Should We Return to Fixed Exchange Rates?
by Nicholas V. Karamouzis

There has been growing dissatisfaction with the current system of managed floating exchange rates, leading a small but increasing number of economists, policymakers, and journalists to call for a return to a system of limited exchange-rate flexibility. One group advocates a return to the gold standard. At the 1984 Republican National Convention, for example, several members of the platform committee favored a return to the gold standard as a vehicle to sustain domestic price stability and to restore international monetary soundness. Others have harbored the view of returning to a system of more stable exchange rates similar to the Bretton Woods system, with an important role ascribed to the dollar.

Critics of floating exchange rates blame exchange-rate variability for many economic problems. These charges are largely unsubstantiated, however, and the introduction of a system of limited exchange-rate flexibility would not mitigate the economic problems. The events that contributed to the collapse of the Bretton Woods system in the early 1970s should be expected to present similar problems in the 1980s, if a system of limited exchange-rate flexibility were introduced.

The Volume of International Transactions
A common argument against exchange-rate flexibility is that it is accompanied by excessive exchange-rate volatility, which generates uncertainties. Over time, these uncertainties tend to reduce the volume of international trade and discourage international investment. In such cases, the welfare of nations is considerably reduced. Although such an outcome theoretically could be possible under certain conditions, empirical studies have failed to establish any strong relationship between nominal exchange-rate volatility and the volume of international trade.

Furthermore, evidence shows no reduction, but instead an actual increase, in each country’s trade transactions as a percent of its own GNP since the end of the Bretton Woods regime (see table 1). Although we should be cautious in generalizing or drawing definite conclusions from these empirical findings, the

Table 1  Imports plus Exports as a Percent of Nominal GNP

<table>
<thead>
<tr>
<th>Nation</th>
<th>Average over 1960-70</th>
<th>Average over 1973-83</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>7.3</td>
<td>14.6</td>
</tr>
<tr>
<td>Japan</td>
<td>16.7</td>
<td>21.7</td>
</tr>
<tr>
<td>West Germany</td>
<td>30.3</td>
<td>43.1</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>29.3</td>
<td>41.3</td>
</tr>
</tbody>
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1. Francois Mitterand, for example, stated “the time has come to think of a new Bretton Woods... outside this proposition, there will be no salvation” (New York Times, May 10, 1983). A Wall Street Journal editorial (June 22, 1982) stated “given the success of Bretton Woods and the failure of what followed, it can certainly serve as a model for the direction we ought to head.”

relationship between the volume of international transactions and exchange-rate volatility appears to be weak, which accords with the finding that, in comparison to other factors which might affect exchange rates, hedging is not an important one. Facilities for hedging against foreign-exchange risk have been adequate, and the cost of hedging constitutes only a small fraction of the total transactions in foreign currencies.

Even if the adverse effects of exchange-rate variability on international trade were well-established, the introduction of a system of limited exchange-rate flexibility would not ensure a reduction of exchange-rate uncertainty. Under such a system, if policymakers fail to submit their policies to the requirements of a system of fixed parities, the current continuous variability of exchange rates will be replaced by abrupt, discrete, and large realignments of exchange rates. Although the lack of a common measure of uncertainty in the two systems makes comparison difficult, a system of limited exchange-rate flexibility should not mitigate the problems associated with exchange-rate uncertainty unless policymakers pursue suitable macroeconomic policies. In fact, a system of limited exchange-rate flexibility might increase uncertainty during those times when the market believes that the officially maintained exchange rate is inconsistent with market fundamentals.

It can be argued that stabilizing domestic macroeconomic policies would be more effective in reducing exchange-rate variability than changing the exchange-rate regime.

Inflation

Another criticism of exchange-rate variability is the claim that such a system is inherently more inflationary. Critics argue that exchange-rate variability tends to exacerbate and perpetuate the price effects of real and monetary disturbances and policy shocks. Moreover, they maintain that the current system is unsuited for countries that have already removed the discipline that a par value system (such as Bretton Woods) or the gold standard imposes on countries. Policymakers thus are more prone toward inflation in the 1970s.

Two theories relate exchange-rate variability to a magnification of the inflation problem—the vicious circle hypothesis and the ratchet effect hypothesis. The vicious circle process of price inflation and exchange-rate depreciation. Depreciation of a currency is rapidly translated into higher domestic prices and costs, which in turn lead to further depreciation of the currency. This dynamic instability is perpetuated because exchange-rate fluctuations reinforce a spiral of exchange-rate depreciation, followed by more inflation. Note that such a process could allegedly be set in motion by exogenous real or monetary shocks, initial exchange-rate overshooting, or even expectations of future changes in domestic monetary policies. The ratchet effect hypothesis posits that in a world of downward price inflexibility, prices in the appreciating economy do not fall as fast or as much as prices rise in the depreciating economy. The net effect is an increase in the world's inflation rate. Even though these views are particularly popular among policymakers, empirical and theoretical studies have shown that, unless monetary policy is accommodative, the long-term effectiveness of the above hypothesis cannot be sustained.

Undoubtedly, exchange-rate movements tend to reinforce the price effects of monetary policy. There is no evidence that policymakers were willing to hold U.S. dollars instead of converting them into gold. Rapid U.S. money-stock growth consequently was not constrained by a reduction in U.S. international reserves. In the early 1970s, with an inflation in the United States accelerated, foreigners became more reluctant to hold dollars in the face of continuing U.S. balance-of-payments problems and rising U.S. inflation. The situation placed excessive strain on foreign-exchange markets and the value of the dollar. On August 15, 1971, crisis erupted, convertibility was suspended, and the system was abandoned. Subsequent attempts to re-establish more realistic exchange-rate parities (and the Smithsonian Agreement) were short-lived because countries were unwilling to submit their policies to the requirements of a system of fixed parities. Critics argue that exchange-rate variability makes comparison difficult. 

The second argument against a system of floating exchange rates is that it is inflationary. Critics argue that a system of fixed exchange-rate variability stems from the assumption that the fixed rate deprecation of the currency. The unsuccessful experience of the United States and the British pound and the gold standard in the early 1930s is repeated. Undoubtedly, inflation rates across countries will probably be less divergent under a system of limited exchange-rate flexibility. However, the reserve-currency country would be able to export its own inflation to the rest of the world. This asymmetry in the system is disadvantageous for smaller countries. Exchange-rate variability provides considerable policy discretion to monetary authorities not to inflate. The remedy for inflation and exchange-rate instability rests not on the choice of the exchange-rate regime but on the ability and willingness of policymakers to pursue sound and stable macroeconomic policies.

External Adjustments

A third argument against exchange-rate variability is that exchange-rate variability makes it difficult to determine the equilibrium of countries, particularly because it entails consideration of sustainability and optimality of the public sector's tax and spending structure.
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Although the lack of a common measure of uncertainty in the two systems makes comparison difficult, a system of limited exchange-rate flexibility should not mitigate the problems associated with exchange-rate uncertainty unless policymakers pursue suitable macroeconomic policies. In fact, a system of limited exchange-rate flexibility might increase uncertainty during those times when the market believes that the officially maintained exchange rate is inconsistent with market fundamentals. It can be argued that stabilizing domestic macroeconomic policies would be more effective in reducing exchange-rate variability than changing the exchange-rate regime.

**Inflation**

Another criticism of exchange-rate variability is the claim that such a system is inherently more inflationary. Critics argue that exchange-rate flexibility tends to exacerbate and perpetuate the price effects of real and monetary disturbances and policy shocks. Moreover, they maintain that the current system does not sufficiently respect the fact that a new exchange-rate system removed the discipline that a par value system (such as Bretton Woods) or the gold standard imposed on policymakers, and kept a system of limited exchange-rate flexibility.

Both theories relate exchange-rate variability to a magnification of the inflation problem—the vicious circle hypothesis and the ratchet effect hypothesis. A vicious circle is an accumulative process of process inflation and exchange-rate depreciation. Depreciation of a currency is rapidly translated into higher domestic prices and costs, which in turn lead to further depreciation of the currency. This dynamic instability is perpetuated, and a spiral of exchange-rate depreciation, followed by more inflation. Note that such a spiral could allegedly be set in motion by exogenous real or monetary shocks, initial exchange-rate overshooting, or expectations of future exchange-rate devaluations about future fiscal and monetary policies. The ratchet effect hypothesis posits that in a world of downward price inflexibility, prices in the appreciating economy do not fall as fast or as much as prices rise in the depreciating economy. The net effect is an increase in the world's inflation rate.

Even though these views are particularly popular among policymakers, empirical and theoretical studies have shown that, unless monetary policy is accommodative, the dynamic instability described above cannot be sustained. Unluckily, exchange-rate movements tend to reinforce the price effects of monetary policy because the short-run time lag between changes in the money stock and changes in the domestic price level. This is not to say that exchange-rate movements cause inflation or that they constitute an independent system source of inflationary pressure. It is not too late to encourage policymakers to pursue a system of limited exchange-rate flexibility that is more prone to the transaction needs of the economy. Furthermore, the sound monetary policy pursued by the Federal Reserve has been a necessary condition for the dollar appreciation in the last three years. Of course, the appreciation of the dollar exerts a beneficial effect on domestic prices. But again, credible monetary policy is the driving force behind exchange-rate appreciation and low inflation.

The second argument why a system of floating exchange rates is more inflationary is that it can act as a self-correcting mechanism. If limited exchange-rate flexibility stems from the presumption that the current system, monetary authorities in each country have regained control over their own money supply, and thus can exercise more policy discretion. In a system such as Bretton Woods or the gold standard, inflationary policies would result in the loss of foreign reserves or gold, respectively, which eventually would pose some restraint on monetary authorities from pursuing inflationary policies.

Our experience with the Bretton Woods system showed that such discipline applies only to the non-reserve-currency countries and not to the reserve-currency countries such as the United States. During much of the Bretton Woods period, the United States maintained a balance of payments surplus, and seldom allowed its currency to appreciate in line with the devaluation of European currencies and the gold standard in the early 1930s. Nonetheless, inflation rates across countries would probably be less divergent under a system of limited exchange-rate flexibility. However, the reserve-currency country would be able to export its own inflation to the rest of the world. This asymmetry in the system is disadvantageous for smaller countries. Exchange-rate flexibility provides considerable policy discretion to monetary authorities and ensures that a nation bears most of the costs and benefits of its own policy choices. The remedy for inflation and exchange-rate instability rests not on the choice of the exchange-rate regime but on the ability and willingness of policymakers to pursue sound and stable macroeconomic policies.

**External Adjustments**

A third argument against exchange-rate flexibility is that exchange-rate variability is not generally consistent with the working of the international adjustment process, i.e., the reduction of the gap between the actual payments balance and the equilibrium payments balance. There are two views on this issue. The first one, which is conceptually and analytically incorrect, is that exchange-rate movements have failed to reduce current account imbalances. The second view, both conceptually and analytically preferable, examines the sum of the current account and the private capital flows as an appropriate indicator...
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of the extent of external disequilibrium, although difficult to measure. Note that the closer to zero that this sum is, the more satisfactory the external adjustment. A recent study by the International Monetary Fund (1984a) concludes that external adjustments have not been slower under the current system of floating rates. For the large industrial countries, particularly West Germany and Japan, adjustments have been substantially better and faster. For instance, the average of current account imbalances plus private net capital flows as a percentage of GNP for large industrial countries has fallen from 0.51 in the 1965-72 period to 0.22 in the 1973-81 period.

When the net normal private capital flows were insufficient to support current account imbalances, movements in exchange rates produced only slow results in changing the current accounts. Such outcomes should not be attributed to a failure of exchange rates to adjust completely. It mainly reflects the influence of three factors: (1) trade flows adjusted to exchange-rate changes only after a lag; (2) supporting demand-management policies often were lacking; and (3) important changes took place in the structure of international trade, particularly the two oil shocks and the emergence of Far Eastern countries as major exporters.

The question arises as to whether a system of limited exchange-rate flexibility would have produced better results in terms of reducing external imbalances. It is undoubtedly true that to maintain the existing exchange-rate parities and reduce these foreign-sector imbalances, countries would have to pursue suitable macroeconomic policies. If such an option were not feasible or were politically impractical, systematic intervention in the foreign-exchange market and/or severe trade and capital-flow restrictions would become necessary. Considering that the effectiveness of these measures is questionable in the longer run, large abrupt changes in exchange rates would have been more likely. The history of events in the early 1970s, when the failure of the United States to deal with the disequilibrium in its balance of payments resulted in several discrete devaluations of the dollar, confirms this scenario. There is no reason to believe that such discrete and sudden changes and the "crisis" conditions that attend them are preferred or superior to a system of exchange-rate flexibility.

The Overvalued Dollar

The most recent criticism of exchange-rate flexibility stems from the argument that the dollar is currently overvalued and that such overvaluation has two significant effects: it adversely influences the level of domestic production and employment, and it exacerbates the problems associated with international debt. While no one disputes that such effects do indeed exist, it is fair to point out that the dollar appreciation is exerting some beneficial effects as well—first, on domestic prices, and, second, on foreign production via stimulation of foreign exports.

The controversial issue is not to assess the effects of dollar appreciation on economic activity at home and abroad, but to examine whether the dollar is indeed overvalued and what policymakers can or cannot do about it. The term overvalued implies that the actual path of the exchange rate deviates from the equilibrium path or the socially
optimal path. There is no consensus today on the equilibrium path of the exchange rate. For instance, there are several competing hypotheses to explain the recent behavior of the dollar. Some argue that the dollar is overvalued because it is not depreciating to eliminate the huge U.S. current account balance. Others argue that the dollar is not overvalued but is being supported by foreign capital flows attracted by high returns on dollar-denominated assets. Some mention irrational speculation or bubbles that sooner or later will burst.

Granting that any one or a combination of these hypotheses is correct, the question arises as to whether policymakers can obtain a better outcome through policy rules than the market does. An affirmative answer to the question presupposes that countries will be able to do the following: (1) identify and arrange the right structure of exchange rates to changes in fundamentals; and (3) intervene systematically (and do so effectively) to preserve a set of announced parities—believed to be the correct ones—even when the market's perception is quite different. To what extent these conditions can be fulfilled is questionable. The evolution of international monetary relations has shown that negotiations among countries about the correct structure of exchange rates has been cumbersome, slow-moving, and characterized by inflexibility when exogenous shocks and structural changes dictate a realignment of parities. Because political factors are implicitly interjected into negotiations, the negotiating process does not converge to a solution fast enough, or it converges to a solution that the market considers inconsistent with the changes in fundamentals. In these instances, the use of foreign-exchange intervention to preserve the established parities is costly, and its effectiveness is questionable.6

Controllability of the Money Stock
A fifth argument against exchange-rate flexibility is related to the issue of international currency substitution. Specifically, it is assumed that domestic and foreign currencies are substitutes in the asset portfolios of corporations and international investors with an allegedly high elasticity of substitution. It is argued that the high substitutability among currencies results in large swings in the exchange rates; furthermore, it makes the controllability of home money stock extremely difficult. For instance, if the public anticipates a dollar appreciation, private agents will massively convert foreign-currency holdings into dollars, leading to an immediate appreciation of the dollar and faster growth in the domestic money stock. If expectations are reversed, the opposite phenomenon occurs. Critics of exchange-rate flexibility argue that, in an era of shifting monetary policy, such swings in the exchange rates and the demand for different currencies are possible, and they can be quite destabilizing. The suggested solution is a return to a system of fixed parities, accompanied by coordinated foreign-exchange intervention, to maintain fixed growth in the world's money stock.

However, empirical evidence, mostly based on quarterly data, does not support the assumption of high elasticity of substitution among currencies; nor does evidence support the hypothesis that controllability of domestic money stock is hindered by international currency substitution.7 In the case of the dollar, the results are even more disappointing for critics of floating exchange rates. It is certainly possible that significant currency substitution occurs in shorter time intervals or that the empirical methodology used was not powerful enough to capture the effects. Nevertheless, based on what we know, there is no serious justification to return to a system of fixed parities because of destabilizing international currency substitution.

The Collapse of the Bretton Woods System
The lesson from the breakdown of the Bretton Woods system should be clear. A return to a workable system of limited exchange-rate flexibility requires first that economic policies be coordinated and second that monetary authorities give up their independence and submit their policy actions to the discipline of fixed exchange rates. This is particularly true for reserve currency countries because of their ability to inflate the world economy and destabilize the system. Many have serious doubts that this is a feasible option. Economic cooperation is faced with serious problems, because countries differ in their institutional arrangements, policy objectives, and socioeconomic constraints. Time after time, policymakers have been unwilling to correct chronic balance-of-payments problems by


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Granting that any one or a combination of these hypotheses is correct, the question arises as to whether policymakers can obtain a better outcome through policy rules than the market does. An affirmative answer to the question presupposes that countries will be able to do the following: (1) identify and arrange the right structure of exchange rates better than the market does; (2) institute rules or formulas—which are generally accepted—to govern adjustments of exchange rates to changes in fundamentals; and (3) intervene systematically (and do so effectively) to preserve a set of announced parities—believed to be the correct ones—even when the market’s perception is quite different. To what extent these conditions can be fulfilled is questionable. The evolution of international monetary relations has shown that negotiations among nations about the correct structure of exchange rates has been cumbersome, slow-moving, and characterized by inflexibility when exogenous shocks and structural changes dictate a realignment of parities. Because political factors are implicitly interjected into negotiations, the negotiating process does not converge to a solution fast enough, or it converges to a solution that the market considers inconsistent with the changes in fundamentals. In these instances, the use of foreign-exchange intervention to preserve the established parities is costly, and its effectiveness is questionable.

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References


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