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The Future of the International Exchange Rate System

Wolf Schäfer*

Abstract

The revival of a multilateral exchange rate system (ERS) with one single anchor currency and binding global rules for national exchange rate management is not a viable or realistic option. It is more realistic that the present 3-polar ERS in the medium term could dynamically enlarge to a 4-polar – in the long run even to a multipolar – system especially when taking China into account. In this view, the global ERS is likely to be extensively characterized by a small number of competing anchor currencies (currency oligopoly) which float vis-à-vis each other and to which pegs and managed floats are attached (satellite currencies). Globalisation contradicts international monopolies including monopoly currencies. Globalisation stimulates international competition including anchor currency competition. This paper underlines that this is why there is no way back to Bretton Woods or to any similar system based on only one single world anchor currency.

Key words: Exchange rate systems, Bretton Woods, anchor currency, currency competition, globalisation

JEL classification: E 44, E 58, F 31, F 33, F 55, G 15

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Wolf Schäfer

Inhalt: 1. Back to Bretton Woods, forward to a New Bretton Woods - or what? – 2. Basic arrangements of BW – 3. The international exchange rate system (ERS) today – 4. Aspects of modern exchange rate theory and policy – 5. Future global ERS architecture

1. Back to Bretton Woods, forward to a New Bretton Woods - or what?

The global financial crisis with its turbulent effects has brought about international debates concerning a new world financial architecture. Though the origin of the crisis is primarily not to be found in a miscarriage of the international exchange rate regime, calls have been made – here and there – for the shaping of a new Bretton Woods System (BW II) with reference to the old one (BW), which, as is well-known, was designed in 1944 and broke down in 1971 resp. 1973.

Today, there is no serious crisis of the international *monetary* system but rather of the international *financial* order. Thus, the call for a new BW II should essentially be interpreted as an urgent request for a reshaping of the institutional arrangements regarding the international financial institutions, i. e., the functionings of the national and international money and capital markets. This includes the management of system-related risks by private and state-owned financial institutions and governments.

At the eleventh anniversary of the Euro, we should have a short glance at the role of the Euro-system in this crisis: Some non-members (e. g. Denmark and Sweden) are reflecting on the pros and cons of remaining outside of the Euro-zone. Some members (e. g. Italy and Spain) have occasionally discussed costs and benefits of potential exit options. Due to the crisis, the spreads for state loans increasingly diverge in the Euro-area indicating growing economic and political heterogeneities between the members of the Euro-zone. It should be stressed that the spreads are currently significantly larger than at the beginning of the Euro-area, though not as large as prior to the introduction of the Euro (with the exception of, i. a., Greece). One main reason for this is the divergent credibilities of Euro-members' national screens for their banking systems and their public institutions' ability (or willingness) to pay for their external debt. Thus, diverging risks are stipulated.

In order to answer the back-to-BW-question in such a complex European and international monetary landscape after 35 years of empirical experience with the post-BW international monetary order, a short re-evaluation of the basic arrangements of BW is needed.

2. Basic arrangements of BW

BW of 1944 implied principally fixed exchange rates to the US-Dollar (USD) as the world anchor currency through intervention obligations of the national member Central Banks (except of the US-Fed) regarding the USD (originally within a +/- 1 %-band) (Schäfer 1981). The USD was irreversibly fixed to gold with an obligation for the USA of convertibility into gold vis-à-vis member Central Banks.

Realignments were allowed only in the case of a country's "fundamental" disequilibrium in its balance of payments. Thus, BW could be termed as system of "step flexibility" of

exchange rates with an asymmetric adjustment mechanism. The main function of the IMF was to supervise the system, to give credits roughly within the limits of a member country's quota resp. drawing right, but not to be an international lender of last resort.

BW collapsed in 1971 when the USA suspended the convertibility obligation, and in 1973 – after a short period of floating and following realignments – it was finally substituted by world-wide flexible exchange rates.

The main reasons for the collapse were manifold. In the first place, a significant mismatch of extended aggregates of USD outside the USA to the US-gold stock had been generated due to the fact that the USA as the anchor country was able to invoice any import and foreign investment in USD, i. e., in a currency which the country could create without limit. Thus, the USD world money supply expanded to such an extent that – in combination with the creation of Special Drawing Rights (SDR) in 1970 by the IMF – the world inflation rate increased (Bordo, Eichengreen 2008). As the USA did not correctly play its role of a hegemon in providing a stable anchor currency, a world-wide confidence problem arose and – especially after the suspension of the US convertibility obligation in 1971 – destroyed the basic pillar of the system.

Secondly, there appeared an extended importance of growing international capital flows. The capital balance therefore increasingly came to dominate the trade balance in the countries' balance of payments. This was relevant also for the determination of exchange rates which became increasingly influenced by capital movements rather than trade which was in a way opposite to the traditional BW philosophy: Exchange rates and their fluctuations had to be explained by stock adjustments (money and financial portfolios) rather than by trade flows. This resulted in foreign exchange interventions becoming ineffective and increasingly counterproductive.

Thirdly, exchange rate policy was highly politicised so that realignments were generally carried out too late. This invited frequent low risk one-way speculative attacks and, furthermore, generated increasing disequilibria in the balances of payments, implying problems of structural distortions in the national economies: Undervaluation (overvaluation) implicitly subsidises (taxes) the export and import substitution sector of the economy and implicitly taxes (subsidises) the import sector. Thus, persistent misalignments of exchange rates – which developed as a core feature of the BW-system – principally means protection generating misallocation of national resources.

As misaligned currencies had to be realigned sooner or later due to world market forces and pressure of the trade partners, the adjustment costs of distorted production structures in the economies were higher in the step-flexible BW arrangements compared to those in a gradually adjusting exchange rate system.

3. The international exchange rate system (ERS) today

Since 1973, the international monetary order can be characterised as a world of principally floating exchange rates. Countries are free to choose their own exchange rate policy, there exists no official intervention obligations except for members of regional systems of fixed exchange rates or monetary unions, e. g., the European Monetary Union (EMU). The absence of intervention obligations does not mean that countries do not intervene casually or even permanently. Free floating is substituted by managed floating. However, there is high empirical evidence that foreign exchange interventions are not effective.

Contrary to BW, there exists no single anchor currency. Instead, three major currencies can be identified: the USD, the Euro and the Yen. They float principally against each other being attached by pegs and managed floats of other currencies. As regards pegs, there are various explicit and implicit ones: single peg, basket peg, crawling peg, currency board, dollarisation, monetary union and others. The theoretical and empirical literature on pros and cons of these alternatives is boundless.

Free floats, managed floats and pegs represent the countries' different philosophies as well as the means and ends concerning the ERS. Contrary to BW, three basic options are available:

The first option is between choosing the price level or the exchange rate as a nominal anchor. In the case that the country chooses the price level then the exchange rate is the resulting variable. An autonomous monetary policy and the realisation of seigniorage is possible. If the country fixes the nominal exchange rate as an anchor no autonomous monetary policy is possible and the price level is the resulting variable. Evidently, you cannot have both anchors at the same time.

The second basic option is between a nominal anchor and a real target. The nominal anchor approach implies that real prices produce internal and external equilibrium: real exchange rates, real wages, real interest rates. The real target approach means that the nominal exchange rate is a policy instrument affecting internal equilibrium, i. e., output and employment.

The third basic option implies the political choice between a unilateral and multilateral ERS. The unilateral approach is characterised by a country which accepts the international environment as given. This is relevant mostly for small countries. The multilateral approach means that countries join a system of binding rules. Examples of this are BW and the EMU.

4. Aspects of modern exchange rate theory and policy

The collapse of BW indicates that this system – and the multilateral succeeding regimes – has combined the disadvantages of fixed and flexible ERS rather than their advantages as was originally intended. Modern exchange rate theory has been developed partly away from paradigms of the BW times (see also Obstfeld, Rogoff 1996). The empirical evidence shows that under certain conditions corner solutions can promote stabilising expectations thus reducing destabilising speculation. Furthermore, corner solutions are recommended within cost-benefit analytical approaches of exchange rate realignments.

These are the main reasons why corner solutions have their high time in theoretical discussions and empirical implementations. Corner solutions represent exchange rate options which refer only to “pure” ERS: either irreversible pegs or totally free floats. The choice of either the first or the latter depends on the size of the economy. By and large, it is theoretically explainable and empirically verifiable that big countries prefer floats whereas small countries choose pegs.

This is reasonable if and because

- real exchange rates bear the main adjustment burden to bring about internal and external equilibrium,
- for big countries (relatively small tradables sector) the adjustment costs of changing export and import prices by changing the exchange rate as only one price are less than changing millions of home prices (relatively large non-tradables sector),

- for small countries the situation is the reverse: the implications being that it is less costly to peg the home currency and make a relatively small number of internal prices flexible.

Furthermore, the demand for irreversible corner solutions stems from the well-known confidence problem: Only trustworthy pegs and floats stabilise expectations of international capital disposers and traders. In addition, irreversible pegs, especially currency boards, reinforce the credibility of a country to gain stability by importing the Central Bank's reputation of the anchor country (i. a. Andersen, Chiriaeva 2007). This seems to be important, especially for small countries, in order to fight high inflation by a non-gradual strategy and to join a monetary union. Good examples are the exchange rate strategies of the former socialist middle and eastern European countries which, as part of their transformation process, are preparing for the EMU.

5. Future global ERS architecture

The revival of a multilateral ERS with one single anchor currency and binding global rules for national exchange rate management is therefore not a viable or realistic option. Consequently, this is also true for the Mundell-claim for a universal currency as well as for the proposal of the Chinese Central Bank for a raw material price based anchor currency to deprive the USD or even the proposal for a revival of the importance of the – inflation creating – SDR (Zhou Xiaochuan 2009). In a globalised world of increasing overall competition monopoly solutions are out of focus: No single currency regime is right for all countries or at all times.

Therefore, it seems realistic that the present 3-polar ERS in the medium term could dynamically enlarge to a 4-polar – in the long run even to a multi-polar – system especially when taking China into account (Schäfer 2008). This is likely to happen because the necessary conditions for becoming a leading currency imply a high share of world output, trade and capital flows in combination with an economic policy which is stability- and liberalisation-oriented. As regards the latter, the Euro might lose some comparative advantage as long as a significant number of members of the EMU (e. g. Greece and other PIGS) will continue to stick to a permanently weak economic and financial performance in combination with the willingness of the EU and their members to bail out these states in contradiction to the EMU constitutional arrangements.

China is still in great deficit regarding liberalisation. However, as the country is already fast approaching the strategy of expanding its political and monetary influence in Asia by increasing the attraction of the Yuan as invoice currency for Asian traders, capital disposers and investors, China is sooner or later forced to liberalise its trade and capital arrangements. In the same sense this also refers to a number of Arabic countries of the Middle East which are urgently striving to create an Arabic currency area in order to obtain more independence, especially from the USD.

Therefore, the global ERS is likely to be extensively characterised by a small number of competing anchor currencies (currency oligopoly) which float vis-à-vis each other and to which pegs and managed floats are attached (satellite currencies). Globalisation contradicts international monopolies – including monopoly currencies. Globalisation stimulates international competition – including anchor currency competition. This is why there is no way back to BW or to any similar system based on only one single world anchor currency.

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