Fixed or Flexible Exchange Rates?

History and Perspectives

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Vernon Series in Economics

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Introduction

After the Second World War, the United States of America became the financial center of the West. Most of the international agreements after the war, such as the *Bretton Woods* or the *Marshall Plan* in Europe, endorsed the position of prominence of the United States and at the same time tried to avoid monetary and trade tensions that had characterized the years following 1945. With the agreement of *Bretton Woods* the convertibility of US dollar was 35 dollars per "ounce" in fixed exchange rates; the main scope of this agreement was the pledge of all participants to put into effect the full convertibility of their currencies and the gradual abolition of foreign exchange controls created after the great depression during the thirties.

The system of fixed exchange rates or "dollar-gold" standard was constituted by a combination of laws, commitments and conventions by which the United States (inner country) fixed its currency to gold and the outer countries fixed their currencies to the US dollar, either directly or indirectly through another currency (such as the pound sterling, the mark or the franc). All these elements quickly restored a world-wide system of free exchange, while the Marshall Plan helped with financing the reconstruction of West, creating at the same time an open market for the United States products.

The *International Monetary Fund (IMF)*, which grew out of *Bretton Woods*, became an international institution invested with the power of regularizing the international monetary system in order to prevent liquidity, scarcity and competitive devaluation. Until the 1970s the United States carried out the role of a central bank which created currency and regularized credit expansion. The dollar became a universal currency accepted for international payments, therefore the exchange rate stability and international flow of goods and capitals depended on the dollar's stability. The United States in many aspects had acquired the position of Great Britain in the 19th century.

In the last forty years, international organizations such as IMF and World Bank have taken on important weight in global monetary decisions, although there were likewise other national and interregional organisms like Federal Reserve in the United States, and later the foundation of the European Central Bank in Europe to which all EU members gave up their monetary sovereignty for the creation of monetary union.

The debate about fixed or flexible exchange rates began in the early 1950s when Milton Friedman wrote his first influential paper, "The Case for Flexible

Exchange Rates" (1953). It developed further in the 1960s when the *Bretton Woods* system was in crisis, and the prevalent opinion moved in favor of flexibility of exchange rates. Furthermore, the publication of *Optimized Currency Areas Theory* by Robert Mundell (1961) opened another front on the debate about the exchange rates as never seen before. Although more than six decades have passed, the debate about fixed or flexible exchange rates is still relevant today as it was in the 1950s.

The aim of this work is to reconsider at length the monetary debate on fixed versus flexible exchange rates, and theories regarding the optimum currency areas.

The Bretton Woods System

In July 1944, before the Great War ended, an international conference took place at Bretton Woods, New Hampshire (USA) that had its main mission to carry out the creation of the International Monetary Fund (IMF) an international organization which was supposed to be created after WWII to manage the control of international payments. The *Bretton Woods* system was developed by two important protagonists of that time, the American minister of state in the U.S. treasury, Harry Dexter White, and the renowned British economist, John Maynard Keynes.

According to the White's plan, an International Bank for Reconstruction (today the World Bank) and an International Stabilisation Fund (later the IMF) were to be established in order to help different countries reconstruct their damaged economies and ease the problem of balance of payments. Keynes, in general, agreed on this plan although he had another idea. Keynes wanted to vest the IMF with possibilities to create money and with the authority to take actions on a much larger scale on the stabilisation of international finance. In case of balance of payments imbalances, Keynes suggested that both sides, debtors and creditors, should reach an accord and adjust their strategies to achieve the equilibrium in the foreign trade. In few words, countries with payment surpluses should enhance their imports from the deficit countries and in so doing generate foreign trade equilibrium. Harry Dexter White, alternatively saw the imbalance of payments as an issue only for the deficit country. However, Keynes' plan was not taken into consideration as it was not realistic and participants of the Bretton Woods' conference agreed on the White's plan.

The new monetary order created after the Great War was quite different from the pre-war situation. Exchange rates continued to be fixed. Alignments without the previous consensus of the IMF were forbidden. The newly created IMF was provided with its own financial resources in order to guarantee that countries in difficulty with their balance of payments had access to alternative

solutions to devaluation. The exchange rates demanded the official declaration of fixed parity as a central value based on the gold unit or the U.S. dollar and all monetary authorities were expected to maintain the market value of their currencies within 1% of the central parity. The United States fixed the price of gold but the new system was not a real international gold standard, and the *Bretton Woods* agreement represented a compromise between gold standard and dollar standard in which both dollar and gold were used as reserves.

The controls on exchange rates and custom tariffs were admitted as a temporary solution to the post-war situation. In reality, the full convertibility of European currencies came only in 1958 although most of the underdeveloped countries did not have convertible currencies and still held the control over capital flows. Officially all currencies were convertible in gold terms. At the end of the Second World War, the U.S. held 70% of all gold reserves and was the only country sufficiently credible for fixing a parity with gold. Gold remained the principal standard although all the currencies were linked to gold through the dollar. The system therefore was based on the ability of the U.S. to maintain the declared fixed parity of $35 per ounce of gold. The use of the dollar as a currency for international transactions implied that the U.S. must continue its deficit balance of payments in order to supply liquidity to other countries.

The volume of financing of international exchanges depends, according to the *Bretton Woods* agreement, on gold production not absorbed from private uses and price variations. The impossibility of financing the increasing volume of international trade with the flow of new “monetary” gold and the opposition of the United States to devaluate the dollar, aggravated the American deficit balance of payments.

At the end of the 1960s and the beginning of the 1970s the increase of American public expenditures for the war in Vietnam and the extension of charitable and social security programs accelerated economic growth and at the same time worsened the deficit payments. Some industrialized western countries were skeptical about the benefits of the international monetary system and made known their protests. Much criticism was aimed at the American government for the monetary policy of seigniorage in order to finance the economic growth and the war efforts in Vietnam. The U. S. policy was overly expansionist. During the first half of the 1960s, the French government decided to exchange US dollars with gold for increasing the inventory of gold. In fact, the French gold stock increased from 3.7 to 5.2 billion dollars between 1964 and 1966. The international markets took into consideration this fact and pressed the monetary authorities of many countries of the *Gold Pool* (Belgium, Holland, Switzerland, Italy, West

Germany, United Kingdom and the USA), to sell gold in order to maintain the parity of 35 dollars per ounce. Rather than bring on a total collapse of the system, the countries changed their mode of operation.

However, the reduction of official gold reserves was accelerated, and the gold pool countries went out from the international gold market and declared that they would change gold to the official price only between themselves but not from private agents. On the free market, the gold was changed to a much higher price than the official one. The internal tension of Gold Pool countries grew until President Nixon's historic decision, on August 15, 1971, to suspend the parity of the dollar with gold. That decision ended the Bretton Woods system.

The Exchange Rates Policy after Bretton Woods

The collapse of the *Bretton Woods* system was an initial manifestation of the growing contradiction between the intrinsic tendency of the productive forces to develop on a global scale and the nation-state system.

The slide to flexible exchange rates in 1971, after systemic crises and the inconvertibility of the dollar, did not come as a result of international conference agreement (as in the case of Bretton Woods) or IMF decision but was a unilateral action of the United States when President Nixon took the dollar off. Then the major western countries took their currencies off the dollar. Although, from a political standpoint the agreement to move to a flexible exchange rate was a decision made in 1973 by three men, George Schultz, US Secretary of the Treasury, Giscard d'Estaing, Minister of Finance in France, and Helmut Schmidt, Minister of Finance in Germany. George Schultz was a distinguished labor economist and had been a colleague of Milton Friedman at the University of Chicago in the 1960s, and later become Secretary of Treasury in Nixon's cabinet (Mundell, R. A., 2001, 15).

Milton Friedman was one of the first economists to assert that the only motivation behind variations of exchange rates was the differential of inflation and that flexibility was necessary in order to maintain the Purchasing Parity Power (PPP). If the hypothesis of Purchasing Parity Power was verified and the variations of exchange rates compensated for the differential of inflation, we would have a relatively constant real exchange rate or at least exchange rates characterized by a regular course. But in reality, things seem to be different, the cause of exchange rate variation is often connected to competitive structural changes in the economy. From an economic standpoint, the real exchange rate in equilibrium changes, but these changes are not very frequent and sometimes continue for a long time. This indicates that the real exchange rate does not always correspond to fundamental structural changes. These oscillations can be also presented as the product of

monetary forces or *overshooting*. The thesis against fixed rates proves that we do not really know the exact value of the exchange rate. This implies that those who are called to address the exchange rates of one country do not always have a solid basis for fixing and defending the right parity. The overvaluation or undervaluation of fixed exchange rates is often a result of political pressures; an argument that in the absence of a clear rule for the fixation of the parties, monetary authorities probably base their decisions on political convenience.

A prominent Nobel-prize economist, Robert Mundell, agreed that Bretton Woods was not perfect because big countries did not follow the rules of adjustment formally introduced by the system from the beginning. For example, Britain and the United States in the 1960s automatically sterilized reserve losses, throwing the burden of adjustment on other countries. The period from 1950 to 1970 was a period of rapid growth for all the western countries and Japan. Many countries, during this period, simply did not follow the rules of a fixed exchange rate system due to the problems with their monetary system. The developing countries tried to use the inflation tax as an instrument of financing economic growth.

According to Mundell[1], there are at least two main reasons for the collapse of Bretton Woods System: the first one is the undervaluation of the gold anchor. The price of gold was politically decided by President Roosevelt administration at $35 per ounce since 1934, and had become obsolete and undervalued especially after the rise of inflation between 1959 and 1970 and during the Korean and Vietnam War[2]. Most of the consumer prices were more than doubled and the price of gold was undervalued.

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[1] "One World, One Money" Robert Mundell and Milton Friedman debate the virtues – or not – of fixed exchange rates, gold, and a world currency. *The Canadian Financial Post*, 14 November- 14 December 2000, conceived and organized by editor-in-chief Terence Corcoran. Re-printed in Mundell R. and Friedman M. (2001), "One World, One Money", *Policy Options* (May), 20.

[2] For political reasons the two biggest producers of gold in the World were South Africa and Soviet Union. South Africa during 1970s was doing a noxious policy of apartheid against the principles of democracy; meanwhile Soviet Union was the historical enemy of the west during the cold war. At this time the credibility of US was at stake so the US rejected the Bretton Woods solution, provided by the IMF *Articles of Agreement*, for a reduction in the par value of currencies, raising the price of gold. At the beginning of 1970s the US lose more than half of its post-war gold stocks and the west countries asked further the US authorities to convert dollars into gold, the United States didn't accepted it and the Bretton Woods system failed.

The second reason is the difference between the inflation objectives of the United States and Europe. The United States, in order to finance the war in Vietnam, imposed on the rest of the world a higher rate of inflation than was optimal for Europe. Consequently, western European countries chose the flexible exchange rate system, sacrificing the valuable convergence with one another, which their economies had achieved around the fixed dollar after the Second World War. Europe was trying to create a rival to the dollar in the form of a new European currency that would be easy to deal with the fixed exchange system.

Friedman agreed with Mundell (Mundell and Friedman 2001, 21-23) in many aspects regarding the benefits of fixed exchange rates but he wanted to add that fixed exchange rate system had a great defect: a country that expands its monetary supply (for example the United States) can benefit by imposing costs on other members of the system until these countries must accept its currency at an unchanged rate. When the exchange rate is changed, and the inflation is not more sustainable, so the rules are broken, the system naturally cannot have any reason to survive. Friedman, differently from Mundell, argues that a major advantage of a flexible rate is that a country will bear the benefits and the costs of its own monetary policy fully. If a country during the flexible rates system expands its monetary policy, will not directly affect all the system and its trading partners but rather indirectly by reducing investment and trade flow. This process is very important not only economically but also politically because it reduces the occasions for international conflicts. Flexible exchange rates offered a way of adjusting monetary and fiscal policies through the market without political conflicts. So Friedman's "verdict", is that the *Bretton Woods* system failed because the fixed exchange rates system was not able to avoid economic and political conflicts in the long run.

The elimination of the gold backing from the US dollar was quickly followed by the ending of fixed currency relationships and the lifting of most of the restrictions on the movement of capital, throughout the 1980s, since several countries were forced to ditch national controls under the rising pressure of international markets. The result has been a series of storms and crises within the international financial system. As a matter of fact, in 1987, differences between the US and German monetary authorities over interest rate policies contributed directly to the October stock market collapse. In order to avoid a global collapse and recession, monetary authorities led by the US Federal Reserve injected large amounts of liquidity into the international financial system. These actions prevented a financial crisis with major consequences for the trade between Europe and North America.

The decade of the 1990s was full of regional financial crisis. It started with the British sterling crisis of 1992, followed two years later by the turmoil in

bond markets in 1994 and the Mexican bailout of 1994-95. In 1997, the Asian crisis arrived, followed by the Russian default of 1998 and subsequent danger to the US financial system in the wake of the collapse of long-term capital management in September 1998. The 2008 financial crisis and the global recession that followed put more pressure on the global financial system worldwide.

The implications of the growing size and the speculative nature of financial movements in the times of globalisation called for a "new system of *Bretton Woods*". In 1996, Michel Camdessus, the Managing Director of the IMF, stated that despite the monetary system had changed since 1944 the goals of *Bretton Woods* were as valid today as they had been in the past. He highlighted that international cooperation would be required to create a new *Bretton Woods* system, which in his view means that countries must make a greater effort to understand the economic policies of other countries and they must listen to the judgement of others about their own national policies (Camdessus, M. 1996).

The main objective of this book is to focus on the longstanding monetary debate on fixed versus flexible exchange rates, and theories related to optimum currency areas and monetary unions. The monetary debate will be introduced in a historical context by taking into consideration a variety of views, opinions, historical facts and theories since the end of WWII to present. The new developments in global currency areas and monetary unions will give more insights into the evolution of the national currencies and exchange rates.

The Structure of the Book

The book is divided into six chapters, each of them containing a considerable number of segments with tables and illustrations. Chapter one discusses the role of exchange rates in the balance of payments theories after the WWII and the convertibility of national currencies to the gold standard. Chapter two will take into account the discussion about the theories of capital mobility, fiscal policy and dynamic adjustment under alternative exchange-rate systems. This chapter will also focus on the credibility of monetary policy and the role of a central banker on optimal contracts. Chapter three investigates in depth the long-lasting monetary debate on fixed versus flexible exchange rates, exchange rate regime classifications and shock absorbers.

Chapter four explores the theories about optimum currency areas and the creation of monetary unions. In addition, chapter four will also deal with costs and benefits of a common currency, the centralized monetary policy in a monetary union and the debate over fiscal federalism. Chapter five, among others, discusses the recent theories on current financial crisis and

unconventional monetary policies. It also explores the impact of quantitative easing on interest rates, exchange rates, fiscal policy and considers other unconventional monetary concepts such as balance-sheet recession, etc. Chapter six discusses in depth the new approaches of new exchange rates theories developed in recent years.

Chapter 1

Exchange Rates and Balance of Payments Theories

Introduction

In the late fifties of the last century, the discussion of possible arrangements for international payments and liquidity was reopened. The opinion of economists was that the balance of payments of the United States was in disequilibrium and that the international monetary arrangements in place were showing inadequate structural soundness. Some of them tried to consider the case for flexible exchange rates as a method of dealing with the problems of international liquidity and balance-of-payments equilibrium. The system of flexible exchange rates, different from *Bretton Woods* system, was considered to offer, under ideal circumstances, a solution to problems of both international liquidity and external equilibrium. One of the main objections to the gold standard system was that it served as the mechanism by which a depression originated in one part of the world was transmitted throughout the rest of the world. Under gold standard regime, there was a high degree of positive correlation between the rate of output in one part of the world and output elsewhere (Laursen S. and Metzler A. 1950).

Two well-known economists in early fifties - Laursen and Metzler (1950) - proposed the flexible exchange rates as an alternative of fixed exchange rates to break the link between the output of individual countries and the fluctuations of the world demand. Professor James Meade, instead, deals with the balance of payments, international labor and capital movements between nations maintaining at the same time full employment domestically. Other advocates of flexible exchange rates like Milton Friedman and Egon Sohmen provide greater room for maneuver for monetary policymakers. Policy makers are free to use monetary supply for other macroeconomic policies such as stabilizing employment or inflation. This chapter will discuss some of the issues related to the application of flexible exchange rates to the balance of payments, convertibility to gold standard and demand elasticities after the WW II.

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