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**1. Discuss and explain the rationale underlying, and the institutional structure resulting from, the Bretton Woods arrangement.**

Under the gold standard there are some automatic stabilizing aspects, in particular, the price-specie-flow mechanism, which was recognized by David Hume in 1752. The mechanism operates to control money supply with current account balance; a deficit will lead to the importation of international reserves. After WWI, the action of selling domestic assets in the face of deficit and buying domestic assets in the face of surplus, as coined by Keynes, is called the gold standard “rules of the game”, based on a game theory approach expecting this process to expedite countries in moving towards their external trade balance and the increased efficiency of the process inherent in the gold standard. Unfortunately the focal point was on deficit economies adhering to the “rules of the game” and internalizing the burden of bringing internationally all economies into balance. Under the Gold Standard, a country with a BoP deficit would be competing for a limited quantity of reserves and may engage in overly contractionary policy that would increase unemployment and leave the reserve position of the country unaffected.

Under the gold standard some countries engaged in a policy called sterilizing the gold flow; this means that when reserves were rising countries would sell domestic assets and when reserves were depleting would purchase domestic assets. The private exportation of gold by governments was also an inherent issue with the gold standard. Fixing prices of currencies with a gold standard aimed to limit the growth of currencies and provide stability for the global markets; however the gold standard was witness to fluctuating price levels and global instability. During the First World War countries

suspended the gold standard; many countries resumed the gold at different times after the war following suspension of the standard during the Great Depression. The shared experiences of the Great Depression, the first World War, and price level instability politically charged the world to adopt the Bretton Woods System. Each country's central bank's increased internalization of the importance to maintain internal balance of central bank was paramount to the ability of countries to agree on adopting the Bretton Woods system.

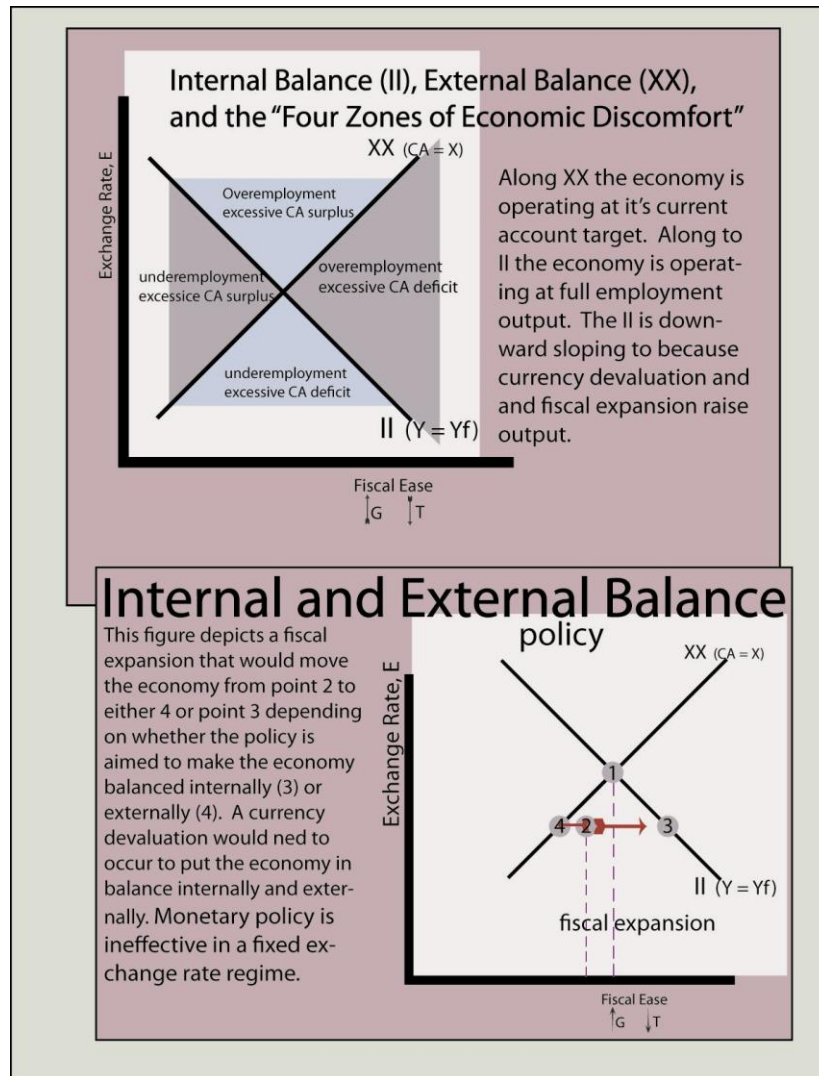
The Bretton Woods agreement led to a system called the Bretton Woods system which was founded on the international agreement to adhere to fixed exchange rates of local currencies based on the dollar and an unvarying dollar price of gold (\$35/oz) called the Bretton Woods agreement. Early convertibility and international clout propagated the US dollar to become the dominant postwar currency for the world. Member countries of the Bretton Woods agreement held their reserves in largely in gold or dollar assets and could sell dollars to the Federal Reserve for gold at the official price. The reduced gains from trade as a result of abandoning trading links during the first World War and the Great Depression and continuing through the second World War provided a global economic environment which was ready to institute an international monetary system that would foster full employment and price stability while allowing countries to engage in trade and promote internal balance without trade restrictions.

A country needs to prevent substantial movements in aggregate demand relative to full-employment level to maintain a stable, predictable price level, and thus a stable exchange rate. Price level and interest rate stability, in real and nominal terms, can be reflected over time in the yield curve and its deviation from the augmented Phillips curve.

This deviation will ultimately be a pivotal indicator of the distribution of income between creditors and debtors and is a risk that was meant to be hedged by instituting the Bretton Woods system and currency that is globally convertible. There are a number of examples such as Britain who sacrificed full employment and free trade to maintain fixed exchange rates.

The United States Federal Reserve was restricted by the necessary agreement to redeem US dollars for gold and thus monetary expansion was heavily monitored. In return, other countries would devalue their reserves by engaging in monetary expansion. Fixed exchange rates were favored because the architects of the policy were under the impression that floating exchange rates are the cause of speculative instability and would negatively impact international trade.

The agreement was designed to allow for internal flexibility to attain external balance without sacrificing internal objectives or fixed exchange rates. The agreement created the International Monetary Fund (IMF) which was designed to help countries in fundamental disequilibrium, and in rare occasions provide the necessary monetary support to engage in a currency revaluation to negate the adverse shift in demand causing disequilibrium.



As a result of the Bretton Woods agreement countries were bound by the ability to transfer fund across borders to the bank with the highest interest rate, and thus the agreement intertwined countries into a global currency market. The integration was not complete and immediate, many countries exercised the right the restrict financial account transactions, a practice allowed by the IMF. A country can gain from investing in economies internationally because those economies may present the highest rate of return on an investment. Current account budgets and deficits may be attractive to certain economies, however it is difficult if not impossible to predict and adopt the target that would maximize the gains for that economy. The rules governing the ability to attain

internal and external balance were the source of demise for the Bretton Woods system.

There were many inherent problems with the Bretton Woods system, however the paramount issue referred to as the confidence problem dictated that over time the reserves in dollars accumulated by foreign central banks would exceed the US deposit of gold and when dollars were no longer “as good as gold” countries could de-stabilize the system by cashing in their dollars for gold. Adjusting the price of gold would have been de-stabilizing and inflationary.

**3. Given the existence of a floating-rate system, discuss the effects of the Reagan tax cuts- together with spending increases- on developing countries’ debt positions, particularly those in Latin American countries that relied heavily on recycled OPEC surpluses. How did this result in the “Washington Consensus” regarding the appropriate ways for them to conduct economic policy?**

The floating rate regime has implications when loans have been taken in foreign currencies and the currency which the principle of the loan is measured is revalued. Tightening monetary policy causes adjustments in the PPP and decrease in the quantitative amounts of the currency in circulation. The monetary contraction that aimed to curb and negate inflation in the US was instigated by Reagan and enacted by Paul Volker increased the domestic interest rate to twice the 1979 level by 1981. The sharply rising interest rate subsequently increased the real debt burden of the developing countries that had debt payments in US dollars. The inability to make loan payments was widespread mainly in Latin America but also hitting countries like Poland who borrowed from the EBRD. Also the global recession caused by the anti-inflationary monetary policy tornadoed and collapsed the prices in the primary commodity goods market, further depressing the developing economies burdened with debt. The countries with the debt can not engage in monetary policy because it is useless in attracting foreign currency

deposits in the form of securities because desirability is based on the real rate of return expected and countries in default are not expected to be profitable.

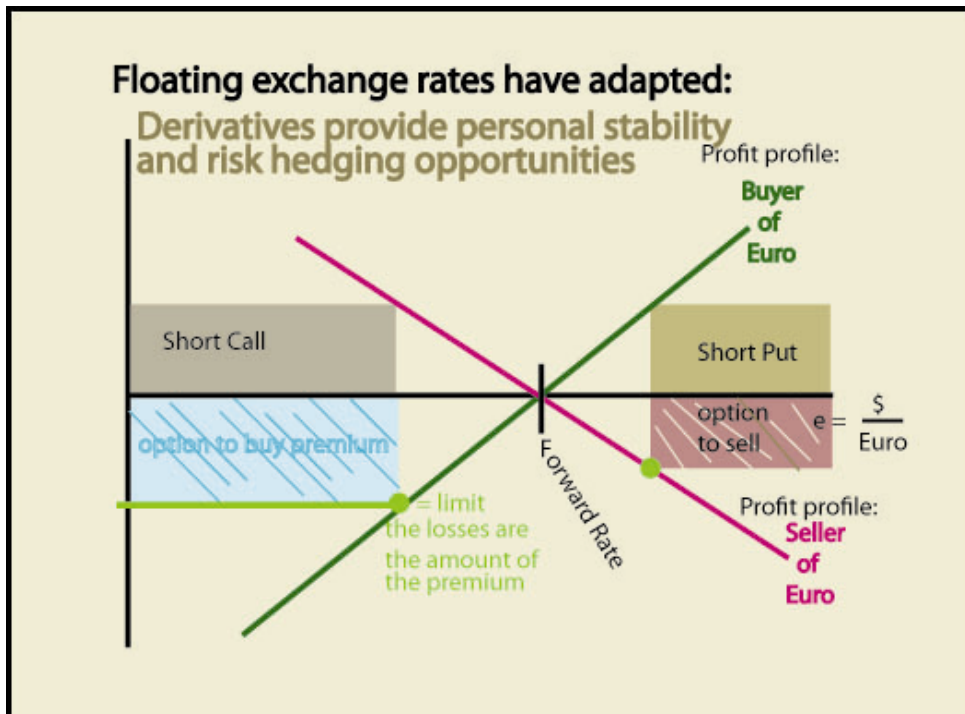
The result of the defaults is the Washington Consensus. Promoting a minimum policy objective with 10 points, the Washington Consensus focused on macroeconomic policy such as liberation of trade, interest rates, stable exchange rates, privatization, secure property rights, and tax reform. The main idea was to make sure that these economies did not go communist or socialist and to make them as liberalized and competitive as possible. If the market was driven to liberalized competition then comparative advantage opportunities would be restored to be exploited.

**7. The original distrust of floating exchange rates that characterized Bretton Woods seems to have been alleviated by the developments of “derivative” markets in addition to simple “spot” for-ex markets. Discuss and explain the nature and function of forward (or “futures”) exchange-rate markets; futures “options”; and “swaps”, and assess their role in removing, or “hedging” exchange-rate risk vs. their potential to destabilize the global financial system.**

Foreign exchange transactions that occur immediately are called spot transactions and will be subject to a spot exchange rate. Foreign exchange transactions that occur on a date preceding the day of the contract are called futures contracts and will be quoted in a forwards exchange rate value. Often a transaction will involve the exchange of local currencies for US dollars to fulfill the contracts; the common use of US dollars and Euros when engaging in foreign exchange transactions qualifies these currencies as vehicle currencies, the level of convertibility of a currency impacts the exchange rates and exchanging abilities. To avoid many issues, The use of derivatives such as forwards, swaps, and options hedges risk by providing predictability to future foreign exchange transactions. A foreign exchange swap is a spot sale of currency combined with a forward repurchase of the currency. A swap essentially finds a counter party that is

willing to hedge the risk for long-term contracts and aims to exploit comparative advantage.

A futures contract dictates that a specified amount of foreign currency will be delivered on a specified date in the future. A foreign exchange option allows an individual to buy or sell a specified amount of currency at a specified price at any time up to the expiration date. Options hedge against what could be unlimited loss. A put option gives the right to sell and can aid the individual in engaging in arbitrage, the process of buying a currency cheap and selling it high. A call option grants the right to buy foreign currency at a predetermined price, generally used to make payments. A “synthetic” option pushes out the buyer curve by instituting a premium and turns a long put into a long call. A straddle option allows the individual to buy or sell if the currency exits the yield bank described in the option. A collar option allows for gains if the currency stays within the band of the yield described by the option



The common lingo for talking about spot and futures rates is: “in the money” meaning for a call option, when the option's strike price is below the market exchange rate and for a put option, when the strike price is above the market exchange rate; “Out of the money” meaning that as of that moment the option is worthless, and “on the money” meaning that the strike price of the option and the exchange rate equivalent. The spread between the treasury bill rate and the LIBOR rate determines which market companies and banks will operate within. Currency continuously chasing down the highest short-term interest rate for deposits is “called hot money“. The interest rate above the treasury rate is quoted in basis points, and is graphically represented by the yield curve. To equally hedge risk simultaneously buy an long call and a long put. Always, the call(buyer) is in the long position and the put(seller) is in the short position.