**Module Eleven**

**Module Eleven Learning Objectives**

1. Describe the historical development of the modern global monetary system.

2. Explain the role played by the World Bank and the IMF in the international monetary system.

3. Compare and contrast the differences between a fixed and a floating exchange rate system.

4. Identify exchange rate regimes used in the world today and why countries adopt different exchange rate regimes.

5. Understand the debate surrounding the role of the IMF in the management of financial crises.

6. Explain the implications of the global monetary system for management practice.

**Introduction to Module Eleven**

The objective of this chapter is to explain how the international monetary system works and its implications for international business. The chapter begins by reviewing the historical evolution of the monetary system, starting with the gold standard and the Bretton Woods System. The chapter explains the role of the International Monetary Fund (IMF) and the World Bank, both of which were initiated by the Bretton Woods Conference. The fixed exchange rate system that was initiated by the Bretton Woods Conference collapsed in 1973. The majority of the chapter explains the workings of the current international monetary system. The pluses and minuses of fixed exchange rates versus floating exchange rates are discussed. Scholars differ regarding which system is best. The current role of the IMF and the World Bank are discussed, including the way the IMF has helped nations restructure their debts.

The assignments for Module Eleven include the following:

1. Read Chapter Eleven of your text.

2. Review the PowerPoint slides for Chapter Eleven.

3. Participate in the Module Eleven/Twelve Critical Thinking Exercise (found in Module Twelve)

4. Complete Module Eleven Assignments.

**1. Chapter Opening Case: Did the IMF Help Egypt?**

You are about to read a short case exploring the role of the International Monetary Fund (IMF) in helping Egypt overcome its economic challenges. In 2016, Egypt borrowed $12 billion from the IMF and, in exchange, agreed to implement a variety of strict economic reforms. You will be asked to answer questions linking your knowledge from the chapter to the situation detailed in the case.

This activity is important because as a manager, you must be able to understand the development of the global monetary system and how that system influences currencies. Today’s major currencies, including the U.S. dollar, the euro, and the Japanese yen, follow a managed float system in which currency values are largely determined by supply and demand with some government intervention. The goal of this activity is to demonstrate your understanding of the development of the global monetary system and the implications of that system on government policy and decision making in organizations.

*Read the case and answer the questions that follow.*

When President Abdel Fatah al-Sissi came to power in a 2013 military coup, he promised to fix Egypt’s mounting economic problems. Three years later, those problems had only intensified. The country was struggling with low economic growth; 13 percent unemployment; a 12 percent inflation rate; a large trade deficit, amounting to 7 percent of gross domestic product (GDP); a persistent budget deficit of around 12 percent of GDP; and public debt, which by 2016 stood at 92 percent of GDP. The tourism trade, a major source of foreign currency, had collapsed in the wake of concerns about terrorism, which included an Islamic State–linked insurgency in the Sinai Peninsula that claimed the bombing of a Russian passenger jet in 2016. Foreign direct investment, another source of foreign currency, had also slumped in the wake of Egypt’s economic and political problems.

One major issue was a lack of foreign currency in the country, which made it difficult to pay for imports and resulted in shortages of key commodities. For example, Egypt imports one-third of its sugar. By mid-2016, this commodity was in short supply due to the inability of Egyptian traders to get the foreign currency required to pay for imported sugar. Historically, in times of trouble, the oil-rich Arab states of the Persian Gulf had loaned foreign currency to Egypt at low interest rates, but a collapse in oil prices had left those states financially strained, and loans were not forthcoming. In an indication of the depth of Egypt’s problems, while the official exchange rate of the Egyptian pound was pegged at 9 pounds to the U.S. dollar, the black-market rate had soared to 18 pounds to the dollar.

In mid-2016, with its foreign exchange reserves being rapidly depleted, the Egyptian government applied to the IMF for a loan. The IMF agreed to loan Egypt up to $12 billion, but only if the government undertook a number of economic reforms. These included liberalizing the exchange rate, letting the Egyptian pound float against other currencies. The thinking was that the pound would depreciate against major currencies such as the U.S. dollar and the euro, making Egyptian exports cheaper and its imports more expensive. The IMF believed that this would help the country to improve its trade deficit and earn more foreign currency. At the same time, the IMF required the Egyptian government to implement an austerity program that included an immediate end to energy subsidies, which had kept energy prices artificially low; reforms to public enterprises to make them more efficient; tighter monetary policy to rein in inflation; privatization of state-owned enterprises; and the imposition of a value-added tax to raise government revenues.

In November 2016, Egypt let the pound float freely. It immediately lost 50 percent of its value against the U.S. dollar, trading at around 13 pounds to the dollar. Egypt also moved rapidly to impose the value-added tax. In return, the IMF released the first $2.75 billion of its loan to Egypt. Additional tranches of the IMF loan were released over the next three years as Egypt made progress implementing IMF policies, with the last IMF loan payment being made in July 2019.

So did the IMF program work? The signs are mixed. On the positive side, while export growth has been less than hoped for, despite the devaluation in the Egyptian pound, the country’s current account deficit has narrowed on the back of rising gas exports and a modest improvement in tourism. Foreign direct investment inflows have increased somewhat. Inflation has declined from over 30 percent in 2017 to around 9 percent in 2019, and unemployment has fallen from 12 percent to 8.1 percent over the same time period. The government has also cut public spending, as required for by the IMF, and there have been some privatizations.

On the other hand, while these macroeconomic numbers have improved, most Egyptians have seen a marked decline in their living standards due to a reduction in government subsidies and higher prices for basic goods such as cooking gas, oil, electricity, and foodstuffs. Today around half of the Egyptian population lives in or near poverty, which the World Bank defines as living off $1.90 a day. Since 2011, the percentage of Egyptians living below the poverty line has risen from 25.2 percent to 32.5 percent.

Moreover, substantial structural problems remain. Companies owned by the Egyptian army, which make up a large proportion of the economy, have been excluded from privatization plans. Businesses owned by the army have also been exempted from value-added tax levied on consumer goods under the IMF program. Perhaps because of this, productivity growth remains low, which may limit future economic growth—a serious problem in a country whose population is still expanding rapidly. Development economists have called for deeper reforms, but in a country where the army has substantial political power, this seems unlikely. The government has also dramatically increased its international borrowing since 2016. Foreign debt now equals around 40 percent of the country’s GDP. By 2019, 70 percent of the taxes paid by Egyptian citizens went toward debt servicing, rather than investment in public goods. If foreign institutions limit future lending to Egypt, the country could be in trouble again and forced to go back to the IMF.

Sources: Heba Mahfouz and Paul Schemm, “Struggling Egypt Devalues Currency by Almost 50% Ahead of IMF Loan,” *Washington Post*, November 3, 2016; Lin Noueihed and Ahmed Aboulenein, “Egypt on Track to Receive IMF Loan’s Second Tranche,” *Reuters*, January 18, 2017; “State of Denial,” *The Economist*, August 6, 2016; Tom Stevenson, “Egypt and the IMF: Success or Failure?” *Middle East Eye*, August 6, 2019.

**1a. Prior to intervention by the IMF in 2016, Egypt followed…**

Prior to intervention by the International Monetary Fund (IMF) in 2016, Egypt followed a \_\_\_\_\_\_\_\_\_\_ exchange rate policy.

Top of Form

Multiple Choice

floating

peggedCorrect

free

fixed-cost

managed

**1b. As part of its 2016 agreement to borrow $12 billion…**

As part of its 2016 agreement to borrow $12 billion from the International Monetary Fund (IMF), Egypt agreed to

Top of Form

Multiple Choice

peg its currency to the euro.

increase the value of its currency.

allow its currency to float against other currencies.

increase energy subsidies to raise profits.

remove value-added taxes that made oil prices too high.

**1c.** The \_\_\_\_\_\_\_\_\_\_ was created to maintain order in the international monetary system.

Top of Form

Multiple Choice

World Bank

United Nations (UN)

International Bank for Reconstruction and Development (IBRD)

International Monetary Fund (IMF)Correct

Currency Board

**1d.** The crisis in Egypt that required the country to take a $12 billion loan from the International Monetary Fund (IMF) in 2016 can best be described as a(n)

Top of Form

Multiple Choice

banking crisis.

currency crisis.Correct

foreign debt crisis.

exchange rate crisis.

managed crisis.

**4. A Business's Strategic Choice**

An international business must make strategic choices about operations across the globe. What happens in the foreign exchange markets and the international monetary system has profound effects on the firm.

The volatility of exchange rates is a key feature of the international monetary system. Most governments use some kind of managed-float system, and foreign exchange markets continually respond to supply and demand. Companies must make strategic choices that respond to the risks, situations, and nature of the business. These strategic choices should work together to support the aims of the business. Firms should pursue strategies that will increase strategic flexibility in the event of unpredictable exchange rate movements -- strategies that will minimize the economic exposure of the business.

*Read the case below and answer the questions that follow.*

You are the head of an international firm considering the strategic options for your business. You produce textiles, and you are concerned about the volatility of foreign exchange rates and how they affect your business. You have customers all over the world, and you are concerned about the actions of speculators, your own government, and the governments in your markets. The long-term profitability–and survival–of the firm depends on the strategic choices you'll make. You realize that exchange rate movements are difficult to predict but can have a major impact on your competitive position in the marketplace.

You might choose to maintain strategic flexibility by dispersing production to different locations around the world to hedge against currency fluctuations. You might also choose to contract out manufacturing of the textiles in order to shift suppliers from one country to another as you respond to exchange rate movements.

**4a.** Companies engaged in significant foreign exchange activities need to be aware that the current system is a mixed system combining speculation and

Top of Form

Multiple Choice



basic and rigid laws of supply and demand.



government intervention.

Correct



micromanagement of currencies by the IMF.

**4b.** The business should use the forward exchange market knowing

Top of Form

Multiple Choice



the forward exchange market is far from perfect as a predictor of future exchange rates.

Correct



insurance coverage will help reduce the risk for the years ahead.



this is the best way to ensure future profitability.

**4c.** Maintaining strategic flexibility can take the form of \_\_\_\_\_\_\_\_\_\_ as a hedge against currency fluctuations.

Top of Form

Multiple Choice

reducing production capability

dispersing production to different locations around the globe

centralizing operations in as few locations as possible

**4d.** Since the firm is producing textiles, it can build strategic flexibility and reduce economic exposure by

Top of Form

* selling only in markets where the textiles are produced, reducing the need for exchanges.
* contracting out manufacturing operations in order to shift production as economic conditions change.
* finding ways to increase value-added manufacturing capacity.

**4e.** Many industries, including textiles, are affected by government actions, so the firm should

Top of Form

take an active role in working with governments to produce favorable conditions.

become a member of the IMF.

keep a low profile as much as possible in production and headquarters' locations.

### 5. Did You Know? Turkish Lira Loses 40 Percent of Its Value Against the U.S. Dollar

This activity is important because as a manager, you must be able understand how the international monetary system, its history and its institutions, and how currency values are determined.

The goal of this activity is to demonstrate your understanding of the international monetary system, the different exchange rate systems, and the implications of the global monetary system on management practice.

**5a. The Turkish lira lost about 40 percent of its value against the U.S….**

The Turkish lira lost about 40 percent of its value against the U.S. dollar in the first part of 2018. Which type of exchange rate system does Turkey follow?

Top of Form

floatingCorrect

fixed

pegged

currency board

gold standard

**5b.** In 2018, investors worried about the uncertainty in the Turkish economy, began exchanging their lira investments for U.S. dollars. Under a floating exchange rate system, how is the value of a currency determined?

Top of Form

Under a floating exchange rate system, the value of a currency is determined by a basket of currencies.

Under a floating exchange rate system, the value of a currency as it follows a floating pegged system.

Under a floating exchange rate system, the value of a currency is determined by the market forces of supply and demand.Correct

Under a floating exchange rate system, the value of a currency is determined by institutional forces.

Under a floating exchange rate system, the value of a currency is determined by a reference currency, usually the euro.

**5c.** A company in Turkey holds a loan in U.S. dollars. What does the downward pressure on the value of the Turkish lira mean for this company?

Top of Form

The company should consider hedging in soft currency locations.

Turkey should consider moving to a pegged rate system.

It will cost more lira to pay back the dollar-based loans.

There will be less competition in the market.

The company should adopt a currency board.

**5d. Turkey’s president is concerned that halting the fall of the Turkish lira…**

Turkey’s president is concerned that halting the fall of the Turkish lira by raising interest rates will make his government less popular. What is the upside of a weak lira?

Top of Form

It decreases the price of imports for Turkish citizens.

It improves trade relation with other countries.

It increases the price of Turkish exports in foreign markets.

It helps Turkey’s trade deficit.

It encourages domestic firms to invest overseas.

**6a.** Why is the International Monetary Fund (IMF) interested in U.S. Treasury Secretary Steven Mnuchin’s comments on the value of the dollar?

Top of Form

The IMF is charged with promoting development.

The IMF is required to work toward establishment of a stable, fixed rate monetary system.

The IMF is responsible for ensuring continued economic development takes place.

The IMF works closely with companies as they interact on currency matters.

The IMF has responsibility for maintaining order in the international monetary system.

**6b.** At the World Economic Forum in Davos, there were discussions regarding the value of the U.S. dollar. What determines the value of the dollar?

Top of Form

The value of the dollar is determined by institutional forces.

The value of the dollar is determined by a reference currency, usually the euro.

The value of the dollar is determined by the market forces of supply and demand.

The value of the dollar is determined by a basket of currencies.

The value of the dollar is determined as it follows a floating pegged system.

**6c.** World Economic Forum meets annually to discuss global, regional, and industry agendas. The IMF plays an important role in these discussions. When was the IMF established?

Top of Form

at Bretton Woods

as part of the UN Treaty Paris Agreement

after the 1997 Asian currency crisis

as part of the Jamaica Accord

following the 2008 global economic crisis

**6d.** What is the upside of a weak dollar?

Top of Form

It encourages domestic firms to invest overseas.

It decreases the price of imports for Americans.

It helps the U.S. trade deficit.

It improves trade relation with other countries.

It increases the price of U.S. exports in foreign markets.

**MC Qu. 03 A(n) \_\_\_\_\_\_\_\_\_\_ system refers to...**

7. A(n) \_\_\_\_\_\_\_\_\_\_ system refers to one in which a country's currency is nominally allowed to float freely against other currencies but in which the government will intervene, buying and selling currency, if it believes that the currency has deviated too far from its fair value.

Top of Form

fixed float

managed-float

floating exchange rate

pegged exchange rate

clean float

8. As an investor studying the gold standard, Kareem knows that he would need more than 1,500 euros to purchase one ounce of gold. These euros represent the

Top of Form

Multiple Choice

gold par value.

gold mix ratio.

balance-of-trade equilibrium.

gold reserve ratio.

gold margin.

9. A country in a state of fundamental disequilibrium suffers from

Top of Form

a lack of competition to help balance pricing.

incomplete trade agreements.

a trade war.

permanent adverse shifts in the demand for their products.

overproduction of goods.

10. A weakness of the Bretton Woods system was that it could not work if

Top of Form

Multiple Choice

the U.S. dollar was under speculative attack.

the value of the British pound increased against the Japanese yen.

Japan's economy grew.

the U.S. inflation rate remained low.

Germany's unemployment rate increased.

11. Images from the Great Depression included lines of people standing at their financial institution waiting to withdraw their money because they didn’t trust the money would be there when they needed it. What was this an example of?

Top of Form

Multiple Choice

a political crisis

a banking crisis

an exchange rate crisis

a foreign debt crisis

a currency crisis

12. The investment manager at Solar Electric Inc. reminds the board that the foreign exchange market is a mixed system. The investment manager wants the board to realize that rates are driven by

Top of Form

Multiple Choice

dynamic competitive forces.

supply and demand.

the interplay of big business and Western practices.

a combination of government intervention and speculative activity.

the globalization of developing nations.

**Chapter 11 Assignment**

1. The institutional arrangements that countries adopt to govern exchange rates are called the

Top of Form

Multiple Choice

financial management information system.

general agreement on trade in services.

international monetary system.

general agreement on tariffs and trade.

1. Under the gold standard, gold flows reduce the money supply in one nation when another nation experiences a trade surplus. The nation with a trade surplus has a swell in the money supply, which leads to price increases. At the same time, the nation with a reduction in the money supply will cause prices to fall. The lower prices create more demand for product from the nation with a reduction in the money supply, which leads to a

Top of Form

Multiple Choice

floating exchange rate.

tragedy of the commons.

facilitating payment.

planned economy.

balance-of-trade.

1. One unit of a peso in a Latin American country was defined as equivalent to 12 grains of "fine" (pure) gold, while one unit of its neighboring countries currency, a dollar, was defined as equivalent to 18 grains of "fine" (pure) gold. Using the gold par value concept (with 480 grains in an ounce), the exchange rate for converting the peso to the dollar is

Top of Form

Multiple Choice

1.5 peso = 1 dollar.

1 peso = 1.5 dollar.

1 peso = 1 dollar.

2 peso = 1 dollar.

3 peso = 2 dollar.

1. Some countries rely on the foreign exchange market to determine the relative value of its currency. This is called a \_\_\_\_\_\_\_\_\_\_ exchange rate system.

Top of Form

Multiple Choice

floating

pegged

nominal

fixed

forward

1. The United States returned to the gold standard in 1934 when more dollars were needed to buy an ounce of gold than before. This implied that the dollar

Top of Form

Multiple Choice

was worth less.

was worth more.

had maintained a steady value.

was no longer used for pegged rates.

1. The adoption of the Marshall Plan redirected the efforts of the World Bank, which then turned its focus on

Top of Form

Multiple Choice

eliminating inflation rates.

creating the gold standard.

creating a balance-of-trade in Latin America.

lending money to third-world nations.

helping European nations rebuild after the war.

1. The International Development Association of the World Bank only provides loans to

Top of Form

Multiple Choice

entrepreneurial companies.

European countries.

Westernized nations.

the poorest nations.

start-up companies.

1. The 1944 Bretton Woods conference created two major international institutions that play a role in the international monetary system—the International Monetary Fund (IMF) and the

Top of Form

Multiple Choice

European Union.

United Nations.

World Bank.

G20.

World Trade Organization.

1. One aspect of the International Bank for Reconstruction and Development (IBRD) scheme of the World Bank is that

Top of Form

Multiple Choice

the interest rate charged by the World Bank is higher than commercial banks' market rate.

the bank avoids offering low-interest loans to risky customers whose credit rating is often poor.

it was established to approve currency devaluations that are beyond 10 percent.

the borrowers have to pay the bank's cost of funds plus a margin for expenses.

the resources to fund IBRD loans are raised through subscriptions from wealthy members.

1. What action did President Nixon take to enable devaluation of the dollar during the increase in U.S. inflation in 1971?

Top of Form

Multiple Choice

* The IMF member countries would adopt the gold standard to fix exchange rates.
* The United States would no longer support the World Bank.
* The dollar would no longer be convertible into gold.
* A new 15 percent tax would be charged on U.S. exports.
* German deutsche marks would be the new reference currency.

Bottom of Form

1. Under the U.S. macroeconomic policy package of 1965–1968, President Lyndon Johnson backed an increase in U.S. government spending that was financed by

Top of Form

Multiple Choice

the sale of gold reserves.

selling bonds in the international capital market.

an increase in the money supply.

an increase in taxes.

borrowing from the International Monetary Fund.

1. A newly independent Eastern European nation wants to adopt a floating exchange rate system in order to restore monetary control to its government. Using the monetary autonomy argument, how do this country's ministers justify establishing this system?

Top of Form

Multiple Choice

Each country should be allowed to choose its own inflation rate.

Speculation in exchange rates dampens the growth of international trade and investment.

Trade deficits are determined by the balance between savings and investment in a country, not by the external value of its currency.

Unpredictability of exchange rate movements makes business planning difficult.

Variable exchange rates are more receptive to a trade balance.

1. One reason for the rapid rise in the value of the dollar between 1980 and 1985 despite a large trade deficit was due to

Top of Form

Multiple Choice

heavy capital outflows from the United States.

political stability in all other parts of the world.

low real interest rates in the United States.

slow economic growth in the developed countries of Europe.

increasing exports against decreasing imports in the United States.

Bottom of Form

Bottom of Form

Bottom of Form

Bottom of Form

Bottom of Form

Bottom of Form

Bottom of Form

1. What was one of the main elements included in the Jamaica Agreement?

Top of Form

Multiple Choice

IMF members were restricted from entering the foreign exchange market.

Floating exchange rates were declared acceptable.

A fixed exchange rate system was established.

IMF quotas were reduced.

Gold was introduced as a reserve asset.

1. During the 1997 Asian currency crisis, the majority of Asian currencies were collapsing with the exception of Hong Kong. How was Hong Kong able to maintain the value of its currency against the U.S. dollar?

Top of Form

Multiple Choice

It introduced a currency board.

It took away the clean-float exchange rate system it had been using.

It adopted the gold standard.

It eliminated the need for a pure-float exchange rate system.

It implemented a free-float exchange rate system.

1. How does a country that introduces a currency board make its commitment to converting its domestic currency on demand into another currency at a fixed exchange rate credible?

Top of Form

Multiple Choice

holding foreign currency reserves equal at the fixed exchange rate to at least 100 percent of the domestic currency issued

borrowing funds from the International Monetary Fund and the World Bank

maintaining a trade surplus with foreign countries

importing more goods from foreign countries than it exports

printing foreign currencies

1. The International Monetary Fund has been criticized for

Top of Form

Multiple Choice

its lack of a "one-size-fits-all" approach to macroeconomic policy.

encouraging moral hazard among banks.

keeping its operations open to outside scrutiny.

its lack of power and authority.

using external experts to gain knowledge about a country.

1. A nation that is experiencing a currency crisis will

Top of Form

Multiple Choice

realize a sharp appreciation in the value of a currency.

find that government sharply increases interest rates to defend the prevailing exchange rate.

face sharp decreases in stock and property prices.

not be eligible for loans from the International Monetary Fund.

force authorities to block large volumes of international currency reserves.

1. What is one result of a banking crisis?

Top of Form

Multiple Choice

It results in a sharp appreciation in the value of the currency.

It creates an uptick in domestic borrowing.

It leads to individuals and companies withdrawing their deposits from banks.

It results in low government deficits.

It leads to price deflation.

1. How does increased foreign exchange risk affect business?

Top of Form

Multiple Choice

This has no effect on a business.

This creates more opportunities for a business.

This has a negative effect on a business.

This makes it easier for a business to obtain customers.

This lowers the cost of doing business.

Bottom of Form

Bottom of Form

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