Exchange Rate Regimes

15.012 Applied Macro and International Economics

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Class Outline

- Fixed vs Flexible Exchange rates
  - Advantages and Disadvantages
  - Mixed regimes: crawling peg, dirty floating
- The International Monetary System
- Optimal Currency Areas
  - The Euro

FIXED

Disadvantages

Difficult to adjust to imbalances

Vulnerable to speculative attacks

Monetary policy ineffective

May need to raise interest rates or cause recession to defend the ER

Advantages

Stable ERs → facilitates Trade and Investment

Credibility to fight inflation and reform

Fiscal policy effective (higher rates, attracts dollars, increase in MS to avoid appreciation leads to more expansion)

FLEXIBLE

Advantages

ER adjusts to shocks and imbalances

Less vulnerable to speculative attacks

Monetary policy effective

No need to raise interest rates or cause recession to defend the ER

Disadvantages

Volatile ERs and prices →uncertain future

Harder to control or reduce inflation

Fiscal policy ineffective (higher rates, attracts capital, currency appreciates)

Monetary and Fiscal Policy

- Flexible E-rate → monetary policy is more effective
- Fixed E-rate → fiscal policy is more effective
  - Why? ↑ G → ↑IS → ↑i → attracts foreign capital → CB must buy the extra dollars & print local currency to maintain E → so also expansionary monetary policy → doble effect on Y (fiscal + monetary)
- Still, when choosing an E-rate regime, the discussion is mostly about monetary policy
  - Fiscal policy takes longer to have effects (lags)
  - In theory fiscal may be effective with fixed-e rates, but countries that introduce fixed regimes usually have no ability (tax or borrowing capacity) to have expansive fiscal policy at all

Range of E-Rate Regimes

- *Dollarization : using foreign currency (eg. Ecuador)*
- *Currency Board: Fixed E-rate + 100% reserves*
- Fixed E-Rate
- *Crawling Peg : series of announced devaluations*
- *Managed "Dirty" Floating : within +/- bands*
- Flexible (floating) E-rates

Fixed vs Flexible

- If you peg, against which currency? Dollar, Euro?
  - The "trade stability" argument suggest fixing against the currency of a large trading partner (if it is a stable currency)
- Some countries choose fixed rates not for stability or credibility, but to pursue an "undervalued" E-rate policy → promote exports
  - Trying to impact Real E-rate
  - Disadvantage? → inflation (prices catch up)
- Who can really use Flexible E-Rates?
  - Countries with credibility on the use of monetary policy → no history of mismanagement and inflation

Flexible E-rates and Inflation Targeting

- Countries with flexible e-rates can gear their monetary policies towards "inflation targeting" (IT)
  - Examples: New Zealand, England, Sweden, Canada, Chile, Brazil, Israel

    CB sets a "target" rate of inflation and adjust policy to match it
  - Important to have credible announcements
  - Since the recent financial crisis → CBs are focusing increasingly on output and financial stability

Short History of the International Monetary System

- 1880s-WWI : Gold Standard
  - Every country at fixed e-rate with gold. Price stability, surge in worldwide trade.
- WWI-1940s: Interwar Gold-Exchange & Dirty Float
  - WWI → countries printed money → later, returning to old parity was too hard (too much contraction needed). Some like UK did it. Other countries pegged to a mixture of gold and foreign exchange. Overall, failed attempts to restore credibility of the gold standard.
  - 1930s & Great Depression → most countries abandoned their pegs
- 1945-1971: Bretton Woods
  - Dollar pegs to gold & other countries peg to the dollar.
  - US plays central role: monetary policy affects all other countries
  - 60's Dollar depreciation → countries request gold → US lost gold reserves → in 1971 Nixon has to close "the gold window" (the dollar floats)

Short History of the International Monetary System

- 1970s : Floating Exchange rates, Oil Shocks and Inflation
- 1979: ERM in Europe, eventually the Euro in 1999
- 1980s/90s:
  - Volker and a strong dollar → 1985 Plaza Accord → dollar starts to depreciate → 1987 Louvre Accord
  - Developed countries: free or managed floating
  - Developing countries: fixed-exchange rates for stability and credibility

Present and Future

- Today, many countries officially have "free floating" regimes, but intervene actively to avoid swings in E-rates → need to balance between E and inflation
- Success or failure of the Euro can have a strong impact on the future of the international monetary system

Optimal Currency Areas

- Mundell (1961)
- A single currency makes more sense if:
  - Countries have more trade between themselves
  - Subject to similar shocks (not asymetric)
  - Labor/Capital can move freely between them
  - There is a fiscal mechanism to help struggling countries and compensate for the lack of country-level monetary policy

The Euro

- ERM 1979-early 90s
  - Managed float among European countries
  - German Mark is the reference currency in practice
  - 1990 Germany reunification → higher rates in Germany to avoid inflation → UK in recession → UK cannot expand money supply (fixed E-rate) → has to leave ERM in 1993
  - So ERM bands were enlarged (+/-15%)

Economic Integration

- Border controls scaled back or eliminated
- Standardization of regulations
- National procurement (government purchases)
- Harmonization of value-added taxes
- Services
  - Deregulation of financial markets
  - Rights of establishment and marketing across borders

Maastricht 1991

- Maastricht Criteria to join monetary union:
  - **Inflation**: no more than 1.5% above the average inflation rate of the lowest 3 inflation countries in the EU
  - **Interest rates**: the long-term rate should be no more than 2% above the average of the 3 countries with the lowest inflation
  - **Budget deficit**: no more than 3% of GDP
  - **National debt**: no more than 60% of GDP
  - **Exchange rates**: currency within the normal bands of the ERM with no re-alignments for at least 2 years

The EU Countries

16 in the Euro:
France, Germany,
Italy, Austria, Spain,
Benelux, Portugal,
Ireland, Finland,
Greece, Slovenia,
Cyprus, Malta, Slovakia

Opted out of Euro:
Sweden, Denmark,
UK

Not in EU:
Iceland, Switzerland,
Norway

The Euro

- January 1st 1999
- Countries adopt the Euro and cede monetary policy to the European Central Bank
- ECB mandate: price stability (not E-stability)