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- c. What will happen to the value of the U.S. dollar if OPEC members decide to invest more of their petrodollars toward non-dollar-denominated assets, such as euro-denominated stocks and bonds?
- d. In addition to oil producers, China is also accumulating a large stock of dollars, currently

estimated to total \$1.4 trillion. What would happen to the value of the dollar if China and oil-producing nations all shifted out of dollar-denominated assets at the same time? What would be the consequence for the U.S. economy?

Research Task



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The International Monetary System

Use the globalEDGE website (globeledge.msu.edu) to complete the following exercises:

Exercise 1

The *Global Financial Stability Report* is a semiannual report published by the International Capital Markets division of the International Monetary Fund (IMF). The report includes an assessment of the risks facing the global financial markets. Locate and download the latest report to get an overview of the most important issues currently under discussion. Also, download a report from five years ago. How do issues from five years ago compare with financial issues identified in the current report?

Exercise 2

An important element to understanding the international monetary system is keeping updated on current growth trends worldwide. A German colleague told you yesterday that *Deutsche Bank Research* provides an effective way to stay informed on important topics in international finance from a European perspective. One area of focus for the site is emerging markets and economic and financial challenges faced by these markets. Find an emerging market research report for analysis. On which emerging market region did you choose to focus? What are the key takeaways from your chosen report?

CLOSING CASE

Currency Trouble in Malawi

When the former World Bank economist Bingu wa Mutharika became president of the East African nation of Malawi in 2004, it seemed to be the beginning of a new age for one of the world's poorest countries. In landlocked Malawi, most of the population subsists on less than a dollar a day. Mutharika was their champion. He introduced a subsidy program for fertilizer to help poor farmers and gave them seeds. Agricultural output expanded, and the economy boomed, growing by 7 percent per year between 2005 and 2010. International donors loved him, and aid money started to pour in from the United Kingdom and the United States. By 2011, foreign aid was accounting for more than half of Malawi's annual budget.

In 2009, to no one's surprise, Mutharika was reelected president. Then things started to fall apart. Mutharika became increasingly dictatorial. He pushed aside the country's central bankers and ministers to take full control of

economic policy. He called himself "Economist in Chief." Critics at home were harassed and jailed. Independent newspapers were threatened. When a cable from the British ambassador describing Mutharika as "autocratic and intolerant of criticism" was leaked, he expelled the British ambassador. Britain responded by freezing aid worth \$550 million over four years. When police in mid-2011 killed 20 antigovernment protestors, other aid donors withdrew their support, including most significantly the United States. Mutharika told the donors they could go to hell. To compound matters, tobacco sales, which usually accounted for 60 percent of foreign currency revenues, plunged on diminishing international demand and the decreasing quality of the local product, which had been hurt by a persistent drought.

By late 2011, Malawi was experiencing a full-blown foreign currency crisis. The International Monetary Fund urged Mutharika to devalue the kwacha, Malawi's currency,

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to spur tobacco and tea exports. The kwacha was pegged to the U.S. dollar at 170 kwacha to the dollar. The IMF wanted Malawi to adopt an exchange rate of 280 kwacha to the dollar, which was closer to the black market exchange rate. Mutharika refused, arguing that this would cause price inflation and hurt Malawi's poor. He also refused to meet with an IMF delegation, saying that the delegates were "too junior." The IMF put a \$79 million loan program it had with Malawi on hold, further exacerbating the foreign currency crisis. Malawi was in a tailspin.

In early April 2012, Mutharika had a massive heart attack. He was rushed to the hospital in the capital Lilongwe, but ironically, the medicines that he needed were out of stock—the hospital lacked the foreign currency to buy them! Mutharika died. Despite considerable opposition from Mutharika supporters who wanted his brother to succeed him, Joyce Banda, the vice president, was sworn in as president. Although no one has stated this publicly, it seems clear that intense diplomatic

pressure from the United Kingdom and United States persuaded Mutharika's supporters to relent. Once in power, Banda announced that Malawi would devalue the kwacha by 40 percent. For its part, the IMF unblocked its loan program, while foreign donors, including the UK and United States, stated that they would resume their programs.²²

Case Discussion Questions

1. What were the causes of Malawi's currency troubles?
2. Why did Mutharika resist IMF calls for currency devaluation? If he had lived and remained in power, what do you think would have happened to the economy of Malawi assuming that he did not change his position?
3. Now that Malawi's currency has been devalued, what do you think the economic consequences will be? Is this good for the economy?

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Endnotes

1. Charles Forelle, "In European Crisis, Iceland Emerges as an Island of Recovery," *The Wall Street Journal*, May 19, 2012, pp. A1, A10; "Coming in from the Cold," *The Economist*, December 16, 2010; Charles Duxbury, "Europe Gets Cold Shoulder in Iceland," *The Wall Street Journal*, April 26, 2012; and "Iceland," *The World Factbook 2013* (Washington, DC: Central Intelligence Agency, 2013).
2. The argument goes back to eighteenth-century philosopher David Hume. See D. Hume, "On the Balance of Trade," reprinted in *The Gold Standard in Theory and in History*, ed. B. Eichengreen (London: Methuen, 1985).
3. R. Solomon, *The International Monetary System, 1945–1981* (New York: Harper & Row, 1982).
4. International Monetary Fund, *World Economic Outlook, 2005* (Washington, DC: IMF, May 2005).
5. For an extended discussion of the dollar exchange rate in the 1980s, see B. D. Pauls, "US Exchange Rate Policy: Bretton Woods to the Present," *Federal Reserve Bulletin*, November 1990, pp. 891–908.
6. R. Miller, "Why the Dollar Is Giving Way," *BusinessWeek*, December 6, 2004, pp. 36–37.
7. "Recycling the Petrodollars; Oil Producers' Surpluses," *The Economist*, November 12, 2005, pp. 101–02; S. Johnson, "Dollar's Rise Aided by OPEC Holdings," *Financial Times*, December 5, 2005, p. 17; and "The Petrodollar Puzzle," *The Economist*, June 9, 2007, p. 86.
8. For a feel for the issues contained in this debate, see P. Krugman, *Has the Adjustment Process Worked?* (Washington, DC: Institute for International Economics, 1991); "Time to Tether Currencies," *The Economist*, January 6, 1990, pp. 15–16; P. R. Krugman and M. Obstfeld, *International Economics: Theory and Policy* (New York: HarperCollins, 1994); J. Shelton, *Money Meltdown* (New York: Free Press, 1994); and S. Edwards, "Exchange Rates and the Political Economy of Macroeconomic Discipline," *American Economic Review* 86, no. 2 (May 1996), pp. 159–63.
9. The argument is made by several prominent economists, particularly Stanford's Robert McKinnon. See R. McKinnon, "An International Standard for Monetary Stabilization," *Policy Analyses in International Economics* 8 (1984). The details of this argument are beyond the scope of this book. For a relatively accessible exposition, see P. Krugman, *The Age of Diminished Expectations* (Cambridge, MA: MIT Press, 1990).
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11. "The ABC of Currency Boards," *The Economist*, November 1, 1997, p. 80.
12. P. Carroll and C. Torres, "Mexico Unveils Program of Harsh Fiscal Medicine," *The Wall Street Journal*, March 10, 1995, pp. A1, A6; and "Putting Mexico Together Again," *The Economist*, February 4, 1995, p. 65.
13. International Monetary Fund, *World Economic Outlook, 1998* (Washington, DC: IMF, 1998).
14. Ibid.
15. T. S. Shorrock, "Korea Starts Overhaul; IMF Aid Hits \$55 Billion," *Journal of Commerce*, December 8, 1997, p. 3A.