

Barbara Sennholz, Peter Chowla and Jesse Griffiths

The international monetary 'system' and financial instability

The international monetary framework which emerged after the collapse of the Bretton Woods system in the 1970s has proved volatile, damaging and prone to crises. It is time for a fundamental redesign and the introduction of a global reserve currency to help stabilise international exchange rates, smooth commodity prices, promote international economic cooperation, and prevent future financial crises.

The current international monetary framework is not really a 'system' at all; it has evolved haphazardly since the collapse of the Bretton Woods system in the early 1970s. The Bretton Woods system, set up in 1944, was created to ensure stable exchange rates to help growth and reconstruction after the second World War, and to prevent the return of the 'beggar thy neighbour' competitive currency devaluations of the 1930s.

The key feature of Bretton Woods was a system of fixed, but adjustable exchange rates, managed by the IMF, and backed by the dollar, whose value was underpinned by the price of gold. The exchange rate of each country's currency was fixed within very narrow bands, and speculative attacks prevented by national central banks acting in consort, backed by the IMF. Every currency was convertible to dollars, whose price was fixed against gold.

If countries found their currency over- or under-valued, they could negotiate a change in exchange rates through the IMF. This absence of exchange rate fluctuations was designed to stabilise and standardise inflation, prevent financial crises and promote the growth of trade. To a large extent, it succeeded in many of these objectives, but became increasingly difficult to sustain, largely because the system was underpinned by a national currency, the US dollar.

Between the creation of the system and its collapse in the early 1970s, the US went from being a major creditor to the rest of the world to becoming a major debtor, partly because of the spiralling costs of the Vietnam war. In 1971, in the face of massive pressure on the dollar by speculators who thought it was over-valued, US president Richard Nixon announced that the dollar would no longer be convertible to gold. By 1973, the

Bretton Woods system of fixed exchange rates had been abandoned.

Features of the current system

There are four main features of the current international monetary system. First, though exchange rates are often described as 'freely floating', determined by market supply and demand for currencies, there are, in practice, a variety of different arrangements in place. Proponents argue that freely floating exchange rates settle at the optimum economic level, preventing undervaluation or overvaluation, and can, in theory, provide greater stability, and allow countries greater freedom to decide their own monetary policies. In practice, however, floating exchange rates have been characterised by enormous volatility, with wide swings on a daily, monthly and yearly basis, and significant divergence from underlying economic realities.

Since the collapse of the Bretton Woods system in the early 1970s, all major industrialised countries have intervened heavily in the foreign exchange markets to protect their currencies, with varying degrees of success. They have also frequently acted in consort to do so. However, international foreign exchange markets dwarf the real economy - over \$3 trillion is traded every day - meaning that even the 'hard' currencies are ultimately subject to the opinion of the market. Speculators eager to make a quick profit can attack and force devaluation of 'weak' currencies.

A number of countries still keep their exchange rates pegged to hard currencies such as the dollar (e.g. Hong Kong and United Arab Emirates) or a basket (e.g. Russia and Tunisia). The euro is the most famous instance of the adoption of a single currency for a group of countries, but it is not the only one, e.g., eight countries in West Africa are part of the Communauté Financière d'Afrique (CFA). Meanwhile, the poorest developing countries have been pushed by the World Bank and IMF towards floating their currencies and developing nascent foreign exchange markets.

Second, the dollar retains its position as the world's reserve currency, though there are signs that this pre-

eminence will have a limited shelf-life. The dollar's central role has two crucial consequences. The first is that it allows the US to borrow cheaply and to continue borrowing indefinitely, with extremely damaging consequences for the rest of the world. A fundamental cause of the current economic turmoil was the huge scale of borrowing by the US government, financed in large part by China and other emerging countries eager to buy US securities to build their reserves. The security provided by this demand for dollars allowed the US government to maintain low interest rates, fuelling the disastrous private-sector borrowing bubble. The second consequence is that American monetary and fiscal policy decisions impact the rest of the world, but the US administration is not forced to think about these impacts when it decides policies.

Third, there is little international oversight or control over the international monetary system. The IMF was created to play this role. However, since the collapse of the Bretton Woods system, the IMF has been unable to exert much influence over the policies of rich countries. The last time the IMF put conditions on a developed country (before the Iceland loan of last year) was in 1976 when Britain went to the IMF.

The only influence over rich countries left in the IMF's toolbox is persuasive power, and this has proved extraordinarily ineffective. Part of the reason for this is that voting rights and power at the IMF remain heavily skewed towards rich countries, with the US retaining a veto over important decisions. This weakens the institution's independence and dilutes its ability to 'speak truth to power'. This democratic deficit, combined with the perception that its prescriptions in the Asian financial crisis in the late 1990s were influenced to benefit rich countries, has reduced the IMF's legitimacy. With a lack of legitimacy, it will be difficult and undesirable to give the IMF a greater role in international monetary arrangements.

The fourth main feature of the international monetary system is that its rules, institutions and norms are guided by a particular ideology and economic model. This model, often known as the 'Washington consensus', was pushed by the World Bank and the IMF. The main feature of this model is a belief in the efficiency of free markets, and scepticism about the ability of governments to improve on market outcomes. This leads to an emphasis on economic liberalisation, and the reduction of state involvement in the economy, including the privatisation of public services. It also creates an economic model oriented toward exports, one of the reasons for the large accumulations of foreign exchange

by Asian countries, whose large export surpluses were matched by US dependence on imports. These large-scale trade imbalances cannot last indefinitely, and threaten major instability when they unravel.

A problematic system

This poorly governed international monetary system has created enormous problems for the world and for developing countries in particular. We highlight four of the most serious.

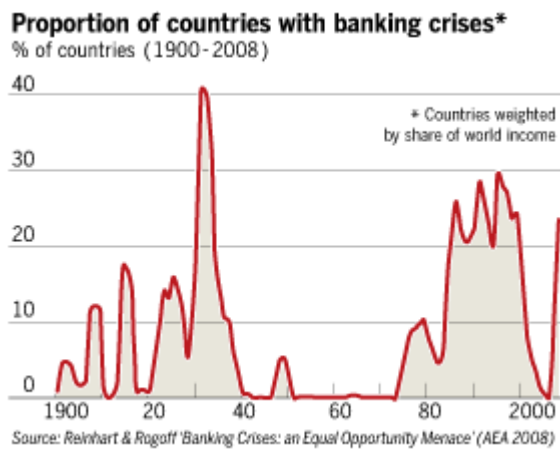
First, it creates a volatile, risky environment for business investment. Even in times of relative global stability, volatile exchange rates damage economic planning and investment in rich and poor countries alike. If there is a lack of stability in exchange rates over the medium- to long-term, where effective markets to hedge risks do not exist, businesses must expect volatility and incorporate that risk into their plans. Investment will be lower, because investments which might be profitable with stable exchange rates will either be unprofitable when risks are included in planning, or not undertaken by risk-averse investors. This reduces job creation, growth, trade and economic development. This is a particular concern given the enormous long term investments that will be required to convert our economies to a low-carbon future. Ultimately exchange rate volatility mainly benefits speculators, while creating enormous costs.

Second, the current international monetary system creates enormous risks for small or poor countries who are extremely vulnerable to swings in their exchange rates. In times of crises, they are often forced to devalue their currencies, increasing the cost of servicing foreign debts and making imports, including essential foodstuffs more expensive. The small size of the markets in most developing countries' currencies makes them targets for speculation and manipulation of their currencies.

Third, there are significant direct costs for the governments of developing countries. Developing countries have accumulated large stashes of foreign currency reserves partly to provide sufficient funds to prevent them from having to turn to the IMF should they need to protect their currencies or stabilise their balance of payments. Holding large reserves means tying up assets that could otherwise be used for investment in green infrastructure, education, health, environmental management or other activities which have long-run benefits for sustainable development.

Fourth, as the graph illustrates, since the collapse of the Bretton Woods system, there has been a proliferation of costly and destabilising financial crises, culminating in

the current debacle, described by the UN as “the worst financial and economic crisis since the Great Depression.”



Barbara Sennholz, Peter Chowla and Jesse Griffiths are with the Bretton Woods Project