Exchange Rate Regimes in the Long Run

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Monetary and Financial History

Oral Comments Guide

- **Friedman's perspective** main points:
  - The Monetary Policy Trilemma – Fixed Exchange Rates ; Open Capital Markets; Monetary autonomy
  - The slow growth of European Countries vs Other Nations
  - The European Common Market: Friend or Foe of Free Markets?

- **Cooper's perspective** main points:
  - Exchange Rate System: Developed countries vs Developing countries
  - Bretton Woods & Economic Stabilization/Cooperation and Output Growth Rates
  - Free Floating vs Fixed Exchange Rates

Was the Bretton Woods system the best exchange rate arrangement?

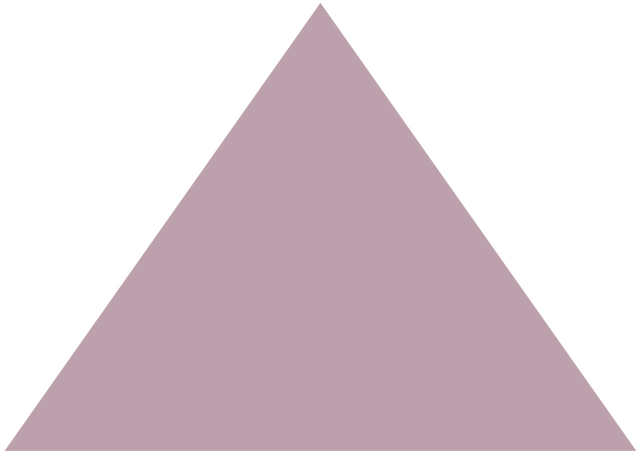
- The Bretton Woods system had its economic shortcomings, however, it played an important, but not immediatly obvious role in a tumultuous period of history.
- Its existence was a factor of international stabilization and might have contributed to the maintenance of world peace.

Was the Bretton Woods system the best exchange rate arrangement?

- Bretton Woods Collapse:
  1. U.S. was growing less than the EU and Japan
  2. U.S. international competitive position deteriorated
  3. Increase of US deficit
  4. In order to restore external balance, U.S. started to adopt excessively expassionary monetary policy (expansion of domestic credit)
  5. Fed failed to react to the divergence between M2 and Monetary base
  6. Dollar destabilization (U.S. external liabilities higher than gold reserves)
  7. Bretton Woods collapse

“The European Community: Friend or Foe of the Market Economy” (Milton Friedman)

- Flexible Exchange Rates and the Monetary Policy Trilemma



“The European Community: Friend or Foe of the Market Economy” (Milton Friedman)

- A Common European Currency
  - Friedman argues that a successful single currency in Europe is unlikely to succeed because of low social and political integration
  - His vision is very American centric and, one could argue, *euroskeptic*.

“Exchange Rate Choices” (Richard N. Cooper)

- **According to Cooper:**
  - The best exchange rate system may not be the same for developing and developed countries
  - Developing countries always choose to peg their exchange rates
- **Cooper and Bretton Woods:**
  - Bretton Woods system is seen as good tool to reinforce stability and cooperation in troubled times may indeed be correct, but this does not extrapolate into the present
  - While the Bretton Woods period saw good output growth rates, it is very hard to prove causality

“Exchange Rate Choices" (Richard N. Cooper)

- **Fixed and Free Floating Exchange Rates:**
  - Cooper suggests that the choice between fixed and free exchange rates can be see as a trade-off between stability and shock absorption

- **Costs of Exchange Rates:**
  - There is no cost on GDP
  - Trade growth is higher under free floating exchange rate
  - Inflation rate variability is lower with fixed exchange rates

“Exchange Rate Choices" (Richard N. Cooper)

- **Floating Exchange Rate:**

  - **Disadvantages:**
    1. Risk for trade transactions that cannot be hedged at moderate
    2. Self-aggravating movements in exchange rates that intensify disequilibria rather than promote adjustment

  - **In favour with Friedman’s view:**
    1. Allow the pursual of both unemployment and price trend objectives
    2. Eliminate the necessity for far-reaching international coordination of internal monetary and fiscal policy

“Exchange Rate Choices" (Richard N. Cooper)

- Fixed Exchange Rate:
  - Advantage:
    1. Moderate lower real interest rates
    2. Moderate the growth of money supply
  - Disadvantage:
    1. May lead to greater financial debt, less effective wage indexation (Hausmann et al., 1999)

- IMF and Exchange Rate:
  - Countries can choose any exchange regime since it goes with “orderly economic growth with reasonable price stability and provide that countries ability to avoid manipulating exchange gains to have some sort of benefits”