IMPORTANT WARNING: These notes are taken from your text book and other related books, so don’t use them without proper references. The paragraphs which are taken from other books are given references in these notes, all other paragraphs are taken from your text book “Timothy C. Lim, Ph.D.: International Political Economy – An Introduction to Approaches, Regimes, and Issues”.

The Global Financial System

The global financial system can be divided into two separate, but tightly inter-related systems: a monetary system and a credit system. The international monetary system, in the most general sense, is defined by the relationship between and among national currencies. More concretely, it revolves around the question of how the exchange rate among different national currencies is determined. The credit system refers to the framework of rules, agreements, institutions, and practices that facilitate the transnational flow of financial capital for the purposes of investment and trade financing.

Exchange Rates and the Exchange-Rate System

An exchange rate is the price of one national currency in terms of another. EUR-USD=1.2 this means that 1 eur equals to 1.2 usd in currency value. TL-USD=4.1 and TL-EUR=4.9. An exchange-rate system (or regime) refers, in general, to the set of rules that govern the relative value of national currencies. Fixed and floating exchange rates represent two major types of exchange-rate systems. While the notion of fixed and floating exchange-rate systems suggests a dichotomous separation, in practice, exchange-rate systems exist on a continuum (Stockman 1999, p. 1484): at one extreme is the pure floating (or flexible) exchange rate, while on the other end is the pure fixed (or pegged) rate system. The fixed and floating-rate systems, in this regard, might be better seen as ideal types—that is, purposeful simplifications or abstractions not meant to correspond to all the actual characteristics of a particular case. In between the pure fixed and floating exchange-rate systems, are many variants. The IMF lists eight specific types or regimes, some with quite interesting names: (1) exchange arrangements with no separate legal tender, (2) currency board arrangements, (3) other conventional fixed peg arrangements, (4) pegged exchange rates with horizontal bands, (5) crawling pegs, (6) exchange rates within crawling bands, (7) managed floating with no predetermined path for the exchange rate, and (8) independently floating (there are also other variants).
What should the relationship between different national currencies be?

To answer this question, we need to recognize a truism in political economy: choices must be made, and typically getting more of something means giving up something else. This is called a trade-off. In the decision over whether to adopt a primarily fixed or floating exchange-rate system, the basic trade-off is easy to discern: stability versus autonomy. Fixed exchange-rate systems generally offer greater exchange-rate stability. This is important, in that it reduces the risks in international trade (because the prices of imports and exports will not fluctuate based on unanticipated changes in the exchange
rate), and, in principle, reduces the risk of currency speculation. The price of greater stability, however, is less flexibility or autonomy in dealing with domestic economic issues. With a fixed exchange-rate system, in particular, governments have less freedom to use monetary policy (e.g., adjusting interest rates, expanding or contracting the money supply) to manage the domestic economy.

Beyond the basic trade-off between stability under a fixed-rate regime and autonomy under a floating-rate regime, a number of more specific advantages and disadvantages can be identified. For example, for a country heavily reliant on exports, such as China, a fixed exchange rate can be used to keep the value of the country's currency low relative to other currencies. This effectively increases the competitiveness of the country's exports on a generalized basis, and thus encourages stronger exports and stronger economic growth for the national economy. Fixed exchange rates also encourage greater and more consistent foreign investment: outside investors do not have to worry that the value of their investments will fluctuate based on the value of the local currency; thus, they are more likely to invest. In principle, a fixed or pegged currency can also help to lower inflation rates, again, because there are fewer concerns that the local currency will unexpectedly lose or gain value. For developing economies, in particular, fixed exchange-rate systems are, in a somewhat counterintuitive way, far easier to maintain than a floating exchange-rate system: floating systems generally require stronger financial institutions and more mature markets to properly maintain (Haekal 2012).

The disadvantages, however, can be quite severe. In particular, over time, fixed exchange-rate systems can lead to major distortions in the underlying value of the currency. If this happens, investors and other with financial interests in an economy may suddenly lose confidence, and begin to withdraw their investments en masse (as they try to convert local currency holdings into, say, dollars or euros at the fixed or pegged rate). In this situation, governments may try to prop up the local currency by using foreign reserves. Invariably, this strategy fails, and the currency's value collapses. The result is a massive financial meltdown, of which there are many real-world examples: Mexico (1995); Thailand, Indonesia, Malaysia, and South Korea (1997); and Russia (1998), to name just a few. In other words, the greatest advantage (i.e., stability) of a fixed exchange-rate system is, ironically, also its greatest weakness. In addition to the potential for economic catastrophe, a fixed-rate system generally requires countries to maintain higher-than-average currency reserves, but this can result in inflation because it increases the supply of currency (i.e., the monetary base) in the economy.
One key advantage of a floating (or flexible) exchange-rate system is that it acts as an automatic stabilizer for the economy. For example, if external demand for a country’s exports decline, this will lead to a decline in overall output and an automatic depreciation in the value of the country’s currency. This, in turn, makes the country’s goods cheaper, which should (in principle) increase exports. In this regard, too, a floating system leads to an automatic adjustment in the balance of payments. As noted above, the floating-rate system gives countries more autonomy with regard to domestic monetary policy, especially in determining interest rates. In a fixed-rate system, domestic interest rates must be set at a level that will keep the exchange rate within a predetermined band; in a floating-rate system, this is not necessary. This allows a government, for example, to sharply cut interest rates during a recessionary period to spur domestic economic growth. The main disadvantages of the flexible exchange-rate system, according to Evrensel (2013), are three-fold. The first disadvantage is greater volatility (a point discussed several times already). The second disadvantage is the potential for too much use of expansionary monetary policy, and the third disadvantage of the floating exchange-rate system is that it does not, in the real world, live up to its reputation as an automatic stabilizer. The U.S. is a case in point: despite using a floating exchange-rate system, the U.S. has run large and persistent deficits in its current account.

**The Mundell-Fleming Model**

Back in the 1960s, Robert Mundell (who won the 1999 Nobel Prize in Economics) and Marcus Fleming argued that, when a small country tries to maintain a fixed exchange rate in a world of perfect capital mobility (keep in mind that basic economic models often use simplifying assumptions to highlight key points of concern), money stock becomes exogenous. In other words, the stock of money is determined by other variables: in practical terms, this means that monetary policy is rendered completely ineffective as a stabilization policy instrument (Fan and Fan 2002). In addition, the two economists theorized that governments could not simultaneously have an independent monetary policy (i.e., control of the Money supply and interest rates), a stable exchange rate (via a fixed or pegged system), and free capital movement. It is possible to achieve two of these objectives at the same time, but not all three: this has been labeled the “impossible trinity” (also known as the “trilemma”).
What is a "Trilemma"?
The impossible trinity, also called the Mundell-Fleming trilemma or simply the trilemma, expresses the limited options available to countries in setting monetary policy. According to this theory, a country cannot achieve the free flow of capital, a fixed exchange rate and independent monetary policy simultaneously. By pursuing any two of these options, it necessarily closes off the third. According to the trilemma model, a country has three options. It can

A - set a fixed exchange rate between its currency and another while allowing capital to flow freely across its borders,

B - allow capital to flow freely and set its own monetary policy, or

C - set its own monetary policy and maintain a fixed exchange rate.

A graphical representation of the trilemma theory:
Balance of Payments

The balance of payments (BOP) is another basic concept; it refers to the method countries use to account for all of their international monetary transactions (this includes transactions for goods and services, as well as purely financial ones by individuals, businesses, and governments) over a specified period of time. “Every international transaction”, as the Federal Reserve Bank of New York (n.d.) explains it, “results in a credit and a debit. Transactions that cause money to flow into a country are credits, and transactions that cause money to leave a country are debits. For instance, if someone in England buys a South Korean stereo, the purchase is a debit to the British account and a credit to the South Korean account. If a Brazilian company sends an interest payment on a loan to a bank in the United States, the transaction represents a debit to the Brazilian BOP account and a credit to the U.S. BOP account” (n.p.). These transactions are further divided into two general categories: the current account, and the capital and financial account (the capital/financial account is sometimes divided into separate accounts). The current account is used primarily to mark the inflow and outflow of goods and services, but also includes earnings on investments, foreign aid, charitable giving, and wages paid to temporary (nonresident) workers. It is referred to as the current account because these transactions mark a short-term or one-time flow of payments or transfers. The capital and financial account is where all cross-border capital transfers are recorded. This includes the transfer of financial and nonfinancial assets such as stocks, bonds, securities (debt), foreign direct investment (FDI), official reserve transactions (e.g., financial assets denominated in foreign currencies or in Special Drawing Rights, also known as SDRs), land, factories, and mines. These are longer-term economic transactions.

In discussing the balance of payments, it is easy to become confused. One major point of confusion stems from the tendency to speak of a “balance-of-payments deficit (or surplus).” Technically, the balance of payments is always in balance, or zero; that is, if the current account has a deficit, the capital account has an exactly equal surplus. Perhaps the easiest way to understand why this is the case is to consider what happens when a country runs a large current account deficit, which is typically the result of an imbalance between exports and imports. In this example, in order to pay for the imports it needs, a country (or economic actors within the country) may borrow money from a commercial bank or from an international financial institution; it could also receive foreign aid money or sell financial or nonfinancial assets. Or in the case of the United States, it could sell Treasury bonds or other government-based securities such as
Treasury bills, known as T-bills, and notes (basically a Treasury bond is a type of long-term debt obligation; Treasury bills are short-term obligations; notes are medium-term obligations). These funds are recorded as a credit for the U.S. because other countries are effectively loaning money to the United States. In other words, what might otherwise be considered a liability or debt is a “credit” in the capital and financial account—which is another reason for confusion. It is important to note, too, that strong demand for U.S. securities (and U.S. securities are generally viewed as one of the safest, most secure investments available) may strengthen the relative value of the dollar, making U.S. exports less competitive (thereby worsening the U.S. current account deficit). From the foregoing example, it should be apparent that the balance of payments is an important issue in international political economy generally, and for individual countries specifically. For the most part, countries see a capital and financial account surplus as a negative: to repeat, a surplus in the capital and financial account means that a country’s debits are more than its credits. More simply, this means that the country is a net debtor to the rest of the world. On the other hand, a country that runs consistent current account surpluses and capital and financial account deficits is a net creditor, which is viewed in very positive terms.

**Constructing the U.S.-Led Postwar Global Financial System**

Any discussion of the global financial system requires an examination of its significance, and especially of the larger context and underlying relations of power that shaped the negotiations and agreements reached at Bretton Woods. With respect to the global financial system, one of the key elements of the negotiations at Bretton Woods was the creation of the gold-exchange system, or GES (or, less commonly, the par value system). Two other key elements were the creation of the International Monetary Fund (IMF) and the World Bank (or the International Bank for Reconstruction and Development [IBRD], as it is formally known).

It is clear that all of these elements of the postwar order were consciously designed—largely by the United States—as part of an overarching whole. It should be very easy to discern why the United States would willingly, even eagerly, take on this role: in a word, hegemony. Remember that hegemony as an analytical concept and tool has resonance in most political-economy or IPE approaches. Even more, from a theoretical perspective it is very hard—and, arguably, unthinkable—to ignore the significance of hegemony in explaining the major economic and political dynamics of the early postwar period. This does not mean that the conceptualization and implications of hegemony are the same in the various theoretical approaches. They are not. In addition to the concept of hegemony,
it is crucial to keep in mind the notion of two-level games, for even in the early postwar period, it is clear that domestic political-economic considerations were an integral part of decision-making within the United States (as well as other countries).

**American Power, Bretton Woods, and the Postwar Global Financial System**

Even before the end of World War II, plans were in the works to construct a specific postwar order premised primarily on American power and interests. One of the first orders of business was to re-establish economic and financial order, which was designed, at least in part, to avoid the mistakes of the past. Two contrasting mistakes were, first, the overly rigid gold standard of the 19th century, which did not allow governments to effectively manage domestic economic issues. The second was the disastrous experiment with floating exchange rates in the 1920s and 1930s: one of the problems with the 1930 system was that it encouraged countries to engage in “competitive devaluations” in order to gain a temporary advantage in international markets (Gilpin 2002). Part of the solution, then, was the gold exchange system, which was designed to provide the best of both worlds. Specifically, the GES was meant to provide the stability of a fixed exchange system by establishing a set value for the U.S. dollar relative to gold (and other currencies relative to the U.S. dollar or gold), but also have the flexibility of a floating system via an “adjustable peg.” Under this exchange regime, participating countries were obliged to declare a specific value for their currency, known as a par value, or peg; they were also required to intervene in currency markets to limit exchange-rate fluctuations with a maximum margin, or band, of one percent above or below parity. (The par value concept, it is worth emphasizing, was originally used to define the Bretton Woods system, which is why it is common to hear people say that the Bretton Woods system collapsed in 1971.) At the same time, all countries retained the right to alter their par value to correct a “fundamental disequilibrium” in their balance of payments (Cohen 2001). In principle, this meant that governments could devalue their currency (beyond the one percent band), but quite unlike the prewar period, devaluations were subject to oversight by a third, supposedly disinterested or impartial, party—the IMF. The IMF, in other words, was given the authority, albeit not unlimited, to approve or reject requests for currency devaluation. This was, in an important respect, a remarkable development in the world of global finance, but it likely could only have happened with U.S. leadership. To see this, consider that, in practice, the IMF was often bypassed in favor of negotiations between the U.S. government and the affected government(s). The IMF, which formally began operations on March 1, 1947, had much more to do than simply approve requests for currency adjustments. Indeed, it was meant
to play a (even the) key role in the postwar global financial system. Thus, while set up as an ostensibly neutral international financial institution, the IMF was clearly meant to represent U.S. interests and power first and foremost, and the interests of the other major capitalist countries (the developed economies) secondarily. Voting power is determined by what the IMF calls a quota. A quota (or capital subscription) is the amount of money that a member country pays to the IMF; it is the price of admission, so to speak, and a central component of the IMF’s financial resources. The quota is supposed to reflect the relative size of a country’s economy; in reality, however, this has never been the case (Bird and Rowlands 2006). China, for example, has the second largest economy in the world, but still has a smaller quota than France, Germany, Japan, and Great Britain. Even more interesting (or telling), China’s quota is only about 35 percent larger than Saudi Arabia’s quota, despite the fact that China’s economy is about 12 times larger (in terms of GDP). This is important, because quotas also determine the number of votes each member has. All members are automatically entitled to 250 basic votes, plus one for each SDR 100,000 of quota (an SDR is a special type of monetary currency reserve created by the IMF): in practical terms, the allocation of 250 basic votes means almost nothing. When the IMF was first formed, the United States had almost 35 percent of all votes, while the other developed countries controlled more than 40 percent. To further ensure decision-making control, the countries with the five largest quotas were given permanent seats on the IMF’s executive board (composed of 24 total members). In addition, important decisions require a supermajority of 85 percent, which means that the largest members effectively have veto power. None of this should be surprising, especially from a political-economy perspective, which tells us to pay close attention to the question of how power shapes the economic system, whether domestically or internationally. Beyond the issue of voting power, the quota system within the IMF was primarily meant to provide a stabilization fund. The IMF’s stabilization fund—which was partly, but not coincidentally, modeled on the U.S. Exchange Stabilization Fund, or ESF (established in 1934)—provided a pool of money available at the international level. This money was loaned, on a short-term basis, to countries suffering from temporary balance-of-payments problems (e.g., a current account deficit). The loans were meant to provide a type of safety valve so that governments would not be tempted to resort to unilateral devaluations of their currencies in an effort to reduce their current account deficits. The stabilization fund, to some extent, worked hand in hand with the IMF’s authority to approve currency devaluation requests. Specifically, if the IMF opposed devaluation, it could not directly
prevent a country from devaluing its currency. After all, the IMF had no enforcement arm, no IMF “police force.” Instead, the IMF was authorized by the Articles of Agreement to bar that country from drawing from the stabilization fund. Unlike the par value system, the stabilization function of the IMF not only survived, but has also, over time, come to play a larger and quite significant role in the global financial system. In this regard, it is important to understand that the basic purpose behind the stabilization fund and IMF lending has changed.

**The IMF and Conditionality**

Originally, the IMF was designed to provide assistance to industrialized countries, and for the first two decades of its existence, more than half of IMF lending went to these richer economies. Since the 1970s, however, the vast majority of recipient countries have been from the developing world (although with the global financial crisis beginning in 2008, the IMF again began providing loans to European countries). A related, but more important change has been a stricter and more expansive application of conditionality. Conditionality, in the broadest sense, refers to any condition or requirement attached to the receipt of a loan, as in, “In return for our willingness to extend this loan to you, you are required to meet the following conditions...” When the IMF was first established, there was no reference to conditionality; nor was it written into the Fund’s original Articles of Agreement. The concept, instead, was first introduced in 1952, but not formally incorporated into the Articles until 1969 as part of the First Amendment (Buira 2003, p. 3). The U.S. wanted the IMF to have “wide discretionary powers” and the ability to exercise “influence and control over the central banks of member countries”. After conditionality was first incorporated into the IMF, it was generally limited to monetary, fiscal, and exchange policies—that is, conditions that were directly related to balance-of-payments issues. But beginning in the 1980s, conditionality began to extend well beyond balance-of-payments issues to “encompass structural change in the trade regime, pricing and marketing policy, public sector management, public safety nets, restructuring and privatization of public enterprises, the agricultural sector, the energy sector, the financial sector, and more recently to issues of governance and others in which the expertise of the Fund is limited” (Buira 2003, p. 19). The IMF, in short, began to encroach more deeply and significantly into issues of state sovereignty. Not surprisingly, this has made the practice of conditionality a deeply controversial and profoundly political practice, with many critics charging that the IMF has become little more than a tool—an extremely effective one—the United States uses primarily to enforce its will on the rest of world.
Why Did the Bretton Woods System Fail?

Given the discussion thus far, it may seem odd that a key element of the Bretton Woods system, the par value system (or the GES), collapsed after a relatively brief period of time. After all, the U.S. largely set up the system it wanted (including in the areas of trade and security), and as the hegemon, used its resources to considerable effect. The reason the system failed, however, is not difficult to discern. It was even predicted. As early as 1960, Robert Triffin argued that the gold-exchange system was inherently flawed since, for it to work, it depended on the U.S. being reliably able to convert dollars into gold. As long as dollars remained relatively scarce, as was the case in the 1950s, the problem was moot. This was because countries that had dollars would spend them on goods and services. As the European economies recovered and as they began building their foreign reserves (composed mostly of U.S. dollars): the dollar gap turned into a dollar glut. This meant, in part, the supply of dollars had begun to exceed the supply of gold held by the United States: in fact, by 1959, U.S. gold holdings and foreign dollar holdings had already reached rough parity. As the situation deteriorated, with a larger and larger “dollar overhang” (the dollar overhang is simply the amount by which U.S. dollars held overseas exceeded U.S. reserves of gold), foreign countries and other holders of U.S. dollars began to lose confidence in the dollar itself, and specifically in their ability to freely convert dollars into gold. The solution to the dollar overhang would have been for the U.S. to reduce the amount of dollars in circulation overseas. But this was problematic for two reasons. First, reducing the supply of dollars would have entailed a significant cutback in domestic spending and an increase in interest rates, neither of which the U.S. government was willing—or, as hegemon, able—to do. The U.S. would have also had to stop running a deficit in its current account. This led to the second, perhaps more significant, problem: by closing the current account deficit, the U.S. would have effectively reintroduced a shortage of the world’s de facto reserve currency; the result would have been a liquidity shortage and a contractionary spiral, perhaps resulting in a worldwide recession. The dilemma, to recap, was simple: Keep spending, and sending dollars to the rest of the world, and erode confidence in the dollar and the Bretton Woods system. Stop spending and eliminate the current account deficit, and risk a global recession and instability. Despite widespread recognition of the dilemma from an early stage—Triffin testified before the U.S. Congress on this very issue in 1960—a viable solution could not be found, although there were several efforts made. One of these was the creation of the London Gold Pool in 1961, in which the U.S. and seven European countries agreed to cooperate in defending a gold price of $35 an ounce.
through coordinated interventions in the London gold market. But it collapsed in 1968. Another effort, based on Triffin’s suggestion, was the creation (in 1969) of an entirely new reserve unit—the SDR, or special drawing right. This effort, however, also failed to avert the U.S. decision to end the GES just two years later. Richard Nixon pursued a third effort when he took office in 1969. His approach was to place the blame squarely on other governments, especially Germany and Japan, both of which had begun to run current account surpluses (specifically trade surpluses) and accumulate foreign reserves starting in the mid-1960s (see table 5.3). The Nixon administration pressured its West European allies and Japan to more actively support the dollar in the foreign exchange market, and to reduce their trade surpluses by importing more from the United States (Eichengreen 1996, p. 130). This policy, too, worked for a short time, but the American allies had their own domestic concerns and interests, and were unwilling to accept too much pain in order to appease the United States. Japan, in particular, was in the midst of its phenomenal postwar economic rise, and was ill-disposed towards slowing its export boom. Indeed, in 1971—the same year Nixon suspended convertibility of the dollar into gold—Japan achieved its largest trade surplus ever. That year, too, Japan’s reserve holdings shot up by $10.8 billion, an astronomical sum relative to the previous years (in 1970, for example, the increase was $903 million). As the dollar overhang increased, confidence sank. This fueled speculative attacks against the dollar (speculators were betting on a major devaluation of the U.S. dollar), which made it even more difficult for foreign governments to support the United States. In May 1971—to cite the most egregious case, at least from the standpoint of the U.S.—Germany formally left the Bretton Woods system, because it was not willing to devalue the deutsche mark any further to support the dollar. The “Nixon shock” (as it was dubbed), therefore, was a surprise only in the sense that he failed to consult with any American allies before he suspended convertibility (Nixon also imposed a 10 percent tax on imports). The end of the GES did not even entail an immediate switch to a floating system; instead, for a couple more years, the global financial regime was based on an adjustable peg system. The floating exchange regime emerged in 1973.