In principle, the gold standard was seen as an automatic mechanism linking the financial systems of all countries in a way that ensured stability; the link was based on the principle that all international payments between countries had to be settled in gold and that the domestic money supply was linked to the country's stock of this metal, whose value was internationally agreed. In a simple model, stability was ensured in each country's balance of payments by the automatic mechanism of buying and selling gold.

This idea can easily be illustrated by a simple example. Assume that the domestic money supply in each country is linked only to gold, which is

equal to the country's stock of gold (an assumption which was never exactly valid but does simplify the analysis). Suppose that Britain is in the fortunate position of having full employment, a stable price level and equality between exports and imports. Now imagine that for some reason British imports increase without a change in British exports, and a balance of payment deficit occurs. Under the gold standard, the deficit on the current account of the balance of payments is temporary and self-correcting. The deficit leads to an outflow of gold to pay for the net imports, and hence the domestic money supply is reduced by an equal amount.

The reduction in the supply of money would lead to a fall in the domestic price level according to the Quantity Theory of Money. This theory states that $MV = PT$ so that, with constant V and T (the Velocity of money and Transactions), the reduction in M (the money supply) is matched by the reduction in P (the price level). The fall in the domestic price level makes home produced goods relatively cheap compared to foreign produced goods and, therefore, imports will fall and exports rise. The process will continue until the current account of the balance of payments is restored to balance and the outflow of gold is halted. This adjustment mechanism is usually known as the 'price-specie-flow mechanism', which is attributed to the 18th century Scottish philosopher, David Hume.

In reality, the gold standard did not operate with such simple consistency, and during the 19th century and early 20th century, politicians and economists were confronted by major difficulties over how to operate it and, in the 20th century, even over whether to adhere to the gold standard at all.

The debate of the early 19th century focused on the way the domestic money supply worked if the currency was 'inconvertible', or separated from the stock of gold, and upon the operation of the banking system. Those debates, which became known as the 'debate between the banking and currency schools', were among the most important debates of all time in monetary theory, and have many modern parallels in theories of banking and financial innovations, which you will probably meet in your later studies. Here, however, I shall concentrate on the *practical* problems of the gold standard in the 20th century, which are more relevant to your study of the evolution of the modern system of international finance.

In the 19th century, the gold standard took a form best known as the 'gold exchange standard'. The stock of money in the country was not equal to the stock of gold, and gold was not the only or main form of money used in international transactions. In particular, the pound sterling developed into a 'key currency' as it was used to finance international trade, and it was held as an international asset in the portfolios of foreign banks, central banks and investors. Pounds were used for these purposes instead of gold, but the pound was able to operate in this way because it was convertible into gold at a fixed price. The system whereby sterling as a key currency was linked to gold and exchangeable for the metal was known as the *gold exchange standard*. Its operation was more complex than the mechanism described by

Hume, but its underlying principle, the link between domestic price and holdings of gold-backed money, was supposed to be the same.

In summary, the 'rules of the game' for the international gold exchange standard were as follows:

- the establishment of an official gold price or 'mint parity' – for example, the United States defined one US\$ as 23.22 fine grains of gold, equivalent to US\$ 20.67 for one ounce of gold, when adopted as the gold standard in 1879
- no restrictions could be placed on the imports or exports of gold
- only gold-backed national currency and coins were to be issued
- thus, price levels will be determined endogenously, based on the world demand for gold.

1.4 The Interwar Period: 1914–1944

The First World War ended the classical gold exchange standard in August 1914 when Britain, France, Germany and Russia suspended the convertibility of their currencies into gold and imposed embargoes on gold exports. After the war there was considerable debate over how to reactivate the gold exchange standard and, in 1925, the British government restored the convertibility of the pound. Switzerland, France and the Scandinavian countries restored the gold standard in 1928. However, Britain restored convertibility at a price that implied high exchange rates, and for that and other reasons Britain could not sustain the arrangement. Sterling was forced to leave the gold standard in September 1931, and the pound was allowed to float. Other countries abandoned it subsequently: Canada, Sweden, Austria and Japan followed suit by the end of 1931, the United States in April 1933 after experiencing bank failures and serious outflows of gold, and France left the gold standard in 1936.

The end of the gold exchange standard was associated with great monetary instability. Under the gold exchange standard, each country had a fixed exchange rate with each other since they all fixed the value of their currency in terms of gold. But when the gold exchange standard ended, foreign exchange dealers had greater freedom to influence exchange rates and governments had greater freedom to alter the exchange rates they would support. During the 1930s, exchange rate variations became a prominent instrument of policy. With the world in serious depression and countries facing weak markets for their exports, the major industrial countries engaged in a process of competitive devaluation. Each reduced the exchange rate of its currency in attempts to increase exports and reduce imports; this was a measure to increase its own share of the world market at the expense of the other countries, but it was self-defeating since each country's action was offset by the others' devaluation.

The instability of foreign exchange markets in the 1930s was accompanied by further government measures, in addition to competitive devaluation, to

solve their balance of payments problems. For example, tariffs were raised to reduce imports. Thus, the end of the gold standard was an element in a period of shrinking world trade, with declining world markets for industrial and agricultural products and rising unemployment in the major economies.

In 1939, at the outbreak of the Second World War, the existing system of international finance and international trade broke down and was replaced by one which could not really be called an *international* system. During the following years, when each industrialised country was concentrating mainly on fighting the war, the small amount of trade and remuneration that existed was organised on the basis of bilateral deals organised by governments. These deals, in turn, reflected the balance of political power between countries instead of being on equal or purely economic terms. In other words, during the war the system of international finance broke down, and arrangements constructed at the end of the war provided the beginning of the modern system.

1.5 The Bretton Woods System: 1945–1972

In the sphere of international finance, the system agreed at Bretton Woods was set up without major changes and its main features lasted almost unchanged until 1971. It started operating in 1946, so the arrangements in force from then until 1971 are known as the Bretton Woods System.

Pilbeam provides a good background to the Bretton Woods system. You should read those pages before studying the system's key elements.



Reading 1.2

Please read pages 257–59, from Chapter 11 'The international monetary system' of Pilbeam now.

Pilbeam (2013) Sections 11.1 'Introduction' and 11.2 'The Bretton Woods system' from Chapter 11 'The international monetary system' in *International Finance*, pp. 257–59.

Two new institutions agreed at Bretton Woods were at the heart of the Bretton Woods System – the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD, or World Bank). We shall look at these institutions themselves in more detail later in the module. In this section, I concentrate upon the international financial arrangements supervised by the IMF, for they were the core of the Bretton Woods system. These arrangements can be divided into three elements:

- exchange rates
- the financing of balance of payments deficits
- international liquidity.

I will briefly outline each of those elements and then ask you to read the pages in Pilbeam where they are examined more fully.

1.5.1 Exchange rates: dollar-based gold exchange standard

Under the Bretton Woods System, exchange rates between the currencies of all countries belonging to the IMF were fixed. The US dollar was the key currency and all currencies had a fixed exchange rate with respect to the dollar. Moreover, the value of the dollar in terms of gold was fixed at US\$35 per ounce of gold; therefore, the value of each currency was fixed in terms of gold. In other words, each country established a par value in relation to the US dollar, which was pegged to gold at US\$35 per ounce.

The main rules of the game of international finance were now:

- to fix an official par value for domestic currency in terms of the dollar, and keep the exchange rate within 1% of this par value
- to permit free convertibility of currencies for current account transactions.



Reading 1.3

For his account of the Bretton Woods exchange rate system, please stop and read pages 259–60 of Pilbeam now.

The attempt to commit countries to these rules does pose the following serious questions:

- How can states fix their exchange rates?
- How could they have agreed to keep their exchange rates with respect to the dollar fixed, and how could the US government agree to fix the value of the dollar at US\$35 per ounce?
- What mechanism could be used to ensure that they kept their agreement?

 I would like you to pause for a moment to consider those questions, and write down brief answers.

The way I would answer those questions is first to identify what the problem is: why are they serious questions? Why don't governments simply give an order that each exchange rate and the gold value of the US dollar should be at a certain level? Then there would be no serious question to answer. The reason the problem is serious can be seen by imagining what would happen if, starting from a position of equilibrium on foreign exchange markets, there is a fall in firms' and banks' demand for a currency or an increase in the numbers of people wishing to sell it. The exchange rate of that currency would fall as foreign exchange dealers mark it down on foreign exchange markets. Similarly, if there is an increase in the demand for gold without an increase in its supply, its price on the gold market will rise.

The second step is to identify how governments can prevent these changes in exchange rates or the price of gold. The mechanism is to commit them to buy or sell each currency at the fixed exchange rate; if there is an excess private supply of pounds and an excess private demand for dollars, governments must buy pounds and sell dollars at the fixed exchange rate to equilibrate the market at that rate. Similarly, the US government had to be willing always to sell (or buy) gold at the price of US\$35 per ounce.

Pilbeam (2013) Section 11.3 'Features of the system: Fixed but adjustable exchange rates' from Chapter 11 'The international monetary system' in *International Finance*, pp. 259–60.

As mentioned earlier, under the Bretton Woods System, exchange rates were not absolutely fixed. One reason was that their 'par value' was fixed, but they were permitted to fluctuate within a narrow band around that par value. Governments had to intervene to prevent the exchange rate of a currency falling below the minimum of its band or, in principle, rising above its maximum. The second important reason why exchange rates were not absolutely fixed was that countries could devalue their currency under certain circumstances and by agreement with the IMF. I shall explain the permitted circumstances of a devaluation in later paragraphs; for the moment, note that the possibility of such adjustments means that the Bretton Woods System is sometimes referred to as an 'Adjustable Peg System' instead of a 'Fixed Exchange Rate System'.

However, although, for those two reasons, the exchange rates of currencies against the dollar and against each other were other not fixed, the price of the dollar in terms of gold was invariable.

1.5.2 Financing balance of payments deficits

There are several ways to define a balance of payments deficit, but the simplest one for the present is that:

- a country has a deficit if it has to use official reserves of gold and foreign exchange to purchase its own currency in order to meet the excess supply on the foreign exchange market.

Therefore, in order to maintain the fixed exchange rate where there are net sales of its currency, a typical country has to use its foreign exchange reserves to buy its own currency. Since those reserves are finite, there may then be a need to borrow additional foreign exchange.

The second element of the Bretton Woods System was that, in principle, members of the IMF had a right to borrow foreign exchange from it in such circumstances. Thus, the right to borrow was never absolute, but was subject to conditions and qualifications depending on the circumstances.



Reading 1.4

I would like you to read pages 259–68 of Pilbeam now. In those pages you will study:

- the main features of the Bretton Woods System
- the problems that some have identified as the cause of its breakdown
- the mixture of floating exchange rates and managed exchange rates that followed the fixed exchange rate system of Bretton Woods.

 Please now make notes on those topics and answer the question implied by the discussion above:

- What was the main source of IMF funds, and what qualifications and conditions constrained the right to borrow under the IMF?
-

Pilbeam (2013) Sections 11.3 'Features of the system', 11.4 'A brief history of the Bretton Woods system' and 11.5 'Why did the Bretton Woods system break down?' from Chapter 11 'The international monetary system' in *International Finance*. pp. 259–68.

As you read in Pilbeam, the basic source of the IMF's funds was the 'quota', which each country subscribed to the Fund when it joined. The amount of a country's quota was calculated by a general formula agreed at Bretton Woods. When a country joined the IMF it had to deposit 25% of its quota in the form of gold and foreign exchange and 75% in the form of its own currency. The country with the largest quota was the United States, which remained the largest single source of the IMF's funds throughout the duration of the Bretton Woods System. The quota system makes clear that the IMF is not a bank; it cannot increase its resources by borrowing on capital markets or money markets as a bank could (and as the World Bank can). In principle, it is a club, for its basic resources come from the subscriptions (*quotas*) of its members. As I have already indicated, those quotas also determine the countries' borrowing rights; the total amounts a country can borrow under various headings are expressed as percentages of its quota (and are more than 100% in total).

In answer to the second half of the question, two types of qualifications and conditions on the right to borrow have been relevant.

The first, embodied in the initial principles of the Bretton Woods System, was the distinction between a deficit considered to be a *temporary disequilibrium* and one that was judged to be a *fundamental disequilibrium*. In the case of a temporary disequilibrium, it was expected that the country would maintain its exchange rate and borrow foreign exchange from the IMF to finance that intervention. But in the case of a fundamental disequilibrium, the country would have to agree a realignment of exchange rates with the IMF and accept a lower exchange rate that could overcome the deficit, and borrowing would be subordinate to that policy.

The second type of condition for borrowing from the IMF is the requirement that the country must adopt a *stabilisation programme* or, in other words, a number of measures to improve the balance of payments and achieve macroeconomic stability. A stabilisation programme includes more measures than devaluation alone, for within such programmes states agree to implement a number of restrictive monetary, fiscal and other policies. This 'conditionality' applies when a country borrows more than a certain amount. The *gold tranche* is an amount of credit, equal to 25% of the country's quota, which could be borrowed without conditionality; the next 25% of the quota, *first credit tranche*, could be borrowed with light conditions, but higher amounts of credit, the *upper credit tranches*, could only be drawn upon if the country agreed a stabilisation programme.

Conditionality in the form of stabilisation programmes is operated through agreements to 'stand-by arrangements'. The structure and operation of this conditionality now follows almost standardised procedures which are an integral part of the modern International Monetary Fund, but it was not always so. Conditionality of this type was not established at Bretton Woods but evolved gradually in the 1950s and 1960s. In Unit 2, you will study in greater detail how stand-by arrangements and stabilisation programmes work.

1.5.3 International liquidity

For world trade to operate smoothly and to grow, countries must have access to internationally acceptable forms of money or credit to pay for the imbalances that inevitably arise in any system that is not confined to bilateral barter. Under a pure gold standard, the world's stock of liquidity would consist of gold. Under the Bretton Woods System, the main form of international liquidity was the US dollar, which – with gold and a residual amount of pounds sterling – was the basis of countries' international reserves and payments. The dollar, in turn, was linked to gold in the sense that the United States guaranteed to convert dollars to gold at US\$35 per ounce.

The British delegate to Bretton Woods, John Maynard Keynes, had proposed that neither gold nor national currencies such as the dollar should be the medium of international liquidity. Instead, he suggested that the Fund should create and manage its own paper currency, the *bancor*, as the world's international money. But that proposal was defeated.

Initially, under the Bretton Woods System, the only contribution the IMF could make to international liquidity was its ability to give credit to finance countries' balance of payments deficits. Although that was marginal compared to the total stock of US dollars, it could be of great significance, so an important question concerned the size and source of IMF credit facilities.

Because of the quota system, there was no automatic or simple mechanism by which the stock of international liquidity at the disposal of the IMF could be increased with any growth in world needs. Instead, member countries could only raise the total of quota resources by agreeing a general increase in quotas; this occurs after special negotiations, which are usually difficult and have operated infrequently.

However, the United States began to experience trade deficit in the late 1950s, which persisted into the 1960s when the total value of the US gold stock, valued at US\$35 per ounce, fell short of the foreign dollars holdings. President John Kennedy's efforts in 1963 to support the dollar were not successful. Moreover, the expansionary monetary policy and rising inflation in the US resulting from the Vietnam War made the dollar overvalued, especially with respect to the mark and the yen. In August 1971, President Nixon suspended the convertibility of the dollar into gold; hence the foundation of the Bretton Woods System cracked. The efforts of 10 major countries (Group of Ten), who met at the Smithsonian Institution in Washington in December 1971 to save the Bretton Woods System, were not successful. In February 1973, the dollar experienced a heavy selling pressure, and the price of gold was raised from US\$38 (the Smithsonian Agreement) to US\$42 per ounce. In March 1973, European and Japanese currencies were allowed to float, which completed the fall of the Bretton Woods System.

Following the demise of Bretton Woods, the IMF devised some additional means to supplement its resources, such as special borrowings from particular members over and above their quotas. But the quota system remains the main basis of the IMF's financial resources.

A major innovation, agreed in 1967 but only implemented as the Bretton Woods System ended, was the creation of a new form of international money under the control of the IMF, which had some similarities with the *bancor* Keynes had proposed. This new source of international liquidity is called ‘Special Drawing Rights’ (SDRs). Member countries’ international liquidity was increased by the creation of SDR accounts for them at the IMF. In addition, SDRs became the unit of account for all transactions involving the IMF and World Bank. Transactions are denominated in SDRs and official measures of countries’ international reserves and debt are recorded in SDRs. Nevertheless, SDRs have not replaced the US dollar as the main form of international money.



Reading 1.5

Now read on in Chapter 11 ‘The international monetary system’, pages 268–96 of Pilbeam, which looks at the aftermath of Bretton Woods.

 Bearing in mind that a major concern under the Bretton Woods System was whether the stock of US dollars was a sound basis for an adequate growth of world liquidity, make notes on the various alternatives proposed.

Pilbeam (2013) Sections 11.6–11.21 from Chapter 11 ‘The international monetary system’ in *International Finance*. pp. 268–96.

1.6 The Flexible Exchange Rate Regime: 1973 Onwards

Within the floating-rate system that developed after the fall of Bretton Woods, the US dollar remained the main currency in international transactions, and all major exchange rates continued to be quoted in terms of the US dollar. The term ‘floating-rate’ does not imply a freely floating or *laissez-faire* system in which market forces are the only determinant of exchange rates. In 1974, the IMF guidelines specified that member countries should intervene to prevent ‘disorderly conditions’ in the foreign exchange market. This was followed by another IMF meeting in January 1976 in Jamaica (*Jamaica Agreement*) in which:

- central banks were allowed to intervene in exchange markets to iron out unwarranted volatilities
- gold was demonetised as an international reserve asset.

During the period 1973–84, industrial countries did their best to smooth short-term variability in the dollar exchange rate while not committing to an official par value or to long-term exchange rate stability. The United States, however, remained passive in the foreign exchange market.

Following the US expansionary fiscal policy and tight monetary control in 1981, and the large-scale inflows of foreign capital caused by unusually high real interest rates, the US dollar experienced a prolonged appreciation (50% in 1985 relative to 1980 in real terms). This resulted in a loss of international competitiveness of US exports while Americans enjoyed cheap imports. In 1985, the Group of Five (G5: Britain, France, West Germany, Japan and the United States) met at the Plaza Hotel in New York City to intervene in the

market. This *coordinated intervention* was a clear signal of a new era influencing foreign exchange markets. In anticipation of the dollar's falling too far, the G-5 plus Canada and Italy (the G-7) made another attempt, in a meeting held at the Louvre in Paris in 1987, to foster stability of exchange rates around their target zones, although the zonal boundaries remained secret. However, the *Louvre Accord* created what is known as the *managed-float* system.

Since June 2009, 69 countries, including the United States, the UK, Japan and Canada, have independently adopted floating systems without pegging; a majority of countries, including China, have accepted some form of 'managed-floating' system, which combines market forces and government controls. EMU members have adopted the Euro as a currency which floats against other currencies externally. For details of individual countries' exchange arrangements, study Pilbeam's Table 11.9, on pages 286–87.



Reading 1.6

Turn now to Pilbeam's conclusions on the Bretton Woods era, the final section of Chapter 11 'The international monetary system' on pages 296–97.

Pilbeam (2013) Section 11.22 'Conclusions' from Chapter 11 'The international monetary system' in *International Finance*, pp. 296–97.

1.7 The Rise of the Eurodollar

As you saw in your reading of Pilbeam, the breakdown of the Bretton Woods System was followed by a system of floating exchange rates, although it included a number of important arrangements for fixing or regulating the exchange rates of several countries. Those exchange rate arrangements were an important feature of the new landscape. However, I think the outstanding feature that really defines the second stage of the modern evolution of international finance was a new institutional development, the rise of Eurodollar markets and Eurodollar banking.

Before going any further, however, let me confess that I am making two simplifications that involve some distortion of the truth. First, 'Eurodollar' is, strictly speaking, an inaccurate term for these developments because the characteristics of Eurodollars are shared with other currencies – there are Euroyen, Eurosterling and other Eurocurrencies – but the new stage originated with Eurodollars and they remain the most important Eurocurrency. I shall continue, therefore, to use the term *Eurodollar* for all the Eurocurrency markets. Second, the Eurodollar existed before the breakdown of the Bretton Woods System in 1971, but its dramatic growth and rapid evolution occurred from 1973 and imposed its mark on all subsequent developments in international finance.

The essential and distinguishing feature of Eurodollar markets is that they are outside the control of any state or national regulation. The banks which are the institutions at the base of the Eurodollar system developed because Eurodollar business was not subject to reserve requirements, requirements for deposit insurance, interest rate controls or other controls that governments and central banks impose on banks operating within their national

financial system. Eurodollar deposits and loans are truly international forms of money and finance in a way that previous monetary and financial instruments were not.

That international character of Eurodollars can be seen from the definition of a Eurodollar bank deposit. *It is a deposit of US dollars held in a bank outside the United States.* Today, it may be physically in the United States, but held in an 'international banking facility', which is effectively outside that country because it is exempt from the controls over 'normal' dollar accounts in the US.

The rapid growth of Eurodollar deposits held in banks in London and elsewhere from 1973 was accompanied by new forms of bank lending by the Eurobanks. From 1973 to 1982, they greatly expanded their loans of Eurodollars to a group of third world countries, most prominently Brazil and Mexico. These loans were sovereign loans (general credits to states rather than to companies) and their growth was based on the development of new lending techniques. These new techniques were crystallised in syndicated loans with variable interest rates linked to *LIBOR*, the London InterBank Offer Rate.

However, sovereign loans from banks to Third World countries are not the only form of Eurodollar credits. Eurodollar loans from banks to large United States and British companies to finance take-over activity became especially important after 1982. And Eurodollar finance in the form of marketable bonds instead of bank loans also grew in relative importance in the 1980s. These provide some indication of the permanent change in international finance created by the development of Eurodollars, but have Eurodollars had wider effects on methods of banking and credit?

From the point of view of bank liabilities, the Eurodollar deposit in a bank is at the base of the system and this has raised the question of whether these deposits represent a net creation of new money. To what extent do Eurodollars increase the stock of international money?



Reading 1.7

I would like you now to read the whole of Chapter 12, pages 298–316, of Pilbeam.

While you read it, I would like you to keep in mind those two questions and write brief answers to them as you complete the reading:

- what effects has the Eurodollar system had on the development of banks and credit?
- what is the relationship between Eurodollar banking and the stock of money?

Pilbeam (2013) Chapter 12 'The Eurocurrency and Eurobond markets' in *International Finance*, pp. 298–316.

1.8 The Latin American Debt Crisis

The growth of sovereign lending by Eurobanks in the 1970s came to an end – for the time being – in 1982, when it became clear that many heavy borrowers were unable to repay their debts on schedule. The signs of that international debt crisis, now known as the Latin American debt crisis, were

apparent from early 1982, but the real signal of its beginning was Mexico's declaration on 12 August 1982 that it could not meet its debt repayments.

Pilbeam discusses this international debt crisis in his Chapter 15. A good discussion of the background to the debt crisis, including its origins and emergence and the Mexican moratorium, is introduced in Sections 15.7 to 15.10. A good account of the definition of low- and middle-income developing countries, their typical financial characteristics and the measures of indebtedness is also provided in the first sections of that chapter, which you may read if you are interested in economic development.



Reading 1.8

Please be sure to read now Sections 15.7 to 15.10 of Chapter 15 'The Latin American debt crisis', pages 377–82, of Pilbeam.

Pilbeam (2013) Sections 15.7–15.10 from Chapter 15 'The Latin American debt crisis' in *International Finance*. pp. 377–82; 370–77.



Optional Reading 1.1

If you are particularly interested in the characteristics of developing countries, you should also read the first sections of Pilbeam's Chapter 15, pages 370–77, but those pages are optional.

I think the problems created by the outbreak of the debt crisis and the way the international financial community dealt with the problems and overcame them represent a new, third, stage in the evolution of the modern system of international finance. To understand the system of international finance from the 1990s it is necessary, I think, to examine how the debt crisis evolved in the previous decade. Let me identify two aspects that I think were key.

One is that, as it faced the 1982 debt crisis of Mexico, the International Monetary Fund linked its willingness to lend to Mexico with the willingness of private banks to extend their lending to Mexico. Since that time, private bank lending to less developed countries and lending by the International Monetary Fund (and World Bank) have been explicitly linked. That is in contrast to the earlier stages of the modern international system. Under the arrangements established at Bretton Woods, it was envisaged that the International Monetary Fund, as an official body of member states, would stand above the banking system and, in the view of some, counteract its operations on international money markets; but in the 1980s a partnership was explicitly recognised.

On their part, before 1982, the banks generally preferred borrowers to have an IMF stabilisation programme in place, but in those early days there were major examples, such as Brazil, where the banks loaned money without an IMF programme. After 1982, the precondition for all new or rescheduled sovereign lending was an IMF programme. The new connection between private banks and the IMF (and the World Bank) reached its peak with the Baker Plan – a plan for solving the Latin American debt crisis, which was promulgated by the US Secretary of the Treasury in October 1985.

A second key effect of that debt crisis on the international financial system was that the banking system developed a different approach to risky loans. In the popular view, and the view of bankers and economists in earlier periods, the risk of lending to a state had previously been seen in terms of the probabilities of two alternative extreme outcomes. It was seen as an ‘either/or’ risk – either the debtor pays the interest and repays the principal without problems, or the debtor defaults. In fact, the third world debtors did not formally default on their loans; instead, bad loans were treated by the banks as ‘non-performing’ but still recoverable, and a number of different arrangements such as rescheduling through negotiations were set in motion. In the process, the debt crisis of the 1980s led to the development of new types of markets, and new regulations and forms of calculating and accounting for risk.

One such development was the creation of a market for the banks’ bad loans to countries; banks could sell their bad debts at a substantial discount, which reflected estimates of the probability of servicing and repayment. In other words, a market assessment of the riskiness of bank loans to sovereign borrowers became available, in contrast to previous times when the only assessment was internal bank evaluation, and the market assessment, as reflected in the price, covered a full range of probabilities.

Another development was that banks were forced to reappraise the adequacy of their own capital base, the value of the equity capital shareholders had put into the bank, relative to both the volume and riskiness of the loans they made (and also relative to the variance of their deposit and debt liabilities). The bad debts or ‘non performing loans’ resulting from the international debt crisis caused banks to show losses which reduced their equity capital, and in rebuilding their capital base they had to judge its adequacy in relation to those risk assessments in a more rigorous and explicit manner than previously.



Reading 1.9

To examine the Latin American debt crisis in more detail, now read pages 382–400 of Pilbeam now, concentrating particularly on the role and viewpoints of the actors in the debt crisis (Section 15.13) and the management of the debt crisis (Section 15.14).

 As you read it, try to answer these three questions:

- why did the less developed countries not default on their debts?
- what were the main mechanisms and arrangements through which the debt crisis was managed and ameliorated from the banks’ point of view?
- what were the main effects on the international financial system of this debt crisis?

I would like you to bear in mind another point. The international debt crisis that broke in 1982 was not the only modern crisis for the international banking system. It led the Euro banks to reduce to almost nothing their sovereign lending to less developed countries. Instead, they made large scale loans available for real estate and property development in the major industrialised countries, and for stock market take-over bids in the US and

Pilbeam (2013) Sections 15.11–15.17 from Chapter 15 ‘The Latin American debt crisis’ in *International Finance*. pp. 382–400.

UK. The growth of these types of lending in the 1980s led to a new crisis of bad loans by the end of the decade as they proved to have been based on faulty risk assessments.

The 1990s saw the globalisation of capital markets and with it a resurgence of lending to developing countries. However, this time around it was not only governments and banks that resumed lending to developing countries. Private sector financial flows shot up as lenders sought to invest in emerging market assets. But the financial systems in many emerging economies were poorly supervised, inadequately regulated and weak. In 1997, another crisis broke and investors pulled out of Thailand, Indonesia, South Korea and Mexico.

With the globalisation of financial markets, panic set in as investors everywhere sought to sell their riskier holdings and cover their losses. The turbulence on world markets continued in 1998 and people began to raise questions about whether or not there was a need for some type of international financial regulation or supervision. While capital markets may be international in scope, supervision and regulation remained mainly a national matter throughout the 1990s.

In the first decade of the 21st century, globalisation of financial markets expanded further and with that, innovation in financial products and in the business models of financial institutions. One outcome of this development as well as of various nations' economic policy choices, was a further inflation of property and other asset prices in many developed economies. The end of that boom saw another, deep and wide, global financial crisis which arose in 2007–08 and whose seriousness reflected the size and the interconnectedness of international financial institutions, reached through market innovation and expansion.

The global crisis has provoked much urgent debate on the appropriate national and international policy responses, as well as much reflection on the balance of market mechanisms and regulation. International coordination of crisis management, of policy formation, and of regulating international financial institutions, has very much put the international financial system centre stage.

We shall return to debates about both the 1997 Asian financial crisis and the 2008 global crisis at the end of the module, considering financial innovation and also returning to the questions posed in this unit including the merits of fixed and floating exchange rates and of currency union arrangements, particularly that of the Eurozone.

Meantime, the concepts and issues introduced here, have prepared you for the study in the following units, of how international finance has been understood, analysed and modelled – turning next to the foreign exchange markets.

1.9 Conclusion

In this unit, we have surveyed the development of the modern system of international finance. Can you now write a brief statement defining each of the concepts I listed previously?

- Bretton Woods system
- Eurodollar system (and other Eurocurrencies)
- Latin American Debt Crisis
- Fixed Exchange Rate system
- Floating Exchange Rate system?

Exercise 1.1

Pause now and write two or three paragraphs on each.

Now that you have a clear understanding of each of those concepts, you should be able to answer the question I posed at the beginning of the unit:

- Under the Bretton Woods system, was international finance regulated by public institutions instead of markets, and did the development of the Eurodollar system reverse the situation to one in which markets operated without regulation?

Exercise 1.2

Please pause here and write a few paragraphs in answer to that question.

This unit provides a foundation for your further work on international finance. It shows how the present world of international finance developed and makes clear that, instead of being a fixed system or the only possible system, it is the product of previous developments; it, too, is developing and will be followed by other arrangements.

At each stage in the development of the international financial system, politicians and their advisers have had to grapple with difficult problems of economic or financial policy. In the following units you will study the principles and models that enable us to analyse those problems. But it is important to bear in mind that models reflect their time; theories of international finance that were developed in the era of the Bretton Woods System used different assumptions from theories that were developed in the context of the floating exchange rates of the 1980s.

References

Baker JC (1998) 'International monetary system'. *International Finance: Management, Markets, and Institutions*. Harlow UK: Prentice-Hall International. pp. 27–64.

Eng MV, FA Lees, and LJ Mauer (1998) 'International monetary system'. *Global Finance*. Harlow UK: Addison-Wesley. pp. 20–64.

Eun CS and BG Resnick (1998) 'International monetary system'. *International Financial Management*. Maidenhead UK: Irwin/McGraw-Hill. pp. 31–57.

Levick RM (1998) 'An overview of international monetary system and recent development in international financial markets'. *International Financial Markets: Price and Policies*. Maidenhead UK: Irwin/McGraw-Hill. pp. 21–64.

Pilbeam K (2013) *International Finance*. 4th Edition. Basingstoke UK: Palgrave Macmillan.

Steil B (2013) *The Battle of Bretton Woods: John Maynard Keynes, Harry Dexter White and the Making of a New World Order*. Princeton NJ: Princeton University Press.