Economic Policy #07_08

Foreign-Exchange Policy

Foreign-Exchange Policy

- History of monetary system
- Convertibility and exchange-rate regimes
- Theory of optimum currency areas
- Balance of payments

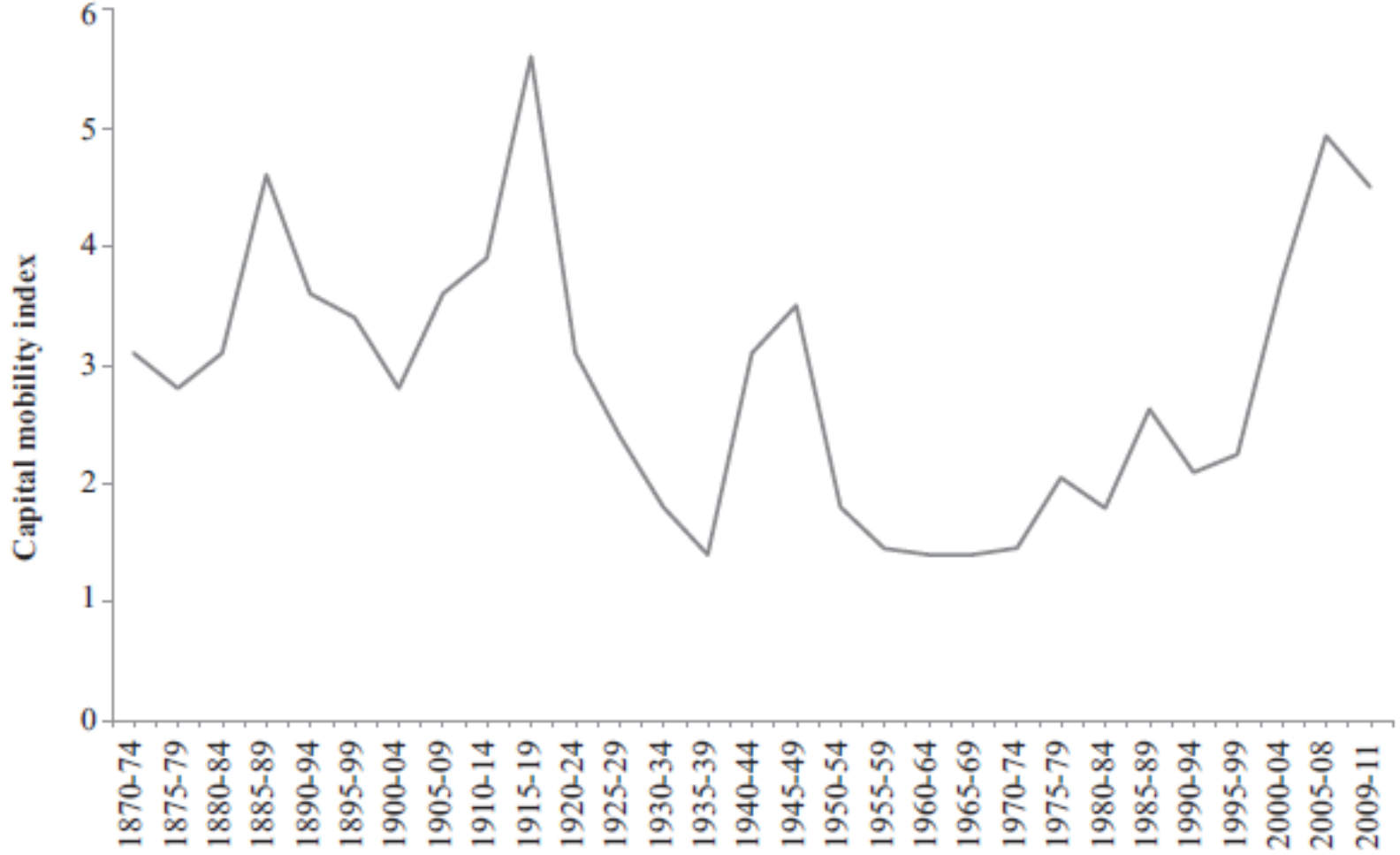
Brief history of the international monetary system #1

- System of *Gold Standard* was extended to all major economies in the 1880s and lasted until WWI: value of national currency was determined by a given gold weight => fixed exchange rates between national currencies.
- Gold Standard was temporarily restored in the end of 19920s but finally abandoned during 1930s as the countries turned to protectionist measures and *competitive devaluations*.

Brief history of the international monetary system #2

- After WWII Bretton Woods Conference established a *Gold Exchange Standard*, where all currencies were convertible into gold at a fixed rate. This system broke down in 1972.
- In 1979 *European Monetary System* (EMS) was established, whereby all cross exchange rates had to fluctuate within margins of +/- 2.25 % (in some cases +/- 6 %) around a central rate.
- In 1999 *European monetary union* was initiated.

International financial integration, 1870-2007



Source: Bénassy-Quéré (2012)

Currency convertibility and exchange rate regimes

Governments need to make two crucial decisions:

- on the conditions for exchanging the domestic currency for foreign currencies => *currency convertibility*
- on the extent of exchange rate flexibility => *exchange rate regime*

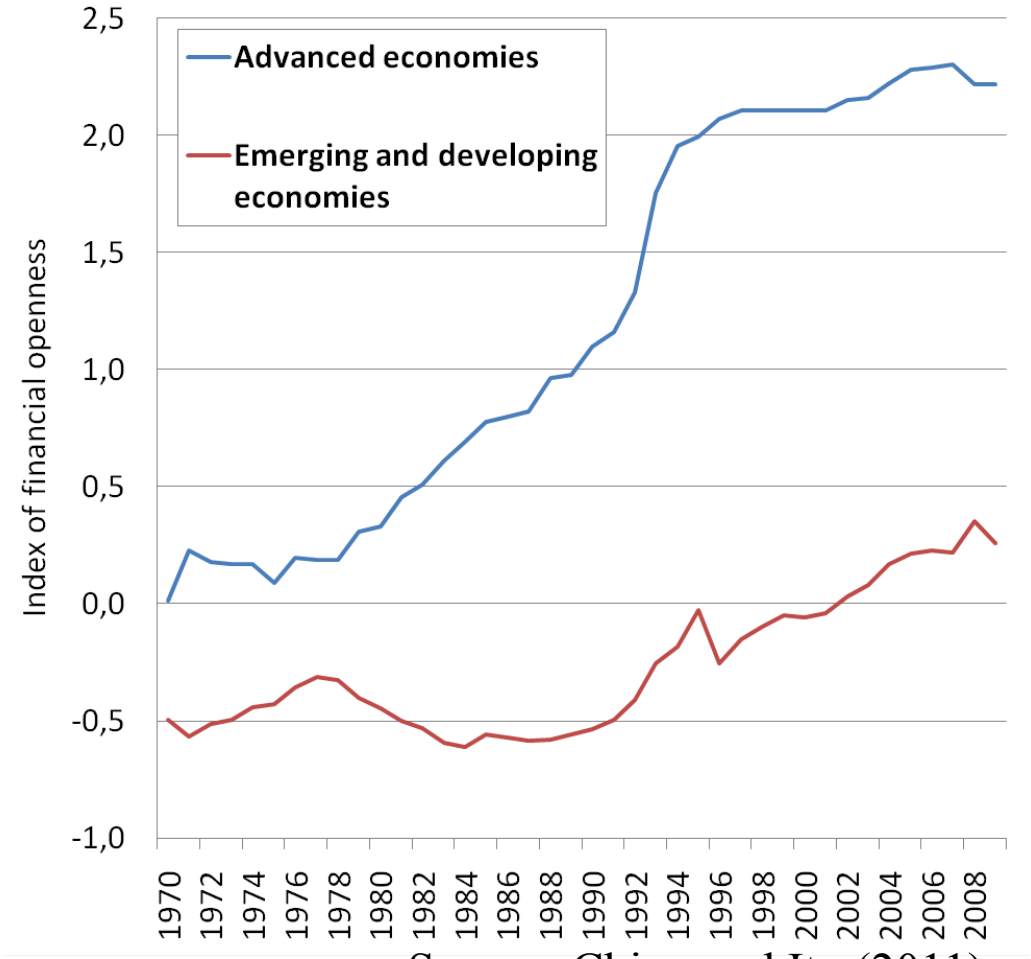
Currency convertibility

Currency is *nonconvertible* if the government set the value of the exchange-rate and submit foreign-exchange transactions to prior authorization (e.g. Soviet bloc before 1990).

It is useful to distinguish:

- *current account convertibility*: the currency can be exchanged freely for the purpose of importing good and services, current transfers and factor income
- *financial account convertibility*: direct investments, portfolio investments and bank loans without restriction (=> *capital mobility*)

Financial openness



Source: Chinn and Ito (2011).

While advanced economies have liberalized capital flows in the 1980s, this movement is still incomplete in developing countries.

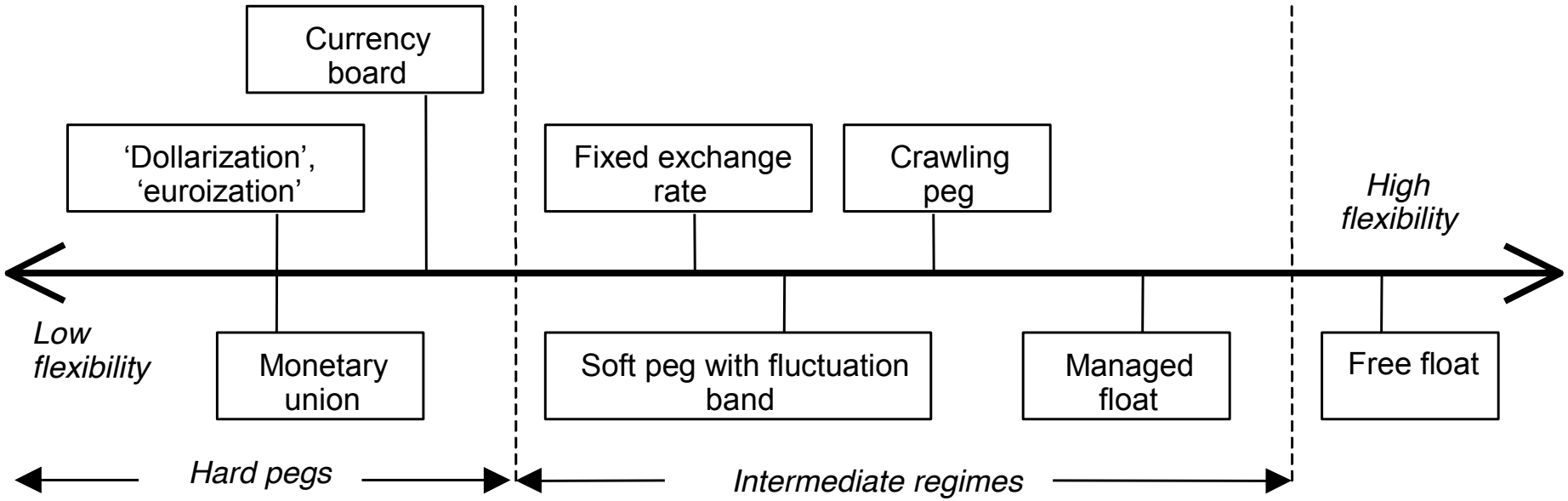
The pros and cons of capital openness #1

- Theoretical advantages:
  - enables the capital to flow to the most efficient places – helping both investors as well as all stakeholders
  - enable emerging economies to diversify narrow production base while simultaneously benefiting from technological spillover
  - capital flows from capital rich to capital poor countries as they should have higher returns
    - reduce cost of capital
    - enable investments
    - increase growth

The pros and cons of capital openness #2

- Potential problems:
  - fear of appreciation of domestic currency and making domestic manufacturers less competitive in global markets
  - fear of hot money; sudden injection of funds into small markets can cause initial dislocation and strains associated with sudden withdrawal
  - fear of large capital inflows, that can cause dislocations in the financial system and fuel asset price bubbles
  - fear of loss of monetary autonomy; see impossible trinity

Exchange-rate regimes #1



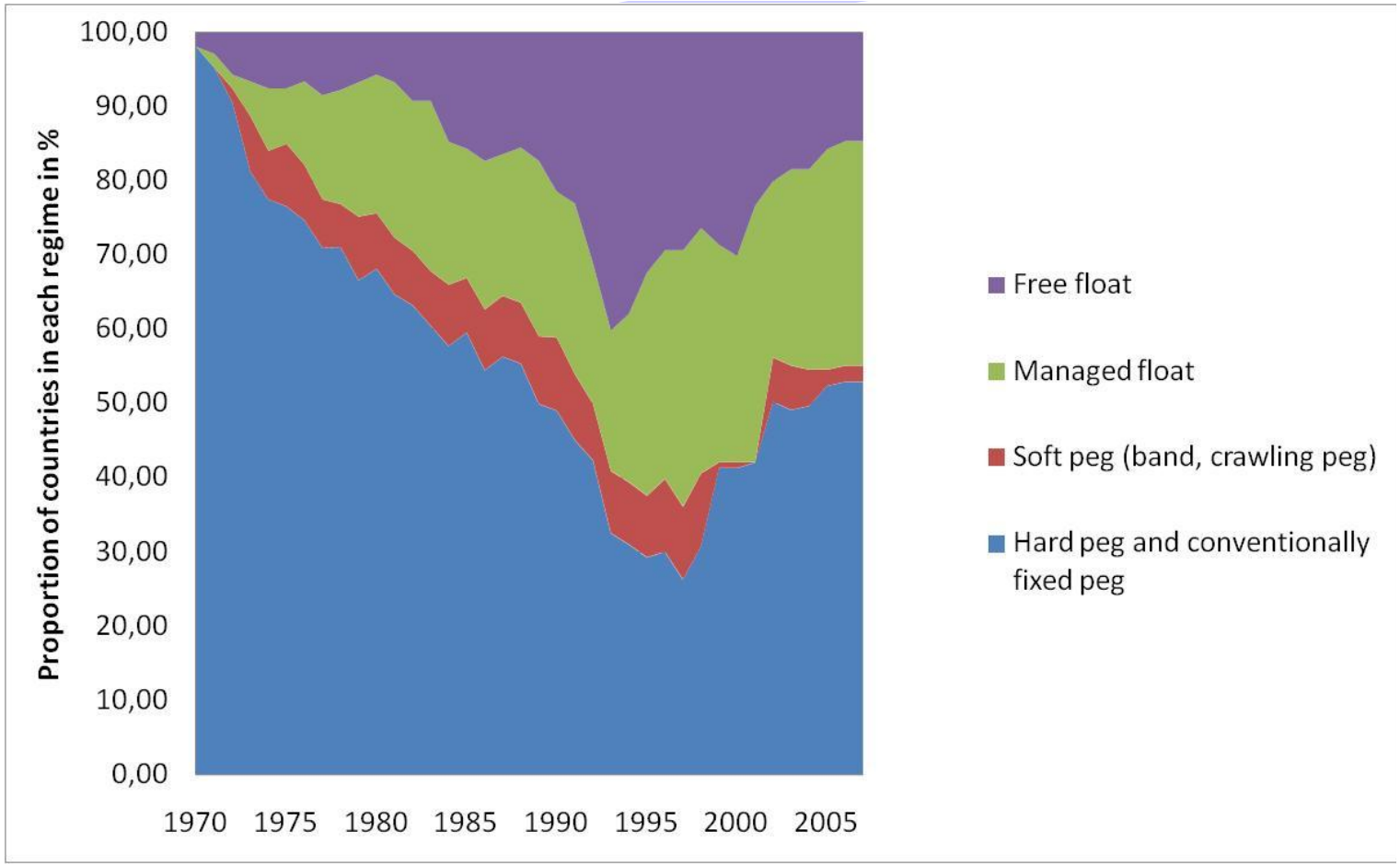
Exchange-rate regimes #2

- ’*Dollarization*’, ’*euroization*’: the currency of another country circulates as the sole legal tender: dollar (e.g. Panama, Ecuador), euro (e.g. Montenegro and San Marino). Another option is that the same legal tender is shared by members of *monetary union*.
- *Currency board*: explicit legislative commitment to exchange domestic currency at a fixed rate, issuance of domestic currency is backed by foreign assets only.
- *Fixed exchange rates*: the country pegs its currency within margins of +/- 1 % or less vis-à-vis another currency (or basket of currencies)

Exchange-rate regimes #3

- *Soft pegs with fluctuation band*: the value of the currency is maintained within certain margins of fluctuation of more than +/- 1 % around a fixed central rate
- *Crawling pegs*: the central rate is adjusted periodically, usually in response to changes in selective quantitative indicators (e.g. inflation differentials)
- *Managed floating*: The CB attempts to influence the exchange rate without having a specific exchange rate path or target
- *Free floating*: the exchange rate is fully market-determined

Exchange-rate regimes: fear of floating?



Source: Bénassy-Quéré (2012)

The Exchange Rate Regime Dilemma: the pros and cons of fixed regime

- The risk of speculative attacks when the firmness of the commitment is being questioned that can lead to currency crisis.
- A country must keep large quantities of foreign currency.
- By commiting to a fixed rate a country commits itself not to engage in inflationary policies.
- CB must give up independent monetary policy.

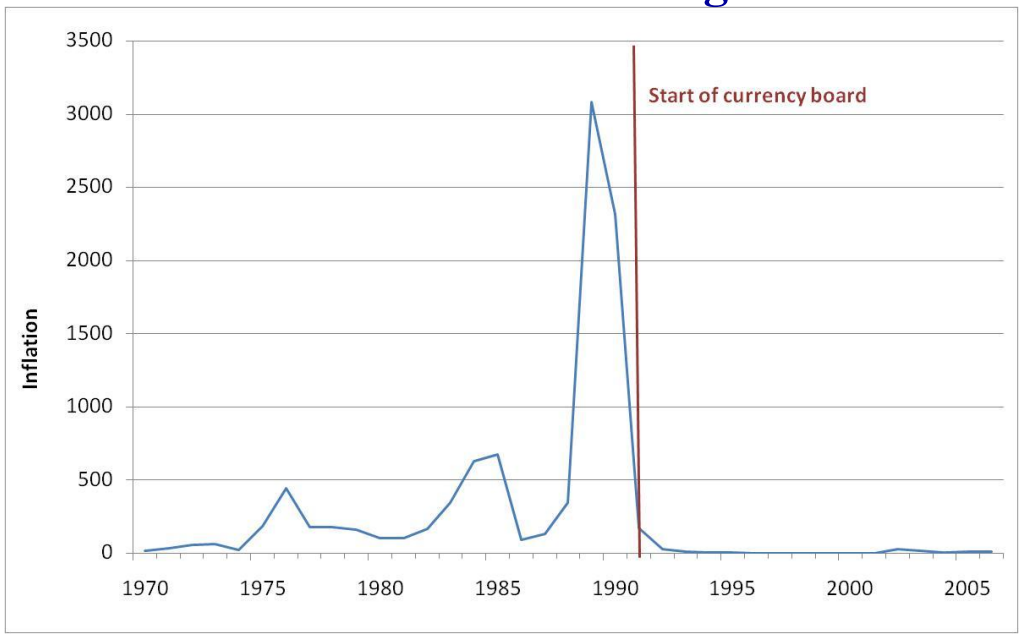
The benefits of pegs: credibility

Inflation and growth performance under various exchange-rate regimes

	CPI inflation	GDP growth
Pegged	8.4%	1.4%
Intermediate	11.6%	2.1%
Floating	15.2%	1.7%

Source: Gulde, Gosh and Ostry (1997), based on 36 countries over 1960-1990.

Disinflation in Argentina

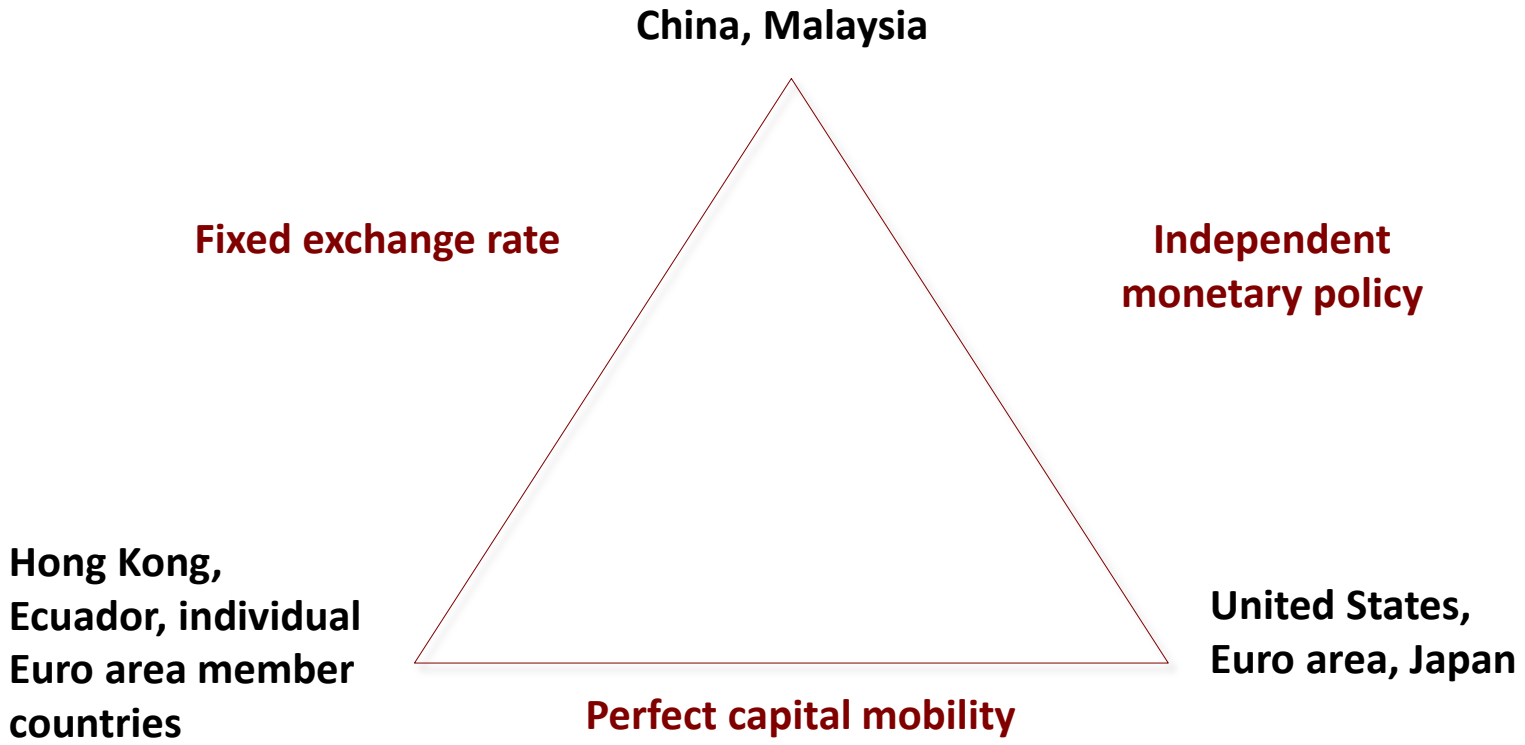


The Exchange Rate Regime Dilemma: the pros and cons of floating

- Large exchange rate fluctuations are a major source of uncertainty.
- Exchange rate fluctuations affect the relative value of assets and liabilities => depreciation raises the value of the external debt.
- Monetary independence of the CB is sustained.
- Countries are better able to absorb economic shocks.

Convertibility and exchange-rate regime: a joint choice

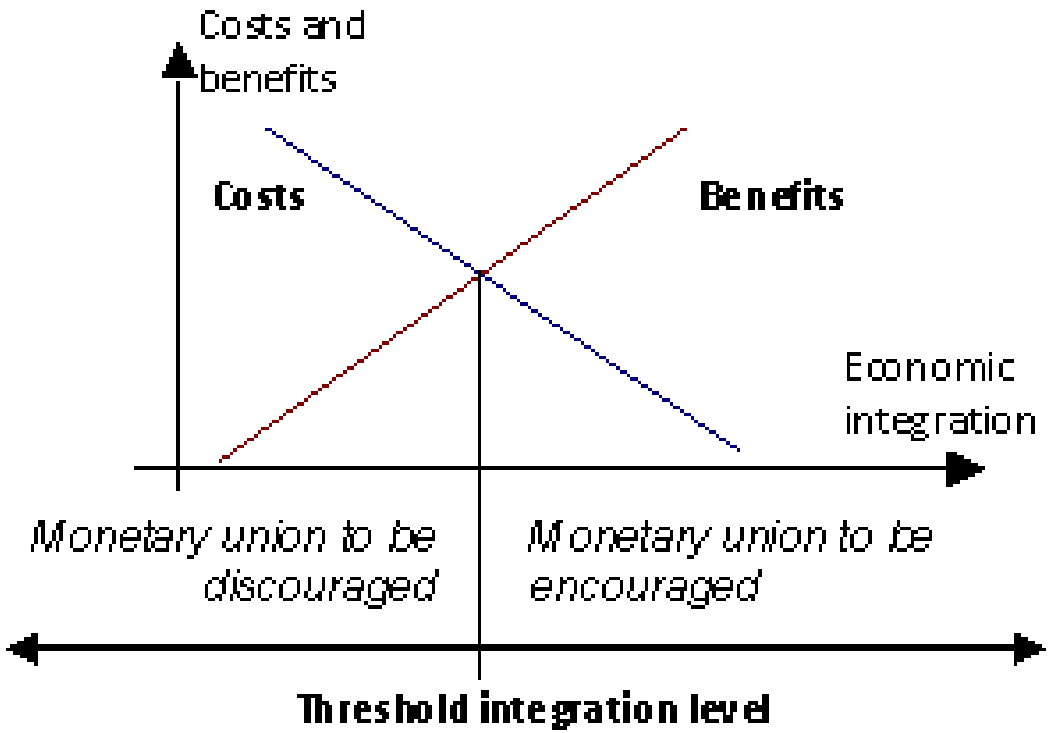
Mundell's impossible trinity



A country cannot simultaneously enjoy an independent MP, a stable exchange rate and a perfectly mobile capital.

Regime choice: the optimum currency area theory (OCA) #1

The OCA theory predicts that fixed exchange rates are most appropriate for areas closely integrated through international trade and factor movements.



The optimum currency area theory #2

- Benefits:
  - saving from avoiding the uncertainty, confusion, and calculation and transaction costs that arise when exchange rates float
  - are higher, the higher the degree of economic integration between the joining country and the fixed exchange rate area

The optimum currency area theory #3

- Costs:
  - arise because a country that joins an exchange rate area gives up its ability to use the exchange rate and monetary policy for the purpose of stabilizing output and employment
  - are lower, the higher the degree of economic integration between a country and the fixed exchange rate area that it joins

Is the euro area an optimal currency area? #1

An OCA occurs when

- Countries have achieved real convergence
- They respond in similar ways to external economic shocks or macro policy changes
- They have sufficient flexibility in both their product markets and labor markets to deal with these shocks
  - High mobility of labor
  - Wage and price flexibility in factor markets
- Countries are prepared to use fiscal transfers to even out some of the regional economic imbalances

Is the euro area an optimal currency area? #2

The Euro Zone does not come close to an OCA by most criteria, because

- The core group of EU countries are broadly similar (Germany + France + Netherlands + Belgium) but peripheral countries have big structural differences
- There are barriers to the mobility of labor
- Price and wage flexibility is rather low
- The role of fiscal transfers is limited

Balance of payments (BP)

- It is a double entry system of record of all economic transactions between the residents of the country and the rest of the world carried out in a specific period of time.

- It takes into account the export and import of both visible and invisible items.

Structure of balance of payment

BP consists of three accounts:

- *Current account*: all payments from/to the rest of the world deriving from exports of goods and services, labor and capital income
- *Capital account*: capital transfers without a counterpart
- *Financial account* (formerly capital account): all sales of domestic assets to the rest of the world (*capital inflows*) and all purchases of foreign assets (*capital outflows*).

The US and euro area BP in 2008

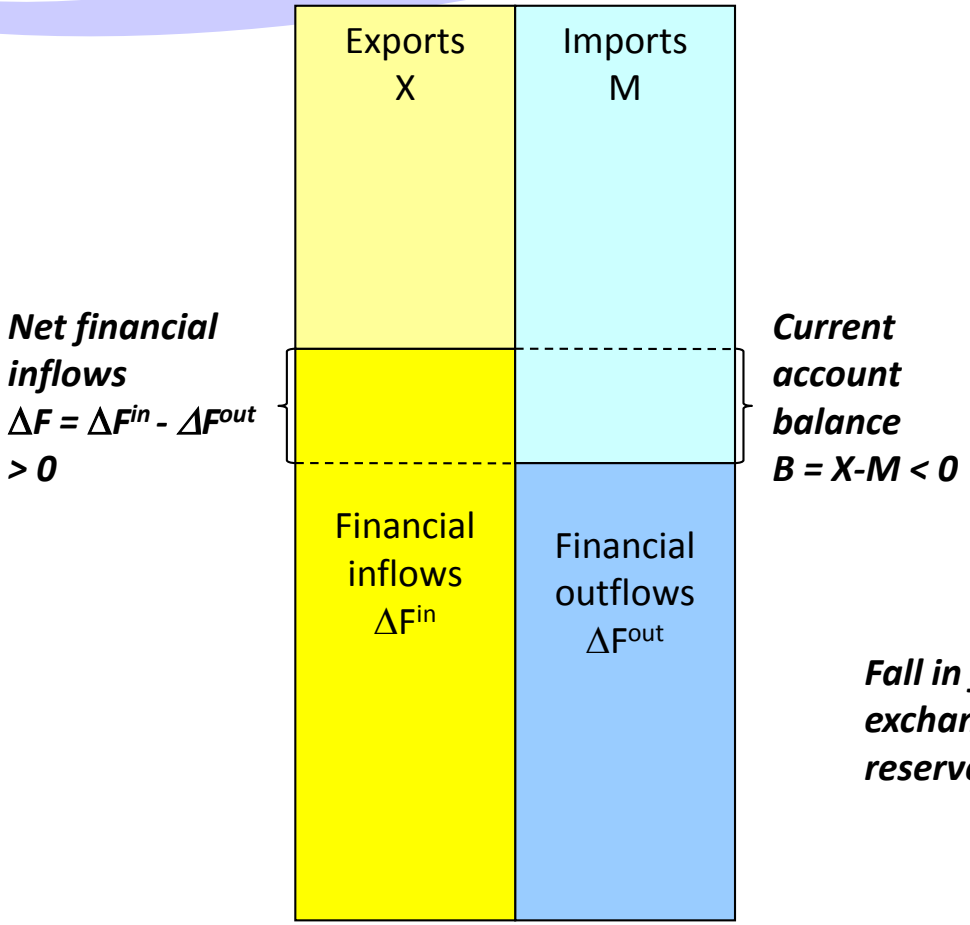
	US		Euro area	
	$bn	% GDP	€bn	% GDP
Current account	**−673.3**	**−4.7%**	**−67.3**	**0.7%**
Goods and services	−681.1		47.0	
Factor income	127.6		−22.0	
Transfers	−119.7		−92.3	
Capital account	**−2.6**	**−0.0%**	**13.7**	**0.1%**
Financial account*	**546.6**	**3.8%**	**212.6**	**2.3%**
Direct investments	7.4		409.2	
Portfolio investments	154.4		235.7	
Financial derivatives	−373.9		−12.3	
Other investments	342.2		102.1	
Foreign exchange reserves	416.5		−4.9	
Statistical discrepancies	**129.3**	**0.9%**	**−151.1**	**−1.6%**

Note: Financial account: net capital inflows (+), net capital outflows (−).

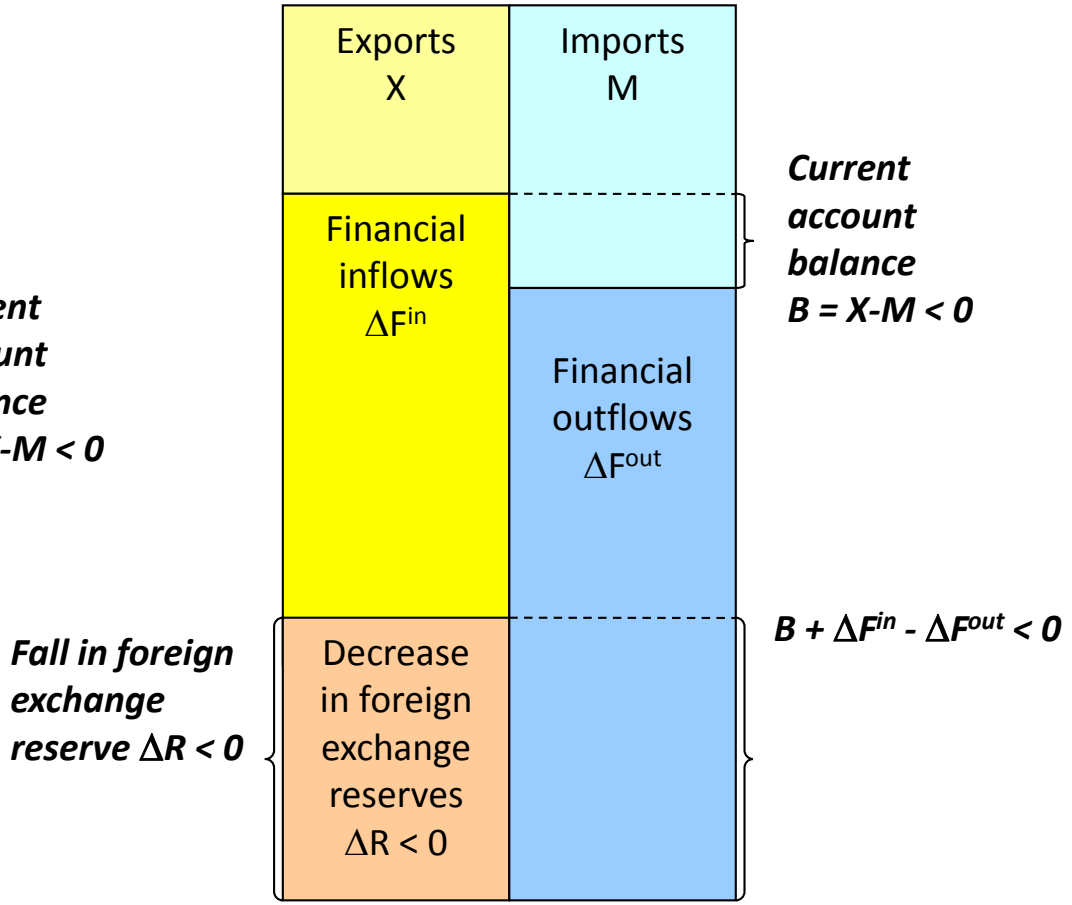
Source: European Central Bank and US Bureau of Economic Analysis.

Adjustment under fixed and floating exchange rates

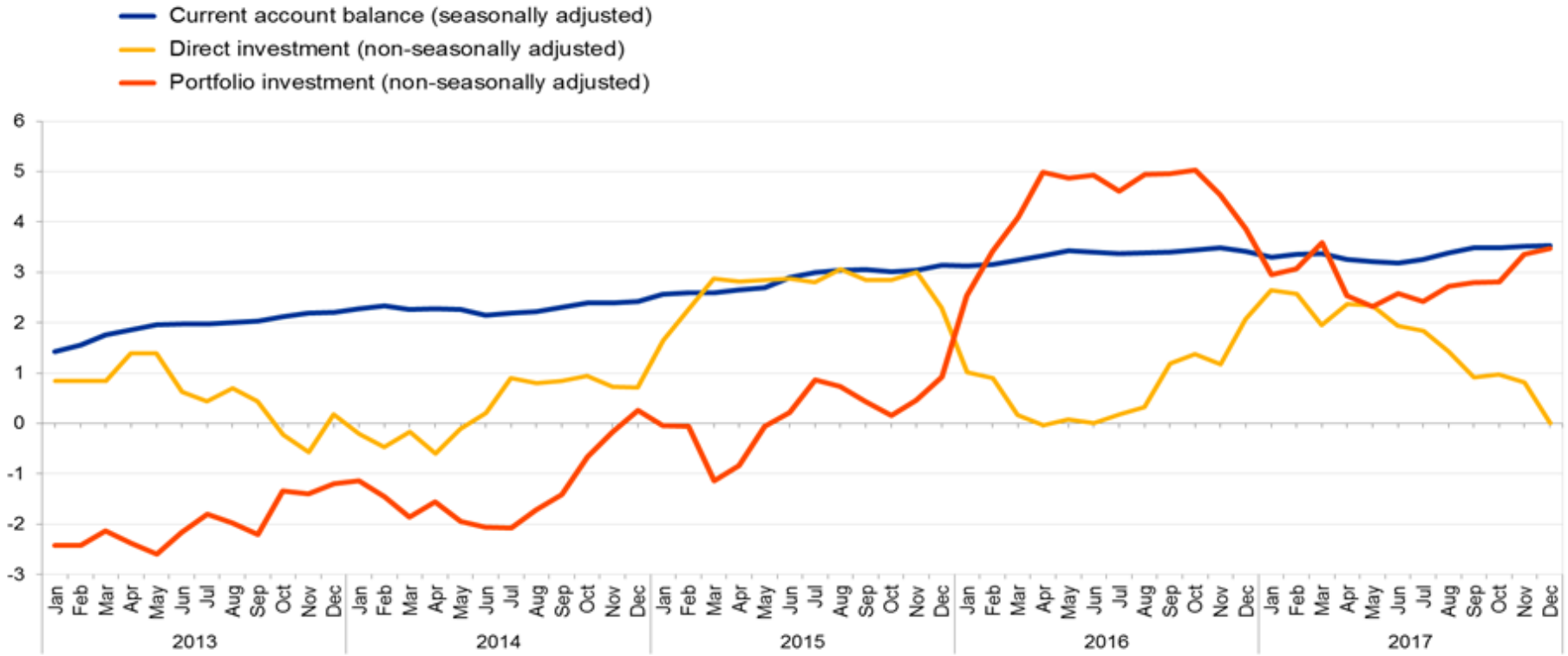
Floating exchange-rate regime: $B + \Delta F = 0$



Fixed exchange-rate regime: $B + \Delta F = \Delta R$

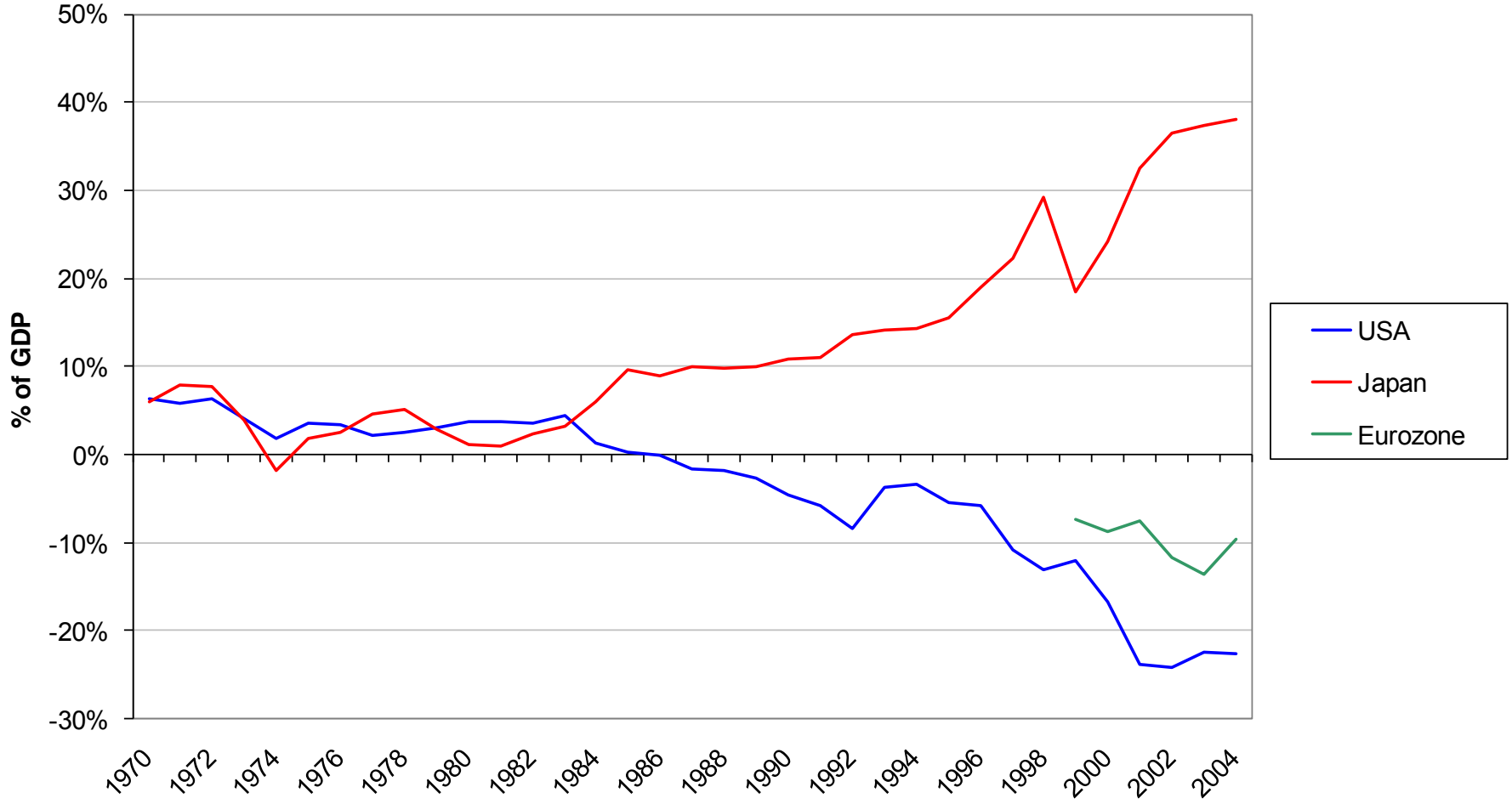


Balance of payment of the euro area (as % GDP)



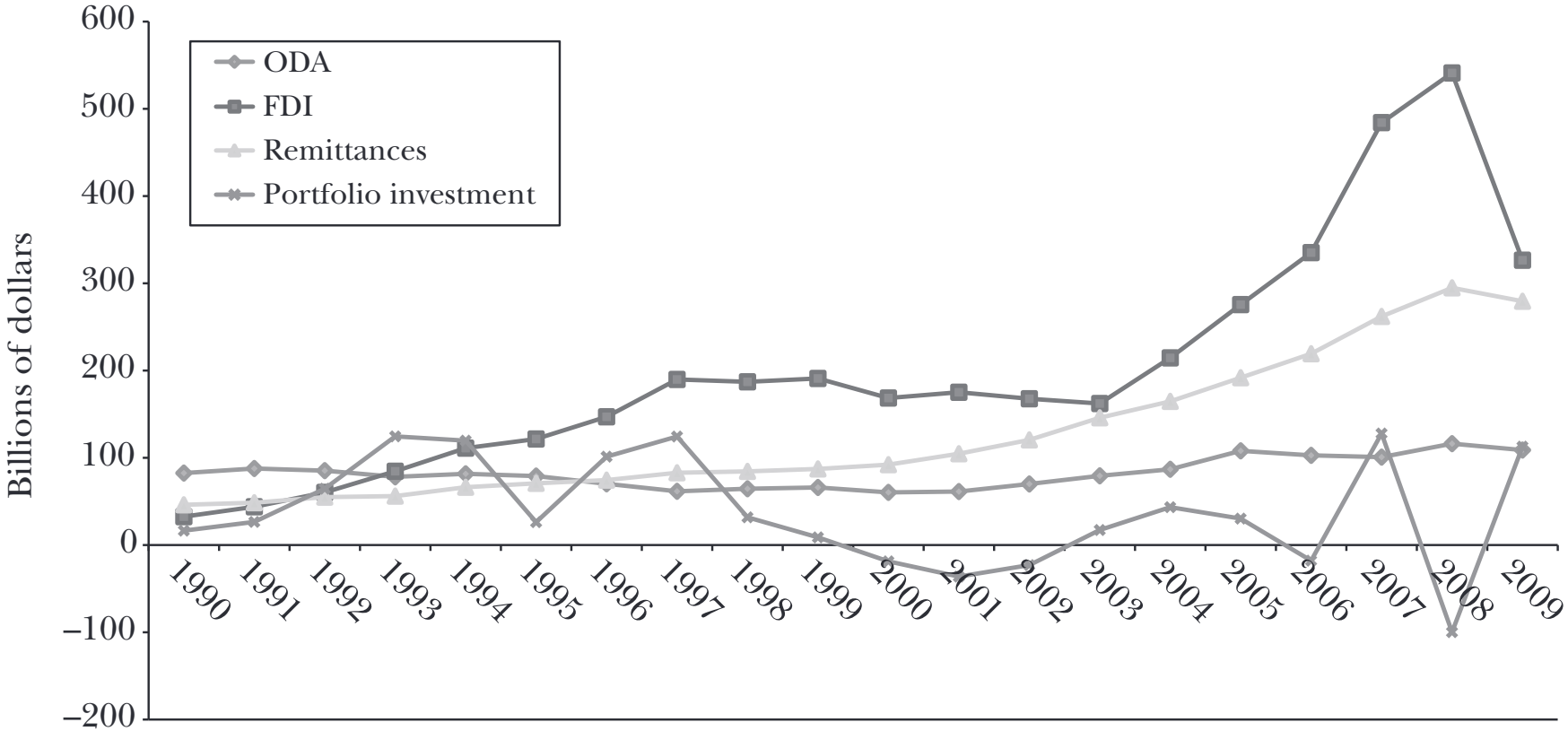
Source: ECB

Net foreign positions of the US, euro area and Japan, 1970-2007



Source: Bénassy-Quéré (2012)

Remittances vs. other international financial flows to developing countries (1990-2009)



Source: Yang (2011)

Reference textbook

Bénassy-Quéré, A. et al. *Economic Policy : Theory and practise*. Oxford University Press, 2010.
Chap. 5