Chapter 19
International Experience with Exchange Rate Regimes

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Outline

- What is to be explained?
  - some countries peg while others float
  - changes over time in pegging & anchor currency

- Theories
  - Why? Is there an optimal choice?
  - What are the costs/benefits of each regime?

- Application
  - Can theories explain exchange rate regime choices in the past and present?
History of fixed & floating rates

- **1870-1913**
  - rise of the gold standard
  - period of peace, growth, globalization

- **1914-45**
  - collapse of gold standard
  - period of war, depression, de-globalization

- **1946-70s**
  - a direct/indirect “dollar standard” (Bretton Woods System)
  - postwar recovery, but limited globalization

- **1970s-present**
  - end of dollar standard
  - more floating, especially in core countries
  - more globalization, especially in core countries
1. Introduction

Objective: criteria for evaluating exchange rate regimes used in the past.

- General costs and benefits of **fixed exchange rate regimes**: Certain costs and benefits apply whenever a country commits itself to fixed exchange rate regimes.

  **Main benefit**: lower uncertainty about cross-border trade and investment. One way to get around this: use forward exchange contracts (not generally available for long time horizons).

  **Main costs**: the country loses the ability to use monetary policy.
  - Fixed exchange rate → monetary policy is tied down: any attempt to increase money supply → depreciate the value of your currency away from the official pegged value.
  - If a country wishes to increase money supply, it must devalue its currency, that is, lower its official pegged exchange rate.
Some additional definitions for later reference

1. **External balance**: keeping the CA deficit near a “sustainable” level: where any net imports on the CA side are fully financed by willing private capital inflows on the KA side.

   Recall “official reserve assets:” if foreigners are not buying U.S. goods or U.S. assets with the dollars we are paying them to buy foreign goods, then the U.S. central bank must be selling off some of its foreign reserve assets to make up the shortfall in the balance of payments. Not sustainable over a long time, eventually the central bank will deplete its reserves of foreign assets (*external imbalance*).

2. **Internal balance**: keeping output near the full-employment level and keeping price levels stable (low inflation). Prevent the economy from going into recession (unemployment, overheating, excessive inflation).
2. Gold Standard

The gold standard is one particular form of fixed exchange rate regime.

The U.S. and most other developed countries followed this from 1870 to WWI.

Defining features:

1. peg domestic currency to gold instead of another currency
2. central bank pegs price of gold by being willing to trade domestic currency for gold of vice versa with anyone at that official price.
3. central bank’s foreign reserve assets in form of gold.
2. Gold Standard

**Price-specie-flow mechanism**

**Benefit of the gold standard:** automatic mechanism to maintain external balance.

Suppose the U.S. sets value of dollar at high level inconsistent with external balance → U.S. large CA deficit (domestic goods too expensive to foreigners) + private capital inflows not enough to pay for it.

- foreigners hold dollars from net exports to the U.S.
- they go to U.S. central bank and demand exchange for gold and get another currency for trade
- U.S. gold reserves drop & dollars in circulation also drop
- Long run (flexible prices): ↓U.S. money supply → ↓U.S. price level
- Given the NER, \( \uparrow q = \frac{E \times P^*}{\downarrow P} \) home goods cheaper relative to foreign goods
- Result: improve CA → restore external balance
History

Started in UK in the early 1800s (1819) UK predominant economic power at the time, so other countries adopted the gold standard later in the century to emulate the UK.

By 1870 many other countries were on the gold standard. The U.S. joined the group in 1879.

World War I: during war many countries abandoned the gold standard (it prevented them from ↑ money supply, needed during the war)

Inter-war period: many countries rejoined the gold standard after the war. But in the early 1930s many countries abandoned the standard again, because of its effects on the Great Depression.
The Great Depression and Internal balance

Keynesian story of the Great Depression in the early 1930s.

Keynes: main cause was a ↓ investment demand in the economy → fall in overall demand → production fell. Worse in those countries belonging to the Gold standard.

Graph:

1) Fall in investment shifted IS left

2) Fixed exchange rate means money supply must adjust to keep interest rate at the original level. This required fall in money supply, which shifted LM left.
2. Gold Standard

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3. Reserve Currency Standard: Bretton Woods System

Set up after WWII, until 1973.
Attempt to reestablish fixed exchange rates.
Reserve Currency Standard: another form of exchange rate regime.

**How it works**: currencies pegged to U.S. dollar, and dollar alone pegged to gold (gold cost $35). Dollar was the reserve currency.
Allowed for more flexibility in the system than the gold standard:

- **International Monetary Fund (IMF)**: lend currencies to country with a temporary current account deficit. Helped countries to finance a CA deficit *without* depleting the country’s foreign exchange reserves.

- **IMF Conditionality**
- **Adjustable parities**: if the IMF agrees the exchange rate is in fundamental disequilibrium, fixed at a level too far away from equilibrium, it may allow the country to change the level at which the exchange rate is fixed.
Collapse of Bretton Woods

U.S. policy in the 1960s made the Bretton-Woods system unsustainable.

U.S. attempted to use expansionary monetary policy to stimulate output and help pay for the war in Vietnam.

Graph:

The IMF did not require convertibility for capital account transactions. That is, governments were permitted to restrict the sale of domestic assets to foreigners. This was to help prevent currency speculators from destabilizing the system, as we will see shortly. Only in the 1960s did countries dismantle their capital controls.

b) Collapse of Bretton Woods

U.S. policy in 1960s made the Bretton-Woods system unsustainable. US attempted to use expansionary monetary policy to stimulate output and help pay for the war in Vietnam.

In terms of the diagram, this would shift the LM curve right. This would tend to lower the interest rate and hence lower the value of the dollar relative to gold. But because of the fixed exchange rate commitment, the US was constantly being asked to yield up its reserves.

Over time the supply of reserves became smaller and smaller, and people began to fear the US would run out of gold reserve. At that point, the US could no longer live up to its fixed exchange rate commitment, and it would have to let the value of the dollar fall.
1974–present

- Capital controls of Bretton Woods era impossible to enforce
  - arbitrage forces reassert themselves and constrain monetary autonomy under pegged rates
  - U.S. less attractive as a base
  - crisis of the Bretton Woods system

- 1973: most advanced countries elect to float
  - only way to preserve autonomy and co-exist with capital mobility (increasingly a desirable end)
  - trend to this day

- Exceptions:
  - Europe: try to preserve fixed rates through various schemes: “currency snake” and later Exchange Rate Mechanism (ERM)
  - Developing countries and emerging markets: “fears of floating” due to inflation and currency mismatches.
  - Some countries have tried “intermediate regimes”
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[Diagram:
- No monetary policy autonomy
- Hard Pegs & Currency Unions
- Intermediate Regimes
- Floating Regimes
- Fixed Exchange Rate
- Capital Mobility
- Capital controls
- Monetary Policy Autonomy
- Floating Exchange Rate
- Bretton Woods System 1946–73]