Historical Monetary Systems (4/18/2012) Econ 390-001

Definitions

- ***classical gold standard*** – countries fix their national monies to a weight of gold and use gold as reserves in central banks
- ***gold exchange standard*** – countries fix their national monies to a weight of gold and use both gold and another currency (e.g., dollars) as reserves in central banks
- ***Bretton Woods*** – countries fix their national monies to the dollar, the dollar fixes to a weight of gold, and countries use mainly dollars as reserves in central banks
- ***floating*** – countries let their currencies float against one another (they don't fix against any currency)
- ***price-specie flow mechanism*** – automatic reduction of current account surpluses and deficits through gold flows
- ***Rules of the Game*** – central bank intervention in the asset market to mitigate gold inflows/outflows
- ***European Monetary System (EMS)*** – a system of fixed exchange rates implemented in 1979 through an exchange rate mechanism (ERM) for participating European countries
- ***euro zone*** – a form of currency union: a subset of the European Union countries that use the euro, a common currency

Historical monetary systems periods

- gold standard (1870-1914) + earlier
- gold exchange standard (1918-1939)
- Bretton Woods (1944-1973)
- floating (1973-present)

EU membership requires

- low trade barriers
- low financial assets barriers
- common immigration policy
- common regulations
  - workplace safety
  - consumer protection
- liberal democracy

EMS membership requires

- EU membership
- adhere to the ERM
  - narrow ER bands
- restrained policies
  - fiscal
  - monetary

euro zone membership requires

- EMS membership
- adopt the euro
  - replace national currency
- coordinate policy
  - European Central Bank

euro zone also requires

- attain exchange rate stability
- attain price stability
  - max inflation: 1.5% above 3 lowest inflation rates
- restrictive fiscal policy
  - deficit < 3% of GDP
  - debt < 60% of GDP

Principles

- Classical gold standard
  - The classical gold standard experienced a gradual deflation of 0.5% per year on average.
  - Countries would temporarily leave the gold standard to inflate for war, and return afterward – often at the old parity (with a painful recession).
  - During the 16th century, Spain's price level increased 200-300% due to gold and silver imports from the new world (1% per year).
  - 185,000 kg of gold was imported in 15 years, increasing Europe's gold supply by 20%.
  - Price specie flow mechanism
    - Gold inflows and outflows increase or decrease the money supply, which affects the domestic price level.
      - An inflow of gold inflates prices.
      - An outflow of gold deflates prices.
    - A current account surplus in excess of the non-reserve financial account means gold flows into the country — raising domestic prices & lowering foreign prices.
      - Domestic goods become more expensive and foreign goods become cheaper, reducing the current account surplus.
    - A current account deficit in excess of the non-reserve financial account means gold flows out of the country — lowering domestic prices & raising foreign prices.
      - Domestic goods become cheaper and foreign goods become more expensive, reducing the current account deficit.
  - Rules of the game
    - Central banks sell domestic assets to acquire money when gold exited the country as payments for imports.
      - This decreased the money supply and increased interest rates, attracting financial inflows to match a current account deficit, reversing or reducing gold outflows.
    - Central banks buy domestic assets to inject money when gold entered the country as payments for exports.
      - This increased the money supply and decreased interest rates, encouraging financial outflows to match a current account surplus, reversing or reducing gold inflows.
  - The gold standard made it hard for countries to have an independent monetary policy.
- Gold exchange standard
  - After World War I countries were not eager to induce recessions by returning at to the gold standard at the old parity.
  - So instead they created a new standard – the gold exchange standard – which allowed more flexibility and monetary policy within some constraints.
  - Under the gold exchange standard several currencies were used as reserves by central banks in addition to gold. These primarily included the American dollar and the British pound.

- Bretton Woods
    - After World War II economists met together at Bretton Woods, New Hampshire to form a new monetary system. John Maynard Keynes (from Great Britain's delegation) was instrumental in its formation.
    - Bretton Woods involved the dollar fixing to a weight of gold ($35/ounce) and all other countries fixing to the dollar. Capital controls were imposed to prevent speculative attacks on the fixed exchange rates.
    - Dollars could be used as reserves by central banks (other than the United States).
    - The United States could have an independent monetary policy, while other countries could not.
    - Other countries became frustrated with the U.S.'s high inflation levels during the late 1960's and early 1970's. The U.S. had high inflation both as a monetary policy to stimulate employment and to monetize the debt incurred by the U.S. government for the Vietnam War.
- Floating
    - The United States left the gold standard for a fiat standard domestically in 1933 when F.D.R. seized all gold by executive order.
    - The United States left the gold standard internationally in 1971 when Nixon ended Bretton-Woods dollar convertability.
    - The U.S. floated internationally to prevent running out of gold reserves.
    - Since 1973 most of the major industrialized countries in the world decided to float their currencies.
    - Smaller countries frequently fix to the currency of a large trading partner such as the dollar or the euro.
- European monetary systems
    - From 1979 to 1993, the EMS defined the exchange rate mechanism to allow most currencies to fluctuate +/– 2.25% around target exchange rates.
        - The exchange rate mechanism was redefined in 1993 to allow for bands of +/–15%.
    - To prevent speculation, early in the EMS some exchange controls were enforced to limit currency trading.
        - But from 1987 to 1990 these controls were lifted in order to make the EU a common market for financial assets.
    - In effect, EMS members were following the restrained monetary policies of Germany, which has traditionally had low inflation.
        - Under the EMS exchange rate mechanism of fixed bands, Germany was exporting its monetary policy.
    - The Single European Act of 1986 recommended that many barriers to trade, asset flows, and immigration be removed by December 1992.
    - The Maastricht Treaty, proposed in 1991 transformed the EMS into an economic and monetary union (the euro zone for those that joined).
    - The euro was adopted in 1999, and the previous exchange rate mechanism became obsolete.
        - But a new exchange rate mechanism—ERM 2—was established between the economic and monetary union and outside countries.
- Basel Accords
    - Basel accords provide standard regulations & accounting for international financial institutions.
    - They standardize bank capital measurements across countries.
    - Basel I was passed in 1988.
    - Basel II (stricter regulations) was passed in 2004.
    - Basel III (even stricter regulations) was passed in 2010.