Exchange Rate Management

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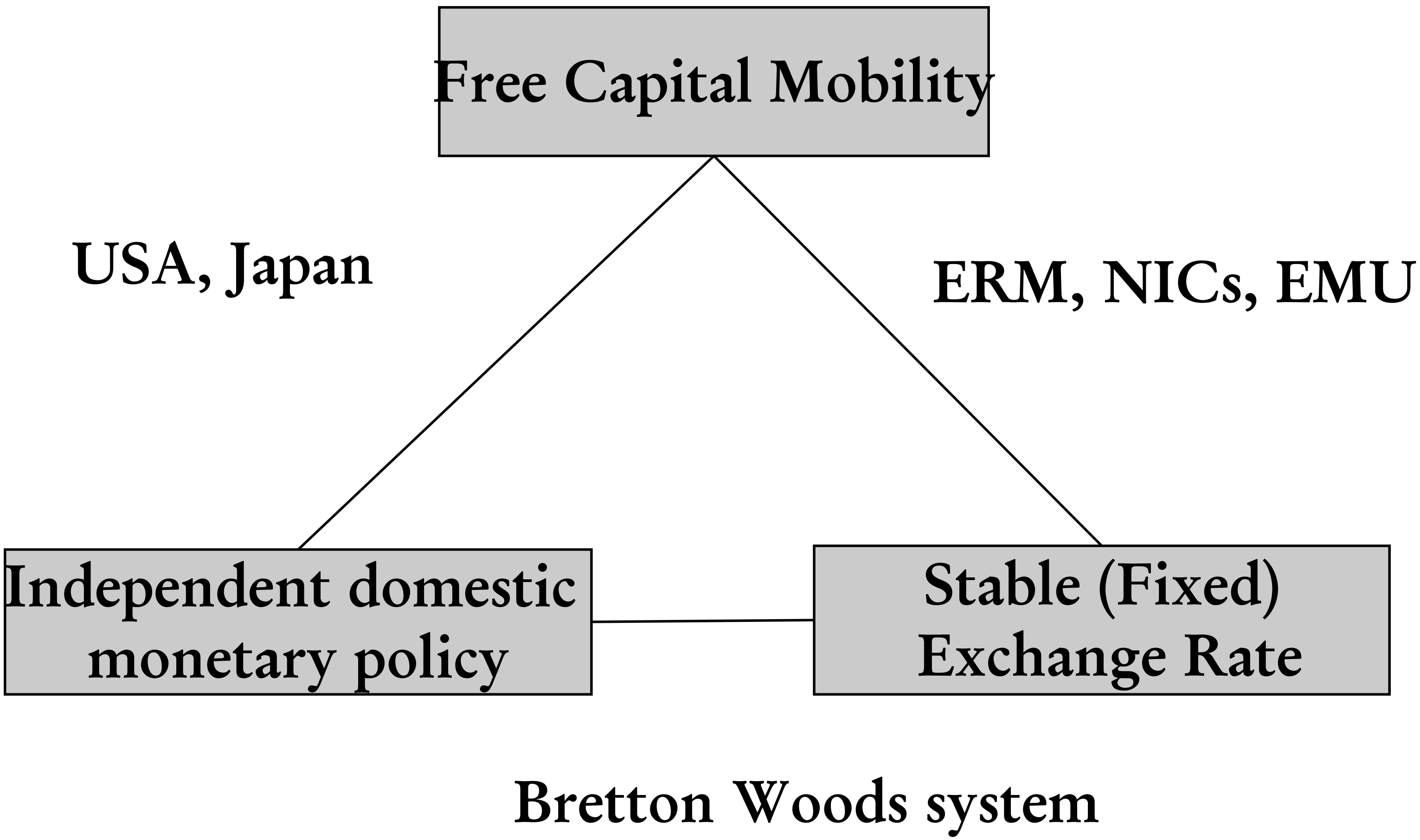
exchange rate regimes

Exchange Rate		FX Intervention
Fixed	Floating	
	Free Float	None
Gold Standard Currency Board		Automatic
Adjustable Peg	Managed Float	Some discretion

the Trinity


Free Capital Mobility
USA, Japan
ERM, NICs, EMU
Independent domestic monetary policy
Stable (Fixed) Exchange Rate
Bretton Woods system

which regime and why?

- Why does the choice of regime matter? A fixed currency may restrain the government from creating inflation.
- ‘I do not think there is any means of strapping down a really wicked Chancellor of the Exchequer.’ J.M. Keynes.
- Possible regimes:
  - Single Currency
  - Gold Standard
  - Currency Board
  - Fixed but adjustable
  - Crawling peg/Target Zone
  - Dirty Float
  - Free Float

single currency

- Germany after 1990; Euroland.
- The optimal currency area (OCA):
    - Lots of trade within the area.
    - Similar industrial structures and financial markets.
    - Flexible labour markets (when wages change, labour moves).
    - Fiscal federalism (i.e. fiscal transfers to depressed regions).

the Gold Standard

- The government of each country fixes the price of gold in terms of its own currency and maintains the convertibility of domestic currency into gold.
- Domestic money creation is tied to the government's holdings of gold.
- Adjustment to full employment is through domestic wages and prices.
- This creates a vulnerability to long and deep recessions (e.g. Britain after April 1925 and the USA between 1880 and 1896).
- 'You shall not press down upon the brow of labor this crown of thorns, you shall not crucify mankind upon a cross of gold' William Jennings Bryan.

currency boards

- Argentina, Hong Kong, Estonia, Latvia.
- Suggested for Mexico, Russia, Indonesia.
- Currency board fixes an exchange rate: monetary base is backed entirely by foreign exchange.
- Prohibited from holding any domestic assets.
- Discourages fiscal profligacy, stabilizes expectations, but may be vulnerable to shocks (e.g. cannot bale out domestic banks in a crisis).

adjustable peg and the dollar standard

- Exchange rates are normally fixed, but countries are sometimes allowed to change them.
- Under Bretton Woods, each country announced a par value for their currency in terms of US dollars (which were valued against gold) – the dollar standard.
- Faced with a balance of payments deficit under the dollar standard:
  - Countries could try to avoid monetary contraction by running down foreign exchange reserves.
  - But devaluation cannot be postponed for ever, given finite reserves.
- Expansion of US money supply in late 1960s and early 1970s spread inflation world-wide.

crawling pegs/target zones

- Latin America
- Essentially a floating exchange rate but with intervention to keep the real exchange rate roughly constant.
- Out of fashion.

floating exchange rates

- Under pure/clean floating, forex markets are in continuous equilibrium.
- The exchange rate adjusts to maintain competitiveness in the long-run.
- But in the short-run, the level of the floating exchange rate is determined by speculation.

effect of a speculative inflow

- Under floating, the nominal (and real) exchange rate rises and competiveness is lost.
- With a fixed rate, the central bank has to sell domestic currency, which causes inflation and raises the real exchange rate.
- This might destroy the peg (Malaysia, Thailand, Mexico).
- No difference in effect in the long-run but may take longer under a fixed system.

effect of monetary relaxation

- With floating rates, a cut in interest rates causes the exchange rate to fall, competitiveness rises, aggregate demand rises.
- This causes inflation which restores competitiveness back to original level.
- With fixed rates, a cut in interest rates isn’t possible if there is high capital mobility (i.e. interest rates must be equal across the world).
- More monetary discipline under fixed rates.

fixed vs floating exchange rates

- Robustness
  - Bretton Woods was abandoned when it couldn't cope with real and nominal strains.
  - A flexible system is probably more robust.
- Volatility
  - Fixed rate offers fundamental stability
  - Flexible system is potentially volatile.
    - US and UK have had twice as much (nominal and real) exchange rate volatility as Germany and France since 1980. Japan has had three times as much.
- Financial discipline
  - Fixed rate system imposes discipline and policy harmonization.

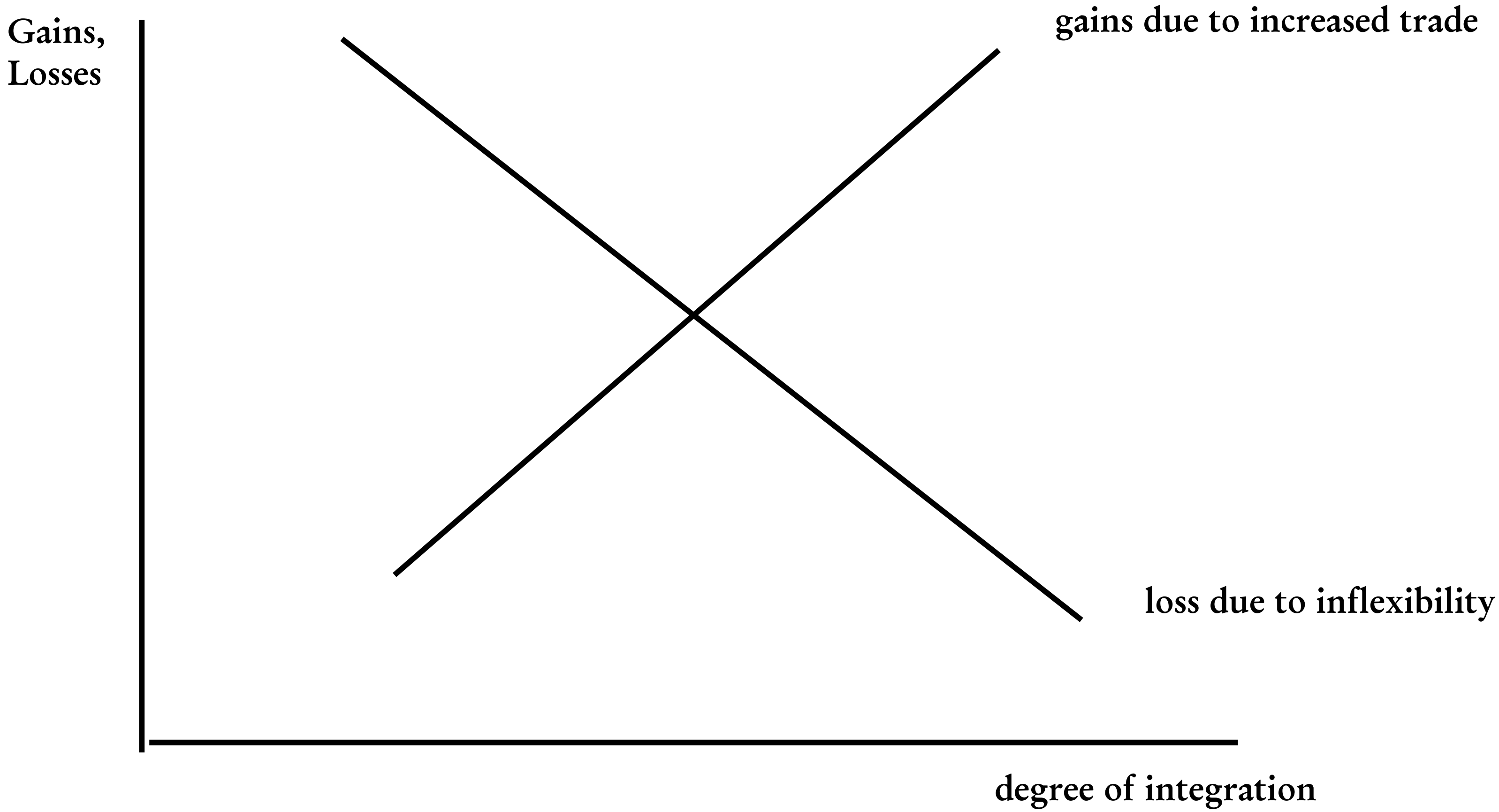
exchange rate overshooting

- Two ingredients:
  - Slowly adjusting prices.
  - Interest parity.
- If interest rates rise, for the asset market to be in equilibrium, the currency must be expected to *depreciate*. But higher interest rates will tend to reduce inflation and therefore lead to currency *appreciation*.
- The exchange rate ‘overshoots’ if, in response to a shock, it initially jumps above its long-run equilibrium and then adjusts back slowly.

the case for EMU

- No overshooting.
- Commitment to Euroland inflation rate.
- Lower transactions costs, so more trade; more open pricing, so more competition.
- But,
  - Loss of monetary independence
  - ECB anti-inflationary credentials unknown (asymmetric target, no transparency of decision making, Growth and Stability Pact)
  - Cannot use exchange rate to offset region-specific shocks.
  - ‘One size fits all’ monetary policy inappropriate for different industrial structures and financial systems.

gains and losses from EMU



Gordon Brown's five tests

- Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?
- If problems emerge, is there sufficient flexibility to deal with them?
- Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?
- What impact would entry have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?
- In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?

summary

- Move towards the two extremes (single currency in EU, floating in developing world).
- Rapid liberalization of capital movements provides threats as well as opportunities.
- No system is universally best. Generally, as long as a country is running a responsible domestic policy the choice of regime is unlikely to be important, but when it has large foreign debts or is acting irresponsibly, any exchange rate regime can become unstable.
- Benefits of EMU likely to be small and spread over a long-period of time.
- Upfront cost of entry might be huge if at too high a rate or at wrong point in business cycle (q.v. Britain in 1925, 1946 & 1990).

syndicate topics

- The world is now about as economically integrated as it was at the height of the Gold Standard (1913). Should it move back to a system of fixed exchange rates?
- How does exchange rate instability affect your firm?
- Did the IMF deal with the Asian crisis effectively?
- Will Euroland become an optimal currency area?
- What was the upfront cost of French entry into EMU?
- How did EMU entry enable Italy to sort out its fiscal profligacy?
- How sensible are Gordon Brown's five tests?