The Economics of European Integration

McGraw Hill Education

Chapter 14

The Choice of an Exchange Rate Regime

Background theory

- A quick refresher on basic macroeconomic principles
- Application of these principles to the question of exchange rate regimes
- Europe's monetary integration is a history of seeking exchange rate stability. Why?

The Question and The Answer

- The question: what to do with the exchange rates:
  - viewpoint of an individual country, in contrast with Chapter 13 which looks at systems
  - underlines the principles to evaluate the merits of a monetary union.
- The answer: there is no best arrangement:
  - a matter of trade-offs.

Three Basic Principles

- Long term: neutrality of money.
- Short term: non-neutrality of money.
- Interest parity condition.

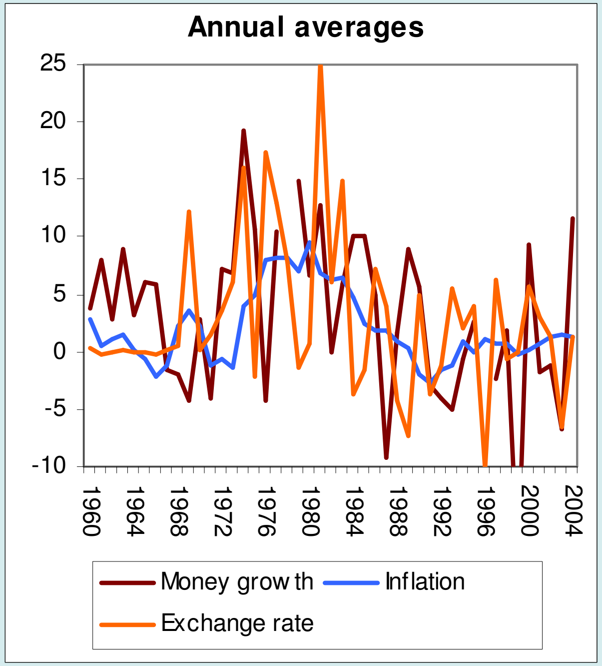
Long Term: Neutrality of Money

- In the long run, money, the price level and the exchange rate tend to move proportionately.

Long Term: Neutrality of Money

Comparison between France and Switzerland

Growth rate in France less growth rate in Switzerland



Year to year:
Nothing really visible

Long Term: Neutrality of Money

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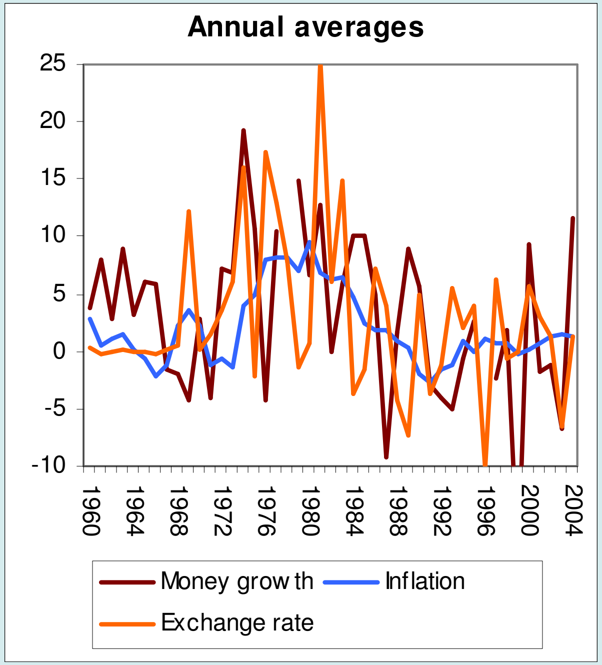

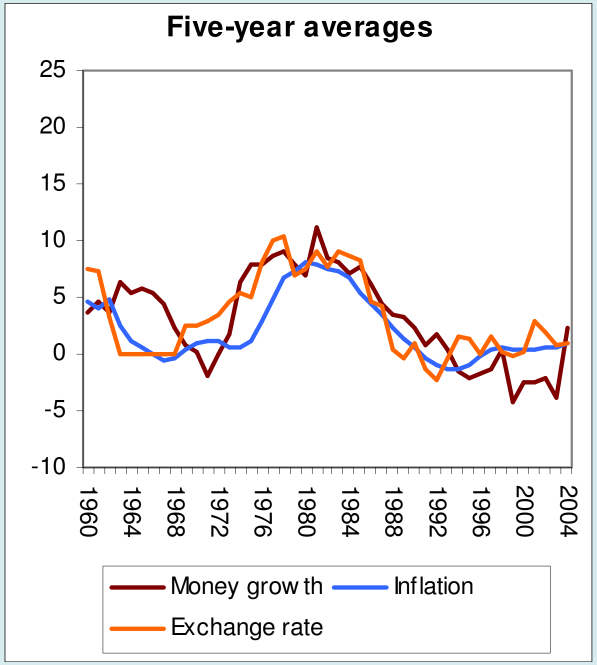

Five-year averages: Something emerges

Long Term: Neutrality of Money

Comparison between France and Switzerland

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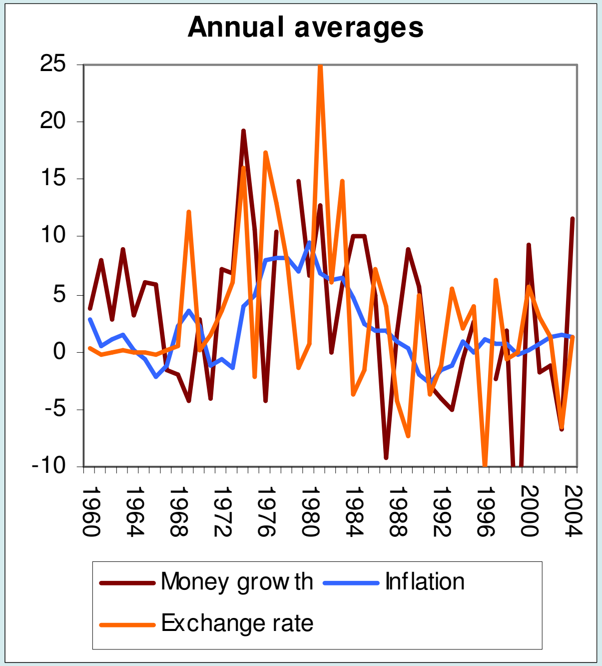
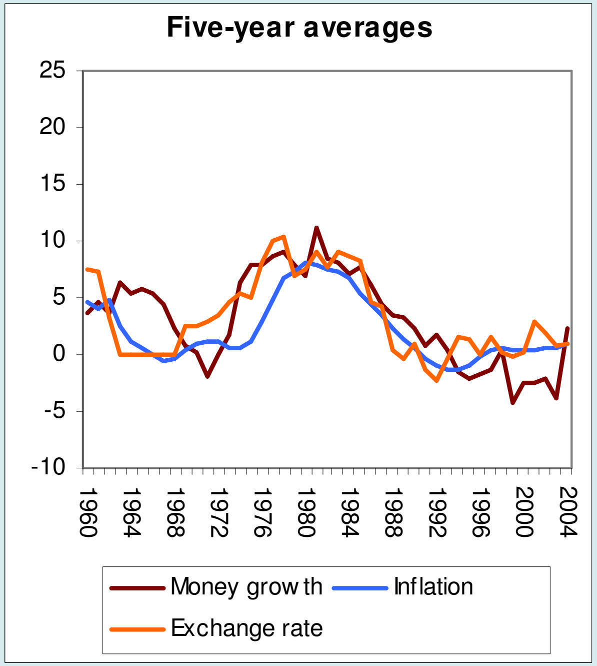
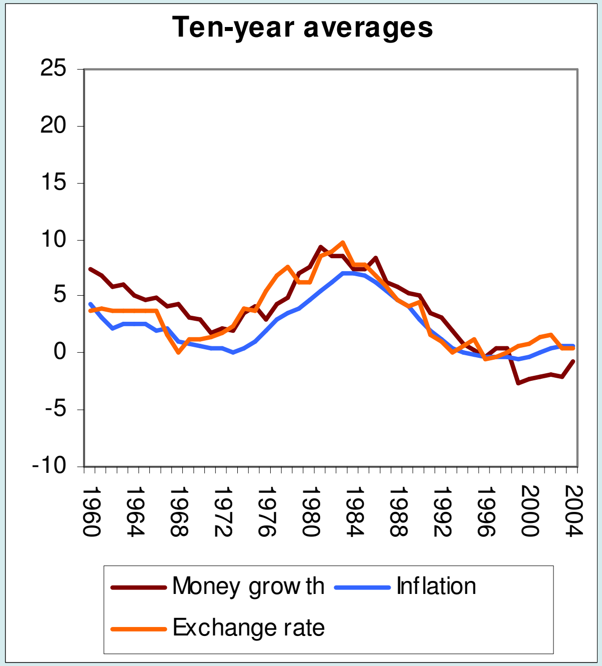
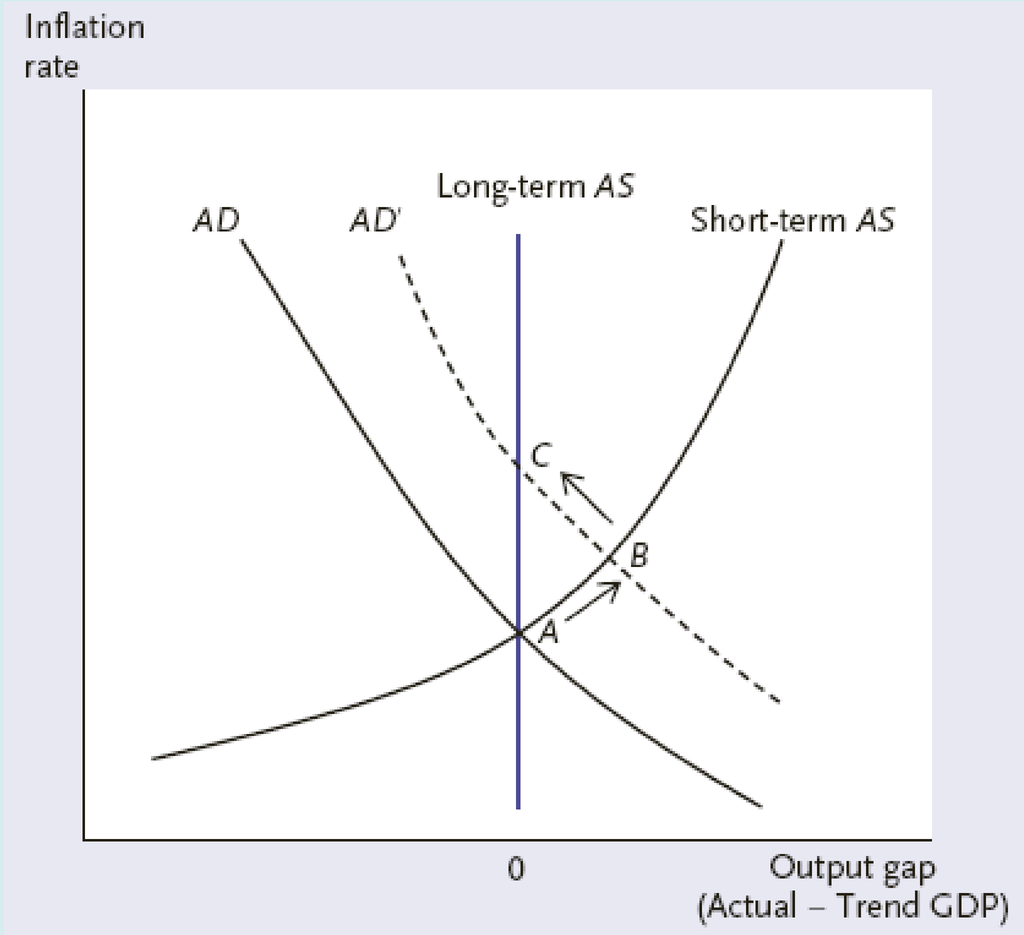






Long Term Neutrality of Money: Theory

- The aggregate demand and supply framework: the vertical long-run aggregate supply schedule.



PPP: An Implication of Long Term Neutrality

- The real exchange rate:
  - defined as $\lambda = EP/P^*$
  - PPP: E offsets changes in P/P^*
  - so λ is constant.
- Equivalently: $$\frac{\Delta E}{E} = \frac{\Delta P^*}{P^*} - \frac{\Delta P}{P}$$
- Many caveats, though.

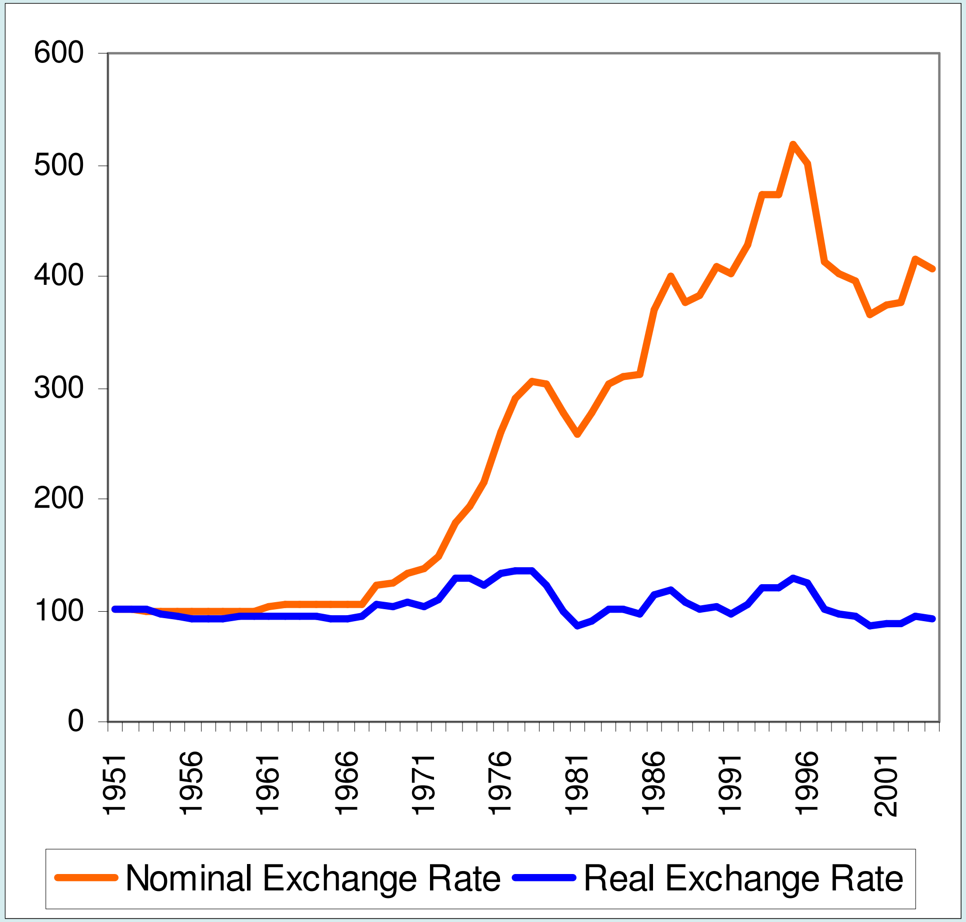
PPP: An Implication of Long Term Neutrality

France and Switzerland: averages 1951-2004

Average money growth: France less Switzerland	2.5
Average inflation: France less Switzerland	2.4
Average appreciation CHF vs. FRF	3.0

PPP: An Implication of Long Term Neutrality

Germany and the UK (1951-2004)



Caveat:
The Balassa-Samuelson Effect

Average annual changes *vis-à-vis* the Eurozone
(1993-2005, % per annum)

	Czech Rep.	Hungary	Poland	Slovak Rep.
Real appreciation	4.4	3.4	2.9	3.5
Inflation differential	3.6	10.3	8.7	4.2
Nominal appreciation	0.8	-6.9	-5.8	-0.7

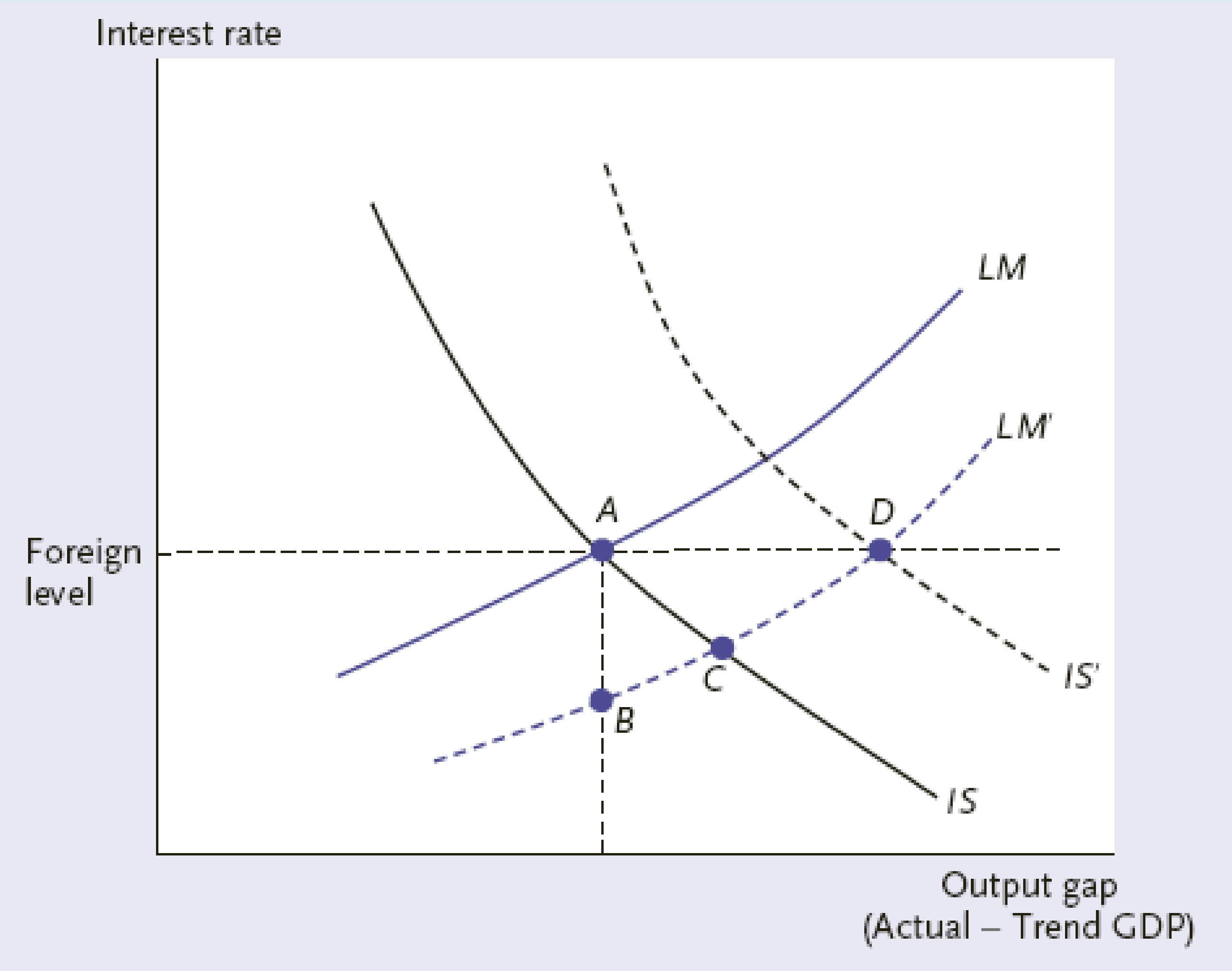
Short Term Non-Neutrality of Money

- From AD-AS: the short-run AS schedule.
- So monetary policy matters in the short run.
- Channels of monetary policy:
  - the interest rate channel
  - the credit channel
  - the stock market channel
  - the exchange rate channel.

Exchange Rate Regimes and Policy Effectiveness

- Fixed exchange rate: no independent monetary policy:
  - money is endogenous.

Exchange Rate Regimes and Policy Effectiveness



Exchange Rate Regimes and Policy Effectiveness

- Fixed exchange rate: no independent monetary policy.
- Flexible exchange rate: no effect of fiscal policy:
  - the exchange rate offets fiscal policy effects.

Exchange Rate Regimes and Policy Effectiveness

	Monetary policy	Fiscal policy
Fixed exchange rate	Ineffective	Effective
Flexible exchange rate	Effective	Ineffective

When Does the Regime Matter?

- In the short run, changes in E are mirrored in changes in $\lambda = EP/P^*$: P and P^* are sticky.
- In the long run, λ is independent of E: P adjusts.

When Does the Regime Matter?

- In the short run, changes in E are mirrored in changes in $\lambda = EP/P^*$: P and P^* are sticky.
- In the long run, λ is independent of E: P adjusts.
- If P is fully flexible, the long run comes about immediately and the nominal exchange rate does not affect the real economy.
- Put differently, the choice of an exchange rate regime has mostly short-run effects because prices are sticky.

What's On The Menu?

- Free floating.
- Managed floating.
- Target zones.
- Crawling pegs.
- Fixed and adjustable.
- Currency boards.
- Dollarization/euroization.
- Monetary union.

The Choice of an Exchange Rate Regime

- The monetary policy instrument:
  - can be useful to deal with cyclical disturbances
  - can be misused (inflation).
- The fiscal policy instrument:
  - can also deal with cycles but is often politicised
  - can be misused (public debts, political cycles).

The Choice of an Exchange Rate Regime

- Exchange rate stability:
  - freely floating exchange rates move ‘too much’
  - fixed exchange rates eventually become misaligned.

The Old Debate: Fixed vs Float

- The case for flexible rates:
  - with sticky prices, need exchange rate flexibility to deal with shocks
  - remove the exchange rate from politicisation
  - monetary policy is too useful to be jettisoned.

The Old Debate: Fixed vs Float

- The case for fixed rates:
  - flexible rates move too much (financial markets are often hectic)
  - exchange rate volatility: a source of uncertainty
  - a way of disciplining monetary policy
  - in presence of shocks, always possible to realign.

The New Debate: The Two-Corners Solution

- Only pure floats or hard pegs are robust:
  - intermediate arrangements (soft pegs) invite government manipulations, over or under valuations and speculative attacks
  - pure floats remove the exchange rate from the policy domain
  - hard pegs are unassailable (well, until Argentina’s currency board collapsed…).

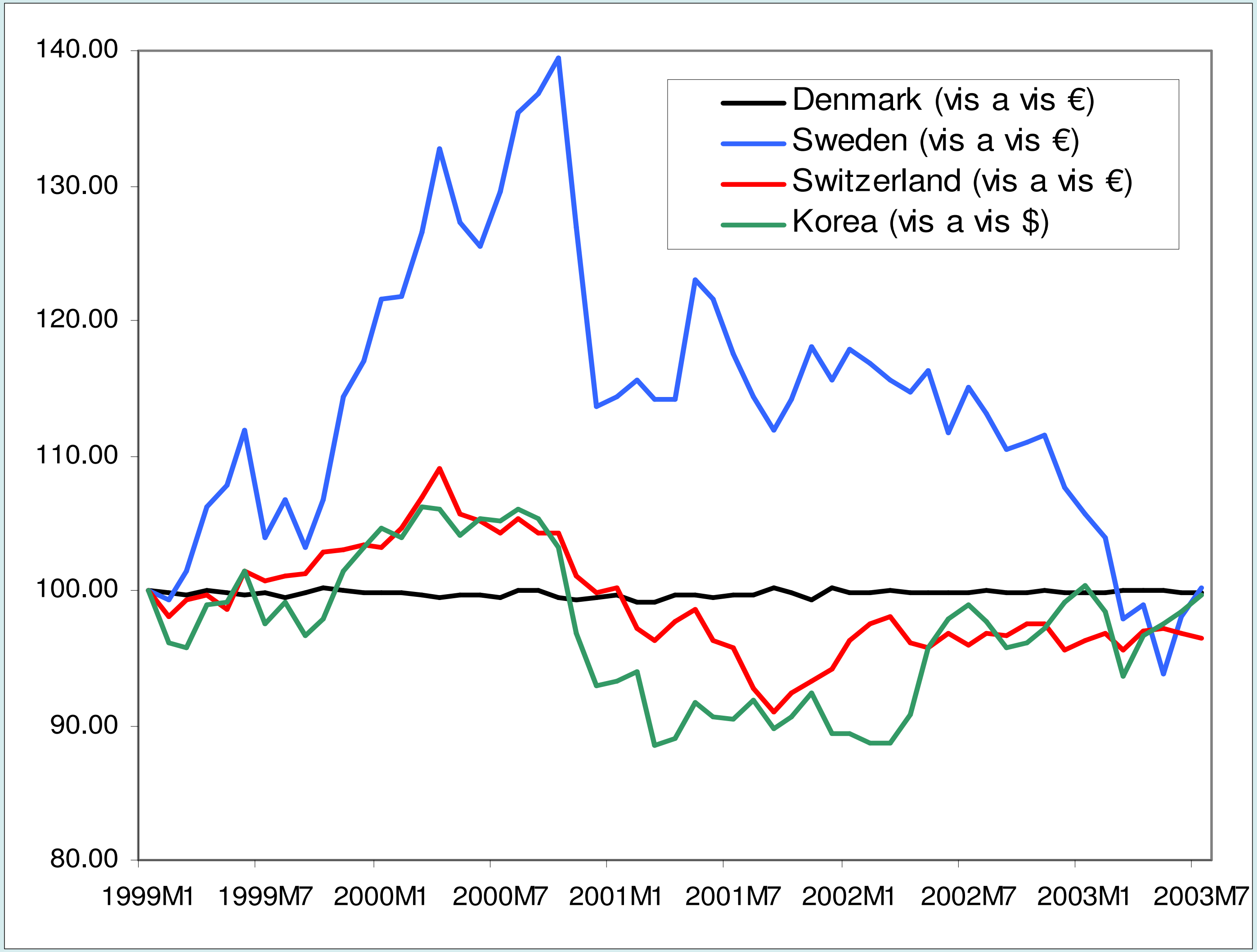
The New Debate: The Two-Corners Solution

- In line with theory:
  - soft pegs are half-hearted monetary policy commitments, so they ultimately fail.

The Two-Corners Solution and The Real World

- Fear of floating:
  - many countries officially float but in fact intervene quite a bit.
- Fear of fixing:
  - many countries declare a peg but let the exchange rate move out of official bounds.

Fear of Floating



The Two-Corners Solution and The Real World

- Fear of floating is deeply ingrained in many European countries.
- Fear of fixing partly explains the disenchantment with the EMS and some reluctance towards monetary union.

Conclusions

- A menu hard to pick from: trade-offs are everywhere.
- All of this takes the view from a single country.
- Systems involve many countries and rest on agreed upon rules, including mutual support.
- Since the end of Bretton Woods, there is no world monetary system.
- This leaves room for regional monetary systems. Enters Europe's experience.