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Beate Reszat\*

## Twenty Years of Flexible Exchange Rates: Experiences and Developments

*The Bretton Woods system of fixed exchange rates was abandoned at the beginning of March 1973 when currencies were allowed to float. Has the system of flexible exchange rates fulfilled the expectations placed in it? How should experiences with regional systems of fixed exchange rates be assessed, and what are the prospects for a return to such a system worldwide?*

When the leading Western industrial countries decided in March 1973 to allow their currencies to float against the US dollar, they freed themselves from constraints that had long prevented them from pursuing an independent national policy.<sup>1</sup> Although many players and observers were uncomfortable at the prospect of leaving exchange rates to be determined largely by the free play of the market, the decision was generally greeted with relief. The pressure generated by repeated waves of currency speculation had become too great. Many saw floating only as a temporary measure, however; they believed there should be a return to a system of fixed exchange rates as soon as circumstances allowed, but one that took account of the weaknesses that had now come to light.<sup>2</sup>

This did not happen. Instead, the world has learnt to live with flexible exchange rates, more of necessity than out of conviction, as the advocates of a system of fixed rates emphasize. Whatever the drawbacks of the present situation, however, a return to fixed rates does not seem advisable, given the experiences of the past twenty years.

In the light of experience with the Bretton Woods system, flexible exchange rates<sup>3</sup> were often seen initially as a panacea for the economic ills of the past. The primary advantage was considered to be that they insulated economies, and especially monetary policy, from disturbing influences from abroad. For example, during previous bouts of currency speculation the Europeans and Japanese had been obliged to accumulate massive dollar reserves, and the associated expansion in their domestic money supply had destroyed all hope of pursuing an effective stabilisation policy. Everybody realised that even with flexible exchange rates economies remained interdependent – via international price effects, for

example – but the constraints were considered small by comparison with those under the Bretton Woods system.

Flexible exchange rates were also expected to counter imbalances in the world economy by preventing exchange rate distortions from becoming as pronounced as in the past. It was claimed that the exchange rate mechanism itself worked in favour of equilibrium over the long term; as soon as a country recorded a current account surplus, the associated demand for its currency would lead sooner or later to a rise in its exchange rate and hence to a reduction in the surplus by increasing the prices of the country's exports in world markets and reducing the prices of imports.

Over the years a third advantage became discernible: freed from the need to subordinate economic and exchange rate policy to a common objective even in times of severe domestic economic and political constraints, the political players in the major industrial countries – heads of state and government, finance ministers and central bank governors – developed new forms of informal contact and new ways of reaching agreement, which were not restricted to monetary issues.<sup>4</sup> This type of co-operation, which came to be known as “summit diplomacy”, was seen

<sup>1</sup> A vivid description of the events leading up to floating is to be found in H. van der Wee: *Der gebremste Wohlstand*, Munich 1984, pp. 534 ff.

<sup>2</sup> For considerations along these lines, see for example: Bank for International Settlements: *Forty-fourth Annual Report*, Basle, 10th June 1974, pp. 32 ff.

<sup>3</sup> Even at the outset, currencies never floated completely freely; instead, there was a hybrid form of “managed floating”, in which the central banks intervened in the foreign exchange markets whenever they saw fit. With regard to the first few months after the collapse of the Bretton Woods system, for example, see Bank for International Settlements, *op. cit.*

<sup>4</sup> For the history of the early economic summits and G-7 meetings, see R. D. Putnam, N. Bayne: *Weltwirtschaftsgipfel im Wandel*, Bonn 1985, or R. Hellmann: *Weltwirtschaftsgipfel wozu?*, Baden-Baden 1982.

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by most of those involved, at least initially, as a satisfactory and efficient means of collaboration that would also avoid the disadvantages of institutional obligations as under Bretton Woods.

### The Return to Reality

Events soon proved, however, that flexible exchange rates could not live up to many of the expectations placed in them and had disadvantages of their own.<sup>5</sup> The first test came as early as the autumn of 1973, when the outbreak of the first oil crisis showed how vulnerable economies remained to external shocks, even under flexible exchange rates, and how much they were still interdependent, contrary to all expectations. This discovery was subsequently confirmed under conditions of divergent economic trends, the second oil price shock and the debt crisis of the eighties.

The hope that external imbalances would not become as pronounced as under the fixed exchange rates of the past was also disappointed. On the contrary: ever since the beginning of the eighties economic relations among the leading Western industrial countries have been dominated largely by the debate about the causes and effects of the enormous US "double deficit" in the federal budget and in the current account of the balance of payments.<sup>6</sup> The potential for conflict that this repeatedly generated, especially in relations with Europe and Japan, was one of the main reasons why the efforts at informal co-operation in international economic and monetary policy that had seemed so promising at the outset frequently came to nothing and the economic summits and G-7 meetings were increasingly in danger of degenerating into political circuses.<sup>7</sup>

Additional problems also arose. The expansion of world trade, the explosive growth in the international financial and foreign exchange markets<sup>8</sup> and their increasing interconnection as a result of the liberalisation of capital movements and the use of new EDP techniques and trading methods increased economic and economic policy interdependence. These factors also made it increasingly difficult for central banks to intervene in the markets to dampen exchange rate fluctuations and meant that intervention was less and less successful. Doubts began

to be voiced about the general effectiveness of exchange market intervention, and although the Plaza and Louvre Agreements gave temporary cause for optimism, in the end the credibility of the guardians of currencies worldwide was seriously damaged.<sup>9</sup>

Strong market growth, increasing international links and the development of new financing and trading instruments, some of them highly speculative, increased the system's vulnerability to shocks. This was reflected above all in extreme short-term exchange rate variability, which hardly anyone had expected on this scale.<sup>10</sup> In addition, exchange rates did not adjust to the longer-term condition of the real economy in the countries concerned and help eliminate external imbalances, as had been expected, but for long periods remained far removed from the levels observers regarded as compatible with economic fundamentals.

### Analytical Deficiencies

These completely unexpected and highly irritating developments made market operators and analysts alike extremely uncertain as to the real determinants of exchange rates. The accepted concepts of the monetary foreign trade theory appeared to have lost most of their validity. The underlying exchange rate trend did not seem to accord with long-term equilibrium, whether in terms of purchasing power parities or non-price "fundamental" determinants, nor did the short-term behaviour of exchange rates correspond to the models.<sup>11</sup>

Exchange rate movements are traditionally explained with the help of linear equilibrium models, in which exchange rate fluctuations are caused mainly by exogenous disturbances. One of the main causes of such disturbances is the emergence of new information that forces a revision of expectations as to future exchange rate movements and leads to corresponding transactions. After all adjustments have taken place, the exchange rate again follows an equilibrium path in accordance with real economic conditions.

<sup>9</sup> Doubts about what central banks could achieve by exchange market intervention had led the participants at the economic summit in Versailles in 1982 to commission a study on the effectiveness of currency intervention. The so-called Jurgensen Report reached an extremely pessimistic conclusion. When the G-7 countries proclaimed a common strategy for the dollar in the Plaza Agreement in 1985 and re-affirmed it in the Louvre Agreement in 1987, many observers assessed the situation much more favourably. In this regard, see also R. C. Henning: *Macroeconomic Diplomacy in the 1980s*, London 1987, or Y. Funabashi: *Managing the Dollar: From the Plaza to the Louvre*, Washington, D.C., 1988.

<sup>10</sup> See for example M. Willms: *Internationale Währungspolitik*, Munich 1992, p. 151.

<sup>11</sup> On the empirical failure of so-called structural exchange-rate models, see R. A. Meese, K. Rogoff: *Empirical Exchange Rate Models of the Seventies: Do They Fit Out of Samples?*, in: *Journal of International Economics*, Vol. 14, 1983, pp. 3-24.

<sup>5</sup> A survey of developments is to be found in L. S. Copeland: *Exchange Rates and International Finance*, Wokingham 1989, pp. 32 ff.

<sup>6</sup> This situation spawned numerous investigations and studies that attempted to find a fundamental solution to the problem. See for example Y. Ishiyama: *International Monetary Reform in the 1990s: Issues and Prospects*, Hamburg 1990.

<sup>7</sup> See also B. Reszat: *Zwischen Kooperation und Konflikt: Japans Stellung in der G-7*, in: M. Pohl (ed.): *Japan 1991/92*, Hamburg 1992, pp. 190-210.

<sup>8</sup> For a detailed analysis of the causes, see U. Denny: *Die Euro-Teilmärkte*, Hamburg 1987.

In the day-to-day course of events, however, the causes of disturbances cannot always be identified, and even if one thinks one has found them a posteriori, they are often out of proportion to the alleged effect. Moreover, some of the statistical properties of exchange rates do not "fit" the behaviour postulated by the theories. In the past this often caused authors to concentrate on these statistical properties without enquiring into the reasons for them.<sup>12</sup> Only recently have attempts been made to get to the bottom of the observed phenomena, for example by examining non-linear relationships.<sup>13</sup>

The theory is deficient not only in explaining exchange rate movements but also in analysing monetary policy relationships. In this respect it has hardly progressed since the sixties and early seventies, when monetary policy co-operation was described with the help of games theory models as a kind of prisoner's dilemma.<sup>14</sup> Played according to these rules, international co-operation should not come about at all, as every agreement invites the players to deceive and to be free-riders.

It is possible to explain why co-operation nevertheless takes place and agreements and treaties are observed only by abandoning the assumptions made in this connection and by stepping outside the framework of strict analysis. However, the treatment of this question then becomes incomplete and fragmentary, and is of only limited usefulness for describing and interpreting the situation. Even mathematically exacting formulations of the problem and time-consuming computer simulations<sup>15</sup> cannot disguise this fact.

It is often seen as a further weakness that there is no uniform theory of international economic relationships to provide decision-making aids for economic policy-makers attempting to assess the situation in which they find themselves and the effect of the instruments at their disposal. Depending on the model used and the type of assumptions made, scientific analyses reach very different and sometimes contradictory conclusions, which serve more to heighten uncertainty than to assuage it.<sup>16</sup>

<sup>12</sup> See also J. Kaehler: Statistische Modelle für den DM-Dollar-Wechselkurs, in: H. Kräger (ed.): Empirische Wirtschaftsforschung, Frankfurt 1988, pp. 131-173, and the literature cited there.

<sup>13</sup> See also B. Reszat: Cycles, Chaos and Exchange Rates, in: Pennsylvania Economic Review, forthcoming, and the literature cited there.

<sup>14</sup> See for example J. Niehans: Monetary and Fiscal Policies in Open Economies under Fixed Exchange Rates: An Optimizing Approach, in: Journal of Political Economy, Vol. 76, No. 4, 1968, pp. 893-920; K. Hamada: Alternative Exchange Rate Systems and the Interdependence of Monetary Policies, in: R. Z. Aliber (ed.): National Monetary Policies and the International Financial System, Chicago 1974, pp. 13-33; and, with regard to more recent works and for a critique of these approaches in general, B. Reszat: Spiele ohne Sieger, in: W. Filc and C. Köhler (eds.): Kooperation, Autonomie und Devisenmarkt, Berlin 1990, pp. 49-65.

In view of these shortcomings, official and private operators in the markets have no option but to muddle through or to base their decisions on uncertain concepts and ideas. In recent years banks and non-banks have been making greater use of technical analyses rather than relying on an exchange rate theory based on "fundamentals". The central banks of the major industrial countries are no less helpless in the face of monetary events. They are often criticised for merely reacting to events rather than pursuing an active policy based on an underlying principle. In view of the gulf that opened up between theory and practice as a result of the collapse of the Bretton Woods system, the Deutsche Bundesbank remarked at the very start of floating: "The international monetary system will develop further ... not as a result of the introduction of comprehensive new models but ... piecemeal and in small steps under the pressure of day-to-day necessity."<sup>17</sup> That has proved to be the case.

### Trend towards Regionalisation

In one respect, however, the monetary guardians and politicians of Western states appeared to be taking an active lead and to be highly successful, at least until a few months ago. This was in the introduction, implementation and further development of the European Monetary System (EMS) as a regional system of fixed exchange rates. When it became clear that a fixed-rate system would not be feasible at international level for many years to come, the European countries concentrated on linking their currencies even more closely together than in the past. Even those operating the system were surprised at the success of the EMS.<sup>18</sup> Within only a few years they achieved remarkable results in terms of stability and convergence, and the occasions on which they were forced to resort to parity changes to correct imbalances became increasingly seldom.

The prospects for a regional fixed-rate system among states that are heavily dependent on one another economically and highly integrated in terms of trade and current account transactions, as in the European Community, are better than for a world monetary system.

<sup>15</sup> See individual contributions in W. H. Buiter, R. C. Marston (eds.): International Economic Policy Coordination, Cambridge 1985.

<sup>16</sup> For an attempt to quantify the possible effects of different model assumptions on the outcome of international co-operation, see J. A. Frankel, K. E. Rockett: International Macroeconomic Policy Coordination When Policy Makers Do not Agree on the True Model, in: American Economic Review, Vol. 78, No. 3, pp. 318-340.

<sup>17</sup> Deutsche Bundesbank: Geschäftsbericht für das Jahr 1973, p. 53.

<sup>18</sup> For a detailed exposition of the reasons, see R. Hasse: Die Europäische Zentralbank: Perspektiven für eine Weiterentwicklung des Europäischen Währungssystems, Gütersloh 1989.

Whereas in a worldwide system exchange rates are largely determined by developments in the financial markets and the excesses of international speculation, at regional level they tend more to reflect real economic factors and are less vulnerable to disturbance by "irrational" flows. For this reason the European Community is not alone in seeking a fixed link among its currencies. Governments in other parts of the world are now also considering a formal co-ordination of policies in order to curb exchange rate fluctuations and a link with an "anchor currency" at regional level.<sup>19</sup>

Recent experience with the EMS has shown, however, that there are limits to how far one can go in this direction. It seemed only logical to crown the success achieved so far by introducing a common European currency. No thought was given to the way in which market expectations would be affected by individual countries deciding to follow an independent monetary and exchange rate policy, or by the protracted process of agreement and compromise, or by the spectacle of indecision and political uncertainty. Frictional losses on the road to European monetary union were predictable; that they would assume such dimensions and even threaten what had already been achieved could not necessarily have been foreseen. The scale of the difficulties was due mainly to the fact that the credibility of all those involved had been seriously damaged by the factors mentioned above.<sup>20</sup>

The lessons to be learnt from this experience are that even if a system has proved its ability to withstand crises over many years its existence is not necessarily assured, and that as soon as steps are taken to develop it further market operators can be expected to see this as an opportunity to take stock – which inevitably means they will also remember the system's weaknesses – and to test the

politicians' ability and determination to adhere to the policy in the future. This requires a conspicuous measure of agreement and consistency of behaviour at an early stage, which in this case the parties involved could not or did not wish to produce. Once the tide of speculation has begun to run, fundamental changes are almost impossible to achieve even at the regional level.

### Return to Fixed Exchange Rates Worldwide?

The difficulties facing even a system such as the EMS make it appear unthinkable to reintroduce fixed exchange rates worldwide, in whatever form.<sup>21</sup> There are three main arguments against such a move.

First, the size of the foreign exchange markets. The sums that are now traded worldwide no longer bear any relation to international flows of goods and services, as they did in the days of Bretton Woods, and far outweigh the resources available to central banks for intervention purposes. The success of every official intervention therefore stands or falls on the credibility of the policy, and that depends on the circumstances; in a system of fixed exchange rates action must be taken at the latest when the currency reaches its margin. There is a great danger that at that stage the central bankers will run out of steam.<sup>22</sup> With flexible exchange rates, on the other hand, the central banks have rather more latitude and can achieve their objectives more easily and more quietly – or abandon them with less loss of face, and hence with less at stake on future occasions.

Secondly, since the seventies the currencies of the Western industrial countries have increasingly become the plaything of international financial jugglers in banks and companies. Their decisions are often only marginally influenced by so-called "fundamentals". Their behaviour therefore largely defies monetary analysis and explanation in terms of the current state of knowledge. This means that an analytical framework on which the international institutionalisation of monetary co-operation and a re-introduction of fixed exchange rates could be based is still lacking.

Thirdly, nothing has happened since the days of Bretton Woods to eliminate the danger that the engineering or maintenance of "unrealistic" exchange rates over a long period of time will exacerbate or even cause imbalances in the world economy. What have changed, however, are the market's responsiveness, which threatens to reinforce the imbalances, and the degree of economic interdependence, the effects of which can be more clearly felt than ever. "Wrong" exchange rates "cost" countries more dearly than twenty years ago. That casts a softer light on the disadvantages of the status quo.

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<sup>19</sup> Discussion centres at present on the prospects for a yen bloc in Asia, similar to the EMS "DM bloc" in Europe. See also J. A. Frankel: *Is a Yen Bloc Forming in Pacific Asia?*, in: R. O'Brien (ed.): *Finance and the International Economy*, Oxford 1991.

<sup>20</sup> For a detailed treatment, see B. Reszat: *Strategic Impediments to Currency Unification*, in: D. E. Fair, R. J. Raymond (eds.): *The New Europe: Evolving Economic and Financial Systems in East and West*, Dordrecht 1993, pp. 281-293.

<sup>21</sup> The proposals for reform of the world monetary system that have been most discussed in recent years have been those put forward by Ronald McKinnon, who advocates joint management of the money supply by the countries whose currencies enjoy a high degree of international substitutability, such as the USA, Japan and Germany, and the proposal from Marcus Miller and John Williamson to establish a worldwide system of target zones. See R. McKinnon: *An International Standard for Monetary Stabilization*, Washington, D.C., 1984; and M. Miller, J. Williamson: *Targets and Indicators: A Blueprint for the International Coordination of Economic Policy*, Washington, D.C., 1987.

<sup>22</sup> Even within the EMS the central banks usually intervene well before currencies reach their intervention points, as they fear they will fail if they wait until that stage. See for example "Europäische Politiker diskutieren über Anpassungen der EWS-Regeln", in: *Frankfurter Allgemeine Zeitung*, 25th January 1993.