



Chapter 19

Macroeconomic Policy and Coordination
under Floating Exchange Rates

Chapter Organization



- The Case for Floating Exchange Rates
- The Case Against Floating Exchange Rates
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- What Has Been Learned Since 1973?
- Are Fixed Exchange Rates Even and Option for Most Countries?
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Introduction



- The floating exchange rate system, in place since 1973, was not well planned before its inception.
- By the mid-1980s, economists and policymakers had become more skeptical about the benefits of an international monetary system based on floating rates.
- Why did the performance of floating rates seem disappointing at the time?
- What direction should reform of the current system take?
- This chapter compares the macroeconomic policy problems of different exchange rate regimes.

The Case for Floating Exchange Rates



- There are three arguments in favor of floating exchange rates:
 - Monetary policy autonomy
 - Symmetry
 - Exchange rates as automatic stabilizers

The Case for Floating Exchange Rates



- **Monetary Policy Autonomy**
 - Floating exchange rates:
 - Restore monetary control to central banks
 - Allow each country to choose its own desired long-run inflation rate

The Case for Floating Exchange Rates



- **Symmetry**
 - Floating exchange rates remove two main asymmetries of the Bretton Woods system and allow:
 - Central banks abroad to be able to determine their own domestic money supplies
 - The U.S. to have the same opportunity as other countries to influence its exchange rate against foreign currencies

The Case for Floating Exchange Rates

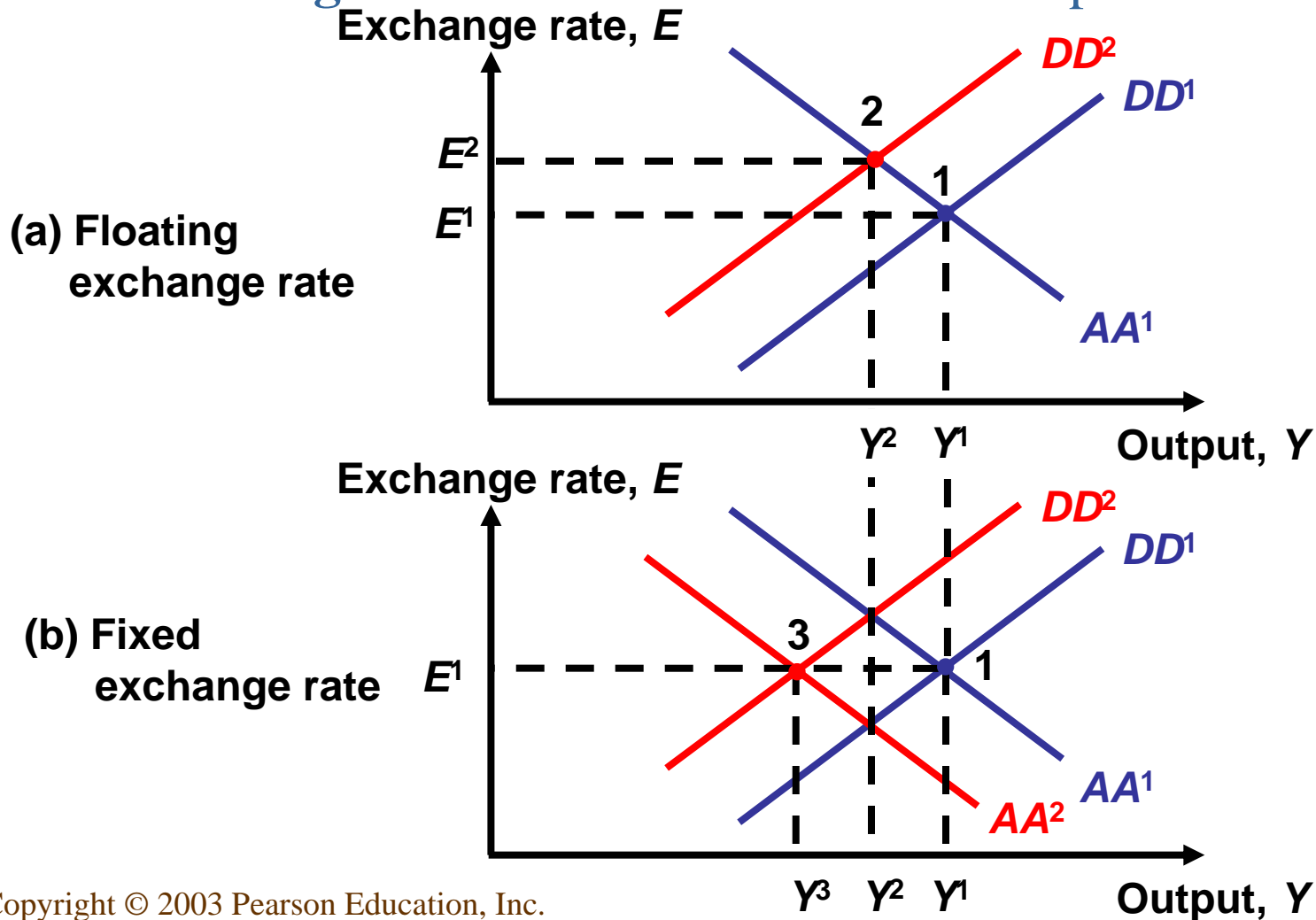


- Exchange Rates as Automatic Stabilizers
 - Floating exchange rates quickly eliminate the “fundamental disequilibriums” that had led to parity changes and speculative attacks under fixed rates.
 - Figure 19-1 shows that a temporary fall in a country’s export demand reduces that country’s output more under a fixed rate than a floating rate.

The Case for Floating Exchange Rates



Figure 19-1: Effects of a Fall in Export Demand



The Case Against Floating Exchange Rates



- There are five arguments against floating rates:
 - Discipline
 - Destabilizing speculation and money market disturbances
 - Injury to international trade and investment
 - Uncoordinated economic policies
 - The illusion of greater autonomy

The Case Against Floating Exchange Rates



■ Discipline

- Floating exchange rates do not provide discipline for central banks.
 - Central banks might embark on inflationary policies (e.g., the German hyperinflation of the 1920s).
- The pro-floaters' response was that a floating exchange rate would bottle up inflationary disturbances within the country whose government was misbehaving.

The Case Against Floating Exchange Rates

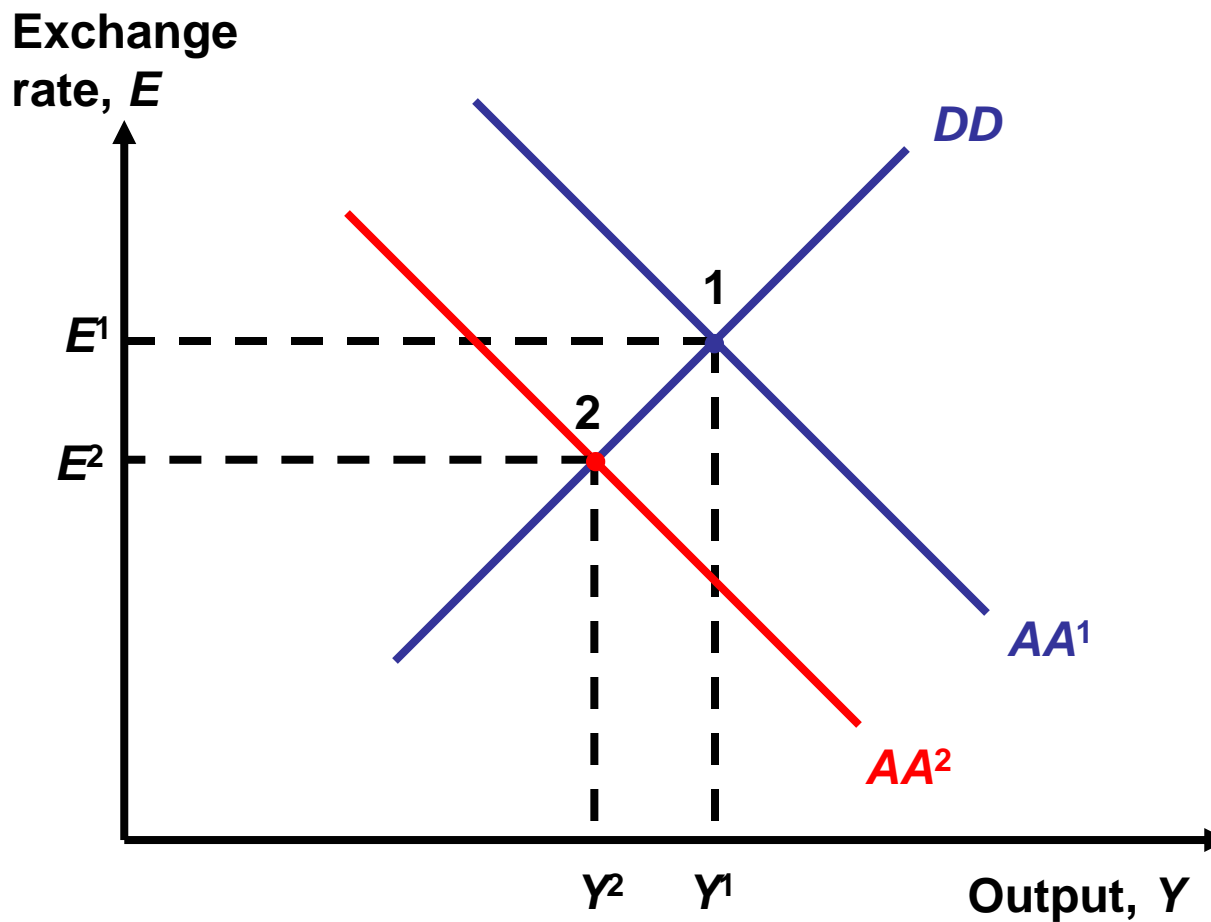


- Destabilizing Speculation and Money Market Disturbances
 - Floating exchange rates allow **destabilizing speculation**.
 - Countries can be caught in a “vicious circle” of depreciation and inflation.
 - Advocates of floating rates point out that destabilizing speculators ultimately lose money.
 - Floating exchange rates make a country more vulnerable to money market disturbances.
 - Figure 19-2 illustrates this point.

The Case Against Floating Exchange Rates



Figure 19-2: A Rise in Money Demand Under a Floating Exchange Rate



The Case Against Floating Exchange Rates



- **Injury to International Trade and Investment**
 - Floating rates hurt international trade and investment because they make relative international prices more unpredictable:
 - Exporters and importers face greater exchange risk.
 - International investments face greater uncertainty about their payoffs.
 - Supporters of floating exchange rates argue that forward markets can be used to protect traders against foreign exchange risk.
 - The skeptics replied to this argument by pointing out that forward exchange markets would be expensive.

The Case Against Floating Exchange Rates



- **Uncoordinated Economic Policies**
 - Floating exchange rates leave countries free to engage in competitive currency depreciations.
 - Countries might adopt policies without considering their possible beggar-thy-neighbor aspects.

The Case Against Floating Exchange Rates



■ The Illusion of Greater Autonomy

- Floating exchange rates increase the uncertainty in the economy without really giving macroeconomic policy greater freedom.
 - A currency depreciation raises domestic inflation due to higher wage settlements.

Macroeconomic Interdependence Under a Floating Rate

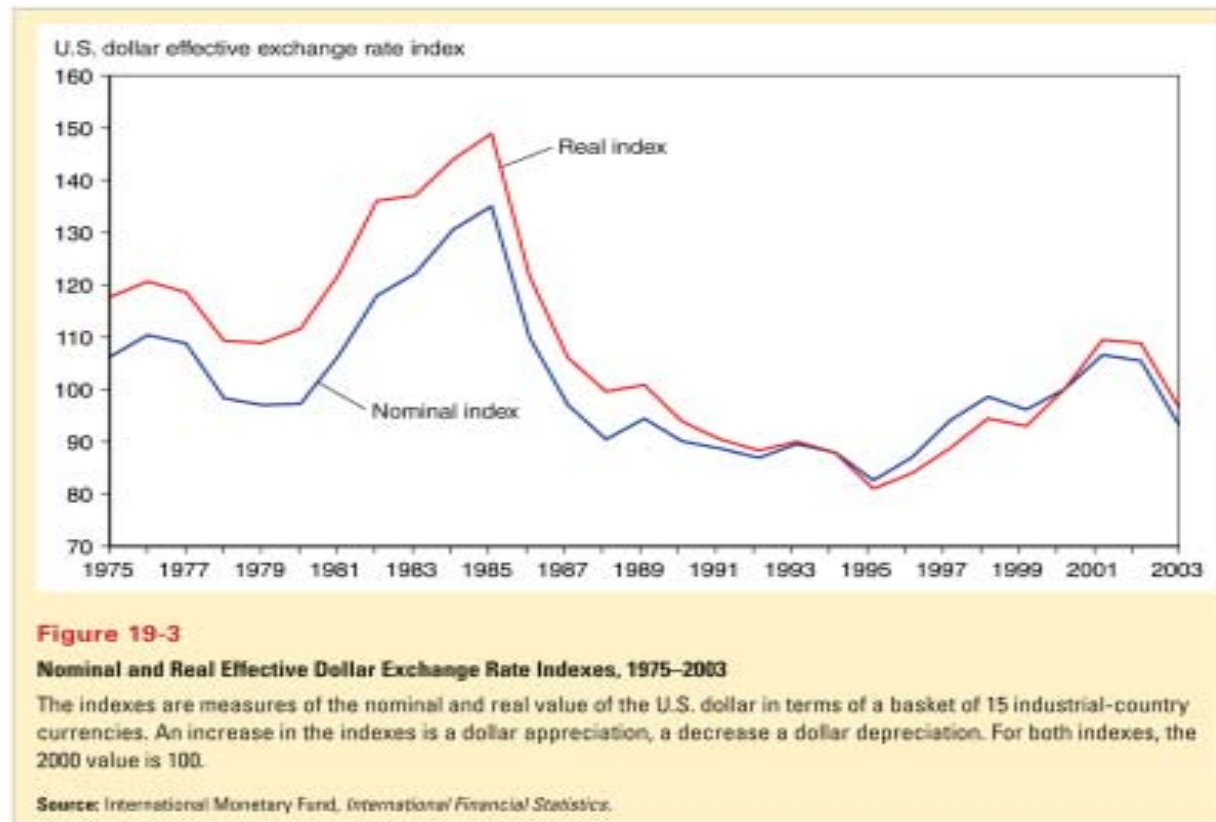


- Assume that there are two large countries, Home and Foreign.
- Macroeconomic interdependence between Home and Foreign:
 - Effect of a permanent monetary expansion by Home
 - Home output rises, Home's currency depreciates, and Foreign output may rise or fall.
 - Effect of a permanent fiscal expansion by Home
 - Home output rises, Home's currency appreciates, and Foreign output rises.

Experience after 1973



Nominal and Real Effective Dollar Exchange Rates Indexes, 1975-2003



Source: International Monetary Fund, *International Financial Statistics*.

Experience after 1973



- First OPEC shock – recycling of petrodollars
- Takeoff of inflation in mid-1970s
- Iranian revolution and second OPEC shock
- Disinflation in US, UK, European Monetary System after late 1970s – high US interest rates – int'l coordination problems?
- Reagan deficits and massive dollar appreciation
- 1982 – LDC debt crisis begins
- Plaza accord to bring dollar down – September 1985
- Louvre accord of major industrial countries to stabilize dollar – February 1987

Experience after 1973



- US eliminates fiscal deficit under Clinton – 1990s a decade of powerful US growth and low inflation
- Japan asset-price bubble collapses (ca. 1990) – 15 years of stagnation follow
- Fall of Berlin wall (1989), German unification, EMU plans, euro launch (1999), sluggish European growth
- Asian financial and currency crises (1997-98)
- Bush II tax cuts (early 2000s) and emergence of big US CA deficit
- Emergence of China as a major global player

Experience after 1973



Inflation Rates in Major Industrialized Countries

TABLE 19-1 Macroeconomic Data for Key Industrial Regions, 1963–2005

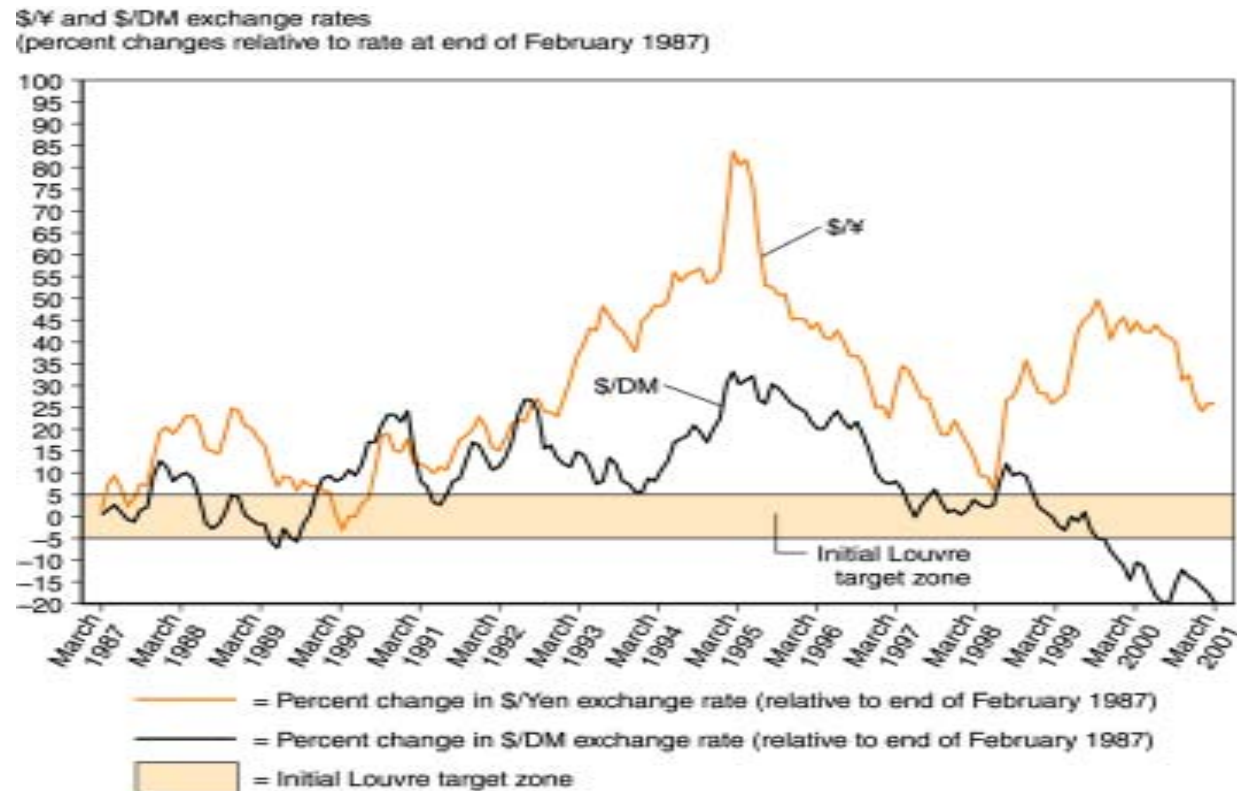
Period	1963–1972	1973–1982	1983–1992	1993–2002	2003	2004	2005
Inflation (percent per year)							
United States	3.3	8.7	4.0	2.6	2.3	3.0	3.0
Europe	4.4	10.7	5.1	2.4	2.0	2.2	2.0
Japan	5.6	8.6	1.8	0.2	−0.2	−0.2	−0.2
Unemployment (percent of labor force)							
United States	4.7	7.0	6.8	5.2	6.0	5.5	5.4
Europe	1.9	5.5	9.4	9.6	8.9	9.0	8.7
Japan	1.2	1.9	2.5	3.9	5.3	4.7	4.5
Per-Capita Real GDP Growth (percent per year)							
United States	2.8	0.9	2.4	2.1	2.0	3.3	2.5
Europe	3.9	2.0	3.0	2.0	−0.1	1.9	1.9
Japan	8.5	2.9	3.4	0.7	2.3	4.3	2.3

Source: International Monetary Fund. Some data are IMF forecasts.

Experience after 1973



Exchange Rate Changes Since the Louvre Accord



The dollar prices of the German and Japanese currencies took wide swings after the February 1987 Louvre meeting despite an initial international agreement to keep those exchange rates within bands 10 percent wide.

Source: International Monetary Fund, *International Financial Statistics*.

What Has Been Learned Since 1973?



■ Monetary Policy Autonomy

- Floating exchange rates allowed a much larger international divergence in inflation rates.
- High-inflation countries have tended to have weaker currencies than their low-inflation neighbors.
- In the short run, the effects of monetary and fiscal changes are transmitted across national borders under floating rates.

What Has Been Learned Since 1973?



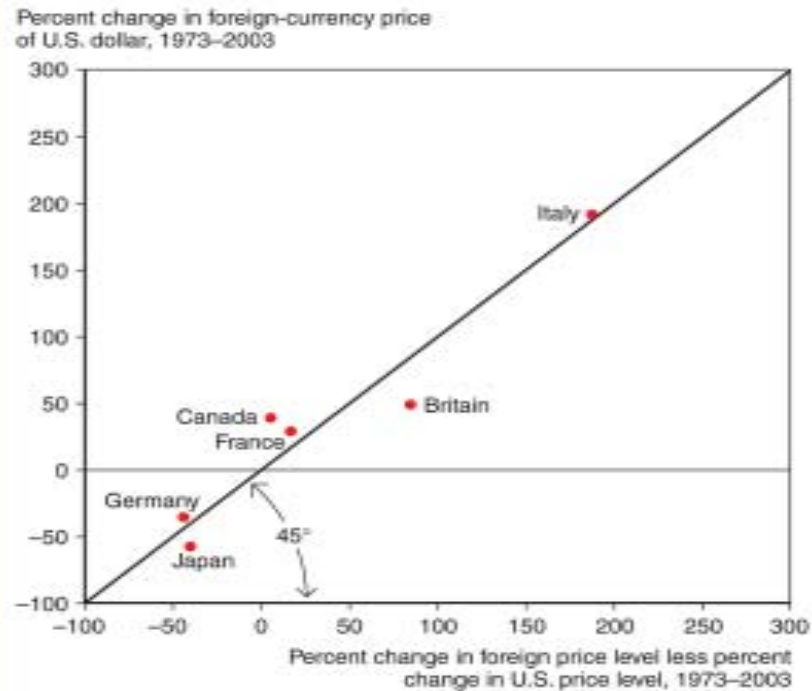
Exchange Rate Trends and Inflation Differentials, 1973-2003

Figure 19-4

Exchange Rate Trends and Inflation Differentials, 1973-2003

Over the floating-rate period as a whole, higher inflation has been associated with greater currency depreciation. The exact relationship predicted by relative PPP, however, has not held for most countries. The inflation difference on the horizontal axis is calculated as $(\pi - \pi_{US}) \div (1 + \pi_{US}/100)$ using the exact relative PPP relation given in footnote 1 on p. 372.

Source: International Monetary Fund and Global Financial Data.



What Has Been Learned Since 1973?



- After 1973 central banks intervened repeatedly in the foreign exchange market to alter currency values.
- Why did central banks continue to intervene even in the absence of any formal obligation to do so?
 - To stabilize output and the price level when certain disturbances occur
 - To prevent sharp changes in the international competitiveness of tradable goods sectors
- Monetary changes had a much greater short-run effect on the real exchange rate under a floating nominal exchange rate than under a fixed one.

What Has Been Learned Since 1973?



■ Symmetry

- The international monetary system did not become symmetric until after 1973.
 - Central banks continued to hold dollar reserves and intervene.
- The current floating-rate system is similar in some ways to the asymmetric reserve currency system underlying the Bretton Woods arrangements (McKinnon).

What Has Been Learned Since 1973?



- **The Exchange Rate as an Automatic Stabilizer**
 - Experience with the two oil shocks favors floating exchange rates.
 - The effects of the U.S. fiscal expansion after 1981 provide mixed evidence on the success of floating exchange rates.

What Has Been Learned Since 1973?



■ Discipline

- Inflation rates accelerated after 1973 and remained high through the second oil shock.
- The system placed fewer obvious restraints on unbalanced fiscal policies.
 - Example: The high U.S. government budget deficits of the 1980s and today.

What Has Been Learned Since 1973?



■ Destabilizing Speculation

- Floating exchange rates have exhibited much more day-to-day volatility.
 - The question of whether exchange rate volatility has been excessive is controversial.
- In the longer term, exchange rates have roughly reflected fundamental changes in monetary and fiscal policies and not destabilizing speculation.
- Experience with floating exchange rates contradicts the idea that arbitrary exchange rate movements can lead to “vicious circles” of inflation and depreciation.

What Has Been Learned Since 1973?



■ International Trade and Investment

- International financial intermediation expanded strongly after 1973 as countries lowered barriers to capital movement.
- For most countries, the extent of their international trade shows a rising trend after the move to floating.

What Has Been Learned Since 1973?



■ Policy Coordination

- Floating exchange rates have not promoted international policy coordination.
- Critics of floating have not made a strong case that the problem of beggar-thy-neighbor policies would disappear under an alternative currency regime.

Are Fixed Exchange Rates Even an Option for Most Countries?



- Maintaining fixed exchange rates in the long-run requires strict controls over capital movements.
 - Attempts to fix exchange rates will necessarily lack credibility and be relatively short-lived.
 - Fixed rates will not deliver the benefits promised by their proponents.
 - A “bipolar” world? (see Fischer article in Further Reading for Chapter 22)

Directions for Reform



- The experience of floating does not fully support either the early advocates of that exchange rate system or its critics.
- One unambiguous lesson of experience is that no exchange rate system functions well when international economic cooperation breaks down.
- Severe limits on exchange rate flexibility are unlikely to be reinstated in the near future.
- Increased consultation among policymakers in the industrial countries should improve the performance of floating rates.

Summary



- The weaknesses of the Bretton Woods system led many economists to advocate floating exchange rates before 1973 based on three arguments:
 - Floating rates would give countries greater autonomy in managing their economies.
 - Floating rates would remove the asymmetries of the Bretton Woods system.
 - Floating rates would quickly eliminate the “fundamental disequilibriums.”

Summary



- Critics of floating rates advanced several counterarguments:
 - Floating would encourage monetary and fiscal excesses and beggar-thy-neighbor policies.
 - Floating rates would be subject to destabilizing speculation and retard international trade and investment.

Summary



- Between 1973 and 1980 floating rates seemed on the whole to function well.
- A sharp turn toward slower monetary growth in the U.S. contributed to massive dollar appreciation between 1980 and early 1985.
- The experience of floating does not fully support either the early advocates of that exchange rates system or its critics.

Appendix: International Policy Coordination Failures



Figure 19A-1: Hypothetical Effects of Different Monetary Policy Combinations on Inflation and Unemployment

		Foreign	
		Somewhat restrictive	Very restrictive
Home	Somewhat restrictive	$\Delta\pi^* = -1\%$ $\Delta U^* = 1\%$ $\Delta\pi = -1\%$ $\Delta U = 1\%$	$\Delta\pi^* = -2\%$ $\Delta U^* = 1.75\%$ $\Delta\pi = 0\%$ $\Delta U = 0.5\%$
	Very restrictive	$\Delta\pi^* = 0\%$ $\Delta U^* = 0.5\%$ $\Delta\pi = -2\%$ $\Delta U = 1.75\%$	$\Delta\pi^* = -1.25\%$ $\Delta U^* = 1.5\%$ $\Delta\pi = -1.25\%$ $\Delta U = 1.5\%$

Appendix: International Policy Coordination Failures



Figure 19A-2: Payoff Matrix for Different Monetary Policy Moves

		Foreign	
		Somewhat restrictive	Very restrictive
Home	Somewhat restrictive	1	8/7
	Very restrictive	8/7	5/6