UNIT THREE
International Finance: Enduring Issues

Chapter 7
Exchange Rate Systems, Past to Present

Joseph P. Daniels, Marquette University
David D. VanHoose, Baylor University

PowerPoint Presentation by Charlie Cook
Copyright © 2004 South-Western/Thomson Learning. All rights reserved.
1. What is an exchange-rate system?

2. How does a gold standard constitute an exchange-rate system?

3. What was the Bretton Woods system of “pegged” exchange rates?

4. What post-Bretton Woods system of “flexible” exchange rates prevails today?

5. What are crawling-peg and basket-peg exchange-rate systems?
6. What is a currency board, and what is dollarization?

7. Which is best, a fixed or flexible exchange-rate system?
Exchange-Rate Systems

• Monetary Order
  - A set of laws and regulations that establishes the framework within which individuals conduct and settle transactions.

• Exchange-Rate System
  - A set of rules that determine the international value of a currency.

• Convertibility
  - The ability to freely exchange a currency for a reserve commodity (e.g., gold) or reserve currency.
The Gold Standard

- The Gold Standard As an Exchange-rate System
  - Allowed the exchange of a currency, both domestically and internationally, at the mint parity rate for the currency.
  - Determines the international exchange value of the currency between gold and the currency.
Gold parity rates (per troy ounce of gold) determine the rate of exchange between two currencies.
Positive and Negative Aspects of a Gold Standard

• Positive
  ➢ Creates long-run stability of the nation’s money stock and long-run stability of prices and exchange rates.
  ➢ Changes in a nation’s money stock depend only on changes in the mining and production of monetary gold.
  ➢ Using monetary gold does not require a central bank.

• Negative
  ➢ Has significant resource costs, such as minting and transportation costs.
  ➢ Can result in inflation or a liquidity crisis if gold supply is unstable.
  ➢ Can be very costly for a nation to maintain and exchange physical gold.
  ➢ Prevents policymakers from pursuing a discretionary monetary policy.
The Economic Environment of the Gold Standard Era

• Bank for International Settlements (BIS)
  ➢ An institution based in Basle, Switzerland, which serves as an agent for central banks and a center of economic cooperation among the largest industrialized nations.

• Overvalued Currency
  ➢ A currency in which the current market-determined value is higher than the value predicted by an economic theory or model.

• Undervalued Currency
  ➢ A currency in which the current market-determined value is lower than that predicted by an economic theory or model.
The Bretton Woods System

• International Monetary Fund
  A supranational organization whose major responsibility is to lend reserves to member nations experiencing a shortage.

• World Bank
  A sister institution of the International Monetary Fund that is more narrowly specialized in making loans to about 100 developing nations in an effort to promote their long-term development and growth.
The Bretton Woods Agreement

• Pegged Exchange-Rate System
  ➢ An exchange rate system in which a country pegs the international value of the domestic currency to the currency of another nation.

• Dollar-Standard Exchange-Rate System
  ➢ An exchange rate system in which a country pegs the value of its currency to the U.S. dollar and freely exchanges the domestic currency for the dollar at the pegged rate.
The Bretton Woods Agreement (cont’d)

• **Devalue**
  - Changing the pegged, or parity, value of a currency so that it takes a greater number of domestic currency units to purchase one unit of the foreign currency.

• **Revalue**
  - Changing the pegged, or parity, value of a currency so that it takes a smaller number of domestic currency units to purchase one unit of the foreign currency.
The Bretton Woods system linked all currencies, other than the U.S. dollar, to gold and to each other through the U.S. dollar. The United States pegged the dollar to gold at a parity rate of $35 per troy ounce.
The Bretton Woods Agreement (cont’d)

• Reserve Currency
  ➢ The currency commonly used to settle international debts and to express the exchange value of other nation’s currencies.

• The Smithsonian Agreement and the Snake in the Tunnel
  ➢ Group of Ten (G10)
    ✷ France, Germany, Japan, the United Kingdom, the United States, Canada, Italy, Belgium, the Netherlands, and Sweden.
Figure 7-3  The U.S. Balance on Goods, Services, and Income: 1960 through 1971

Source: Bureau of Economic Analysis, U.S. Department of Commerce.
Copyright © 2004 South-Western/Thomson Learning. All rights reserved.
The Smithsonian Agreement and the *Snake in the Tunnel*

- **Group of Ten (G10)**
  - France, Germany, Japan, the United Kingdom, the United States, Canada, Italy, Belgium, the Netherlands, and Sweden.

- **European Economic Community (EEC)**
  - France, West Germany, Italy, Belgium, the Netherlands, and Luxembourg agreed to maintain exchange values by selling or buying each other’s currencies.
The Flexible Exchange-Rate System

• Flexible Exchange-Rate System
  ➢ An exchange rate system whereby a nation allows market forces to determine the international value of its currency.

• Jamaica Accords (1976)
  ➢ A meeting of the IMF that amended the constitution of the IMF to allow each member nation to determine its own exchange-rate system.

• Group of Eight (G8)
  ➢ France, Germany, Japan, the United Kingdom, the United States, Canada, Italy, and Russia.
Between 1981 and 1985, the U.S. dollar experienced a considerable appreciation in average value relative to seven major currencies. Within two years, the appreciation had been reversed.

Source: U.S. Federal Reserve Board.
The Plaza Agreement

• Group of Five (G5)
  ➢ France, Germany, Japan, the United Kingdom, the United States.

• Plaza Agreement (1985)
  ➢ A meeting of the G5 nations’ central bankers and finance ministers at the Plaza Hotel in New York.
    ❖ Announced that the exchange value of the dollar was too strong and that the nations would coordinate their intervention actions in order to drive down the value of the dollar.
The Louvre Accord

• Group of Seven (G7)
  - France, Germany, Japan, the United Kingdom, the United States, Canada and Italy.

• Louvre Accord (1987)
  - A meeting of the G7 nations’ central bankers and finance ministers (less Italy).
    - Announced that the exchange value of the dollar had fallen to a level consistent with “economic fundamentals” and that the central banks would intervene in the foreign exchange market only to ensure stability of exchange rates.
The Louvre Accord (cont’d)

• Managed or Dirty Float
  An exchange rate system in which a nation allows the international value of its currency to be primarily determined by market forces but intervenes from time to time to stabilize its currency.
Other Forms of Exchange-Rate Systems

• Crawling Peg
  - An exchange rate system in which a country pegs its currency to the currency of another nation but allows the parity value to change at regular time intervals.

• Exchange-rate Band
  - A range of exchange values, with an upper and lower limit within which the exchange value of the domestic currency can fluctuate.

• Crawling Band
  - A range of exchange values that combines crawling peg features with exchange-rate band flexibility.
Figure 7-5  Current Foreign Exchange-Rate Systems

Figure 7-6  Nicaragua’s Crawling-Peg System: Since 1998

Other Forms of Exchange-Rate Systems (cont’d)

- **Currency-Basket Peg**
  - An exchange-rate system in which a country pegs its currency to the weighted average value of a basket, or selected number of currencies.
Independent Currency Authorities

• Currency Board
  ➢ An independent monetary authority that substitutes for a central bank. The currency board pegs the value of the domestic currency, and changes in the foreign reserve holdings of the currency board determine the level of the domestic money stock.

• Dollarization
  ➢ A system in which the currency of another nation circulates as the sole legal tender of a nation.
Fixed or Floating Exchange Rates?

• Fixed Exchange Rates
  ➢ Promote sound macroeconomic policy
  ➢ Help reduce inflation
  ➢ Lead to a stable economic environment.
  ➢ Exchange rates may appreciate and reduce the competitiveness of the nation’s exporters.

• Flexible Exchange Rates
  ➢ Help a country overcome external shocks such as an unusual inflow of capital from abroad or a sudden price increases of resource.
  ➢ Introduce an additional element of uncertainty and additional volatility.