

# Econ 340

## Lecture 16

### Fixed versus Floating Exchange Rates

## Outline: Fixed versus Floating Exchange Rates

- Both Systems Are Used
- What the "Experts" Recommend
- Pros and Cons of Floating
  - Disruption When Rates Move
  - Automatic Adjustment
- Pros and Cons of Pegging
  - Stability
  - Instability
- Alternatives
  - Crawling Peg
  - Monetary Unification
- The Problem of Undervalued Currencies

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## Who Uses Fixed and Float

- Lessons from the list of exchange arrangements (below)
    - Floating rates are used by many countries
      - Rich & poor
      - Large & small
      - All over the world
    - Pegged rates are used today mostly by small countries
    - Many countries are between fixed and floating
- (Source of table below: IMF, "Annual Report on Exchange Arrangements and Exchange Restrictions 2008")

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## Exchange Arrangements of Sample Countries, as of 2013

Floating Exchange Rates		48 countries + euro 17
Australia	Mexico	
Canada	Sweden	
India	United Kingdom	
Japan	United States	
Pegged Exchange Rates		45 countries
Belize	Latvia	
Denmark	Nepal	
Jordan	Saudi Arabia	

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## Exchange Arrangements of Sample Countries, as of 2013

### Between Floating and Pegged:

Stabilized Arrangement		19 countries
Costa Rica	Ukraine	
Lebanon	Vietnam	
Crawling Peg or Crawl-like Arrangement		17 countries
Argentina	China	
Other Managed Arrangement		19 countries
Bangladesh	Russia	
Malaysia	Switzerland	

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## Exchange Arrangements of Sample Countries, as of 2013

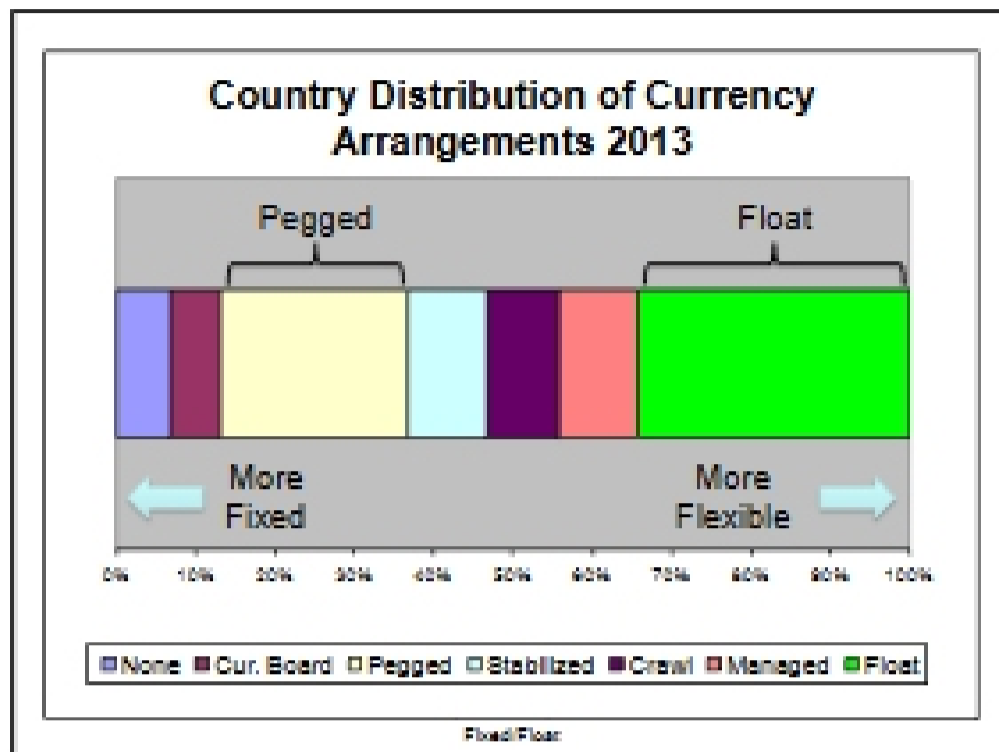
### More Fixed than Pegged:

Currency Board		12 countries
Hong Kong	Lithuania	
No Separate Legal Tender		13 countries
Ecuador (\$)	Montenegro (€)	

- Currency Board
  - Peg to another currency
  - Vary money supply automatically with changes in international reserves (= forced nonsterilization)

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### What "Experts" Recommend


- Some favor freely floating rates
  - Let exchange rate adjust to fix imbalances
  - "Let the market work"
- Others favor perfectly fixed rates
  - Define currency rigidly in terms of something you can't control
    - Gold
    - Foreign currency ("Currency Board")
  - AND give up control of the money supply
    - Let flows of money fix imbalances
    - i.e., do not sterilize!

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### What "Experts" Recommend

- Advocates of floating rates
  - Milton Friedman (Nobel Prize 1976):

"A country that enters into a hard-fixed rate bears an economic cost. The cost is discarding a **means**—a flexible exchange rate—of **adjusting** to external forces that impinge on it differently than on the other country or countries whose currency it shares."



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### What "Experts" Recommend

- Advocates of floating rates
  - Jeffrey Sachs:

"Once reserves are gone, investors panic. The worst **mistake** is for countries to **wait too long** to float their currencies."




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### What "Experts" Recommend

- Advocates of fixed rates
  - Robert Mundell (Nobel Prize 1999):

"A world currency of some sort has existed for most of the past 2,500 years. Two thousand years ago, in the age of Caesar Augustus, it was the Roman aureus... A hundred years ago it was the gold sovereign. Less than thirty years ago it was the 1944 gold dollar. The **world** has been **without a universal currency** for only a tiny fraction of its history."



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## What “Experts” Recommend

– Milton Friedman:

“If [over the last 30 years] the Canadian dollar had been rigidly tied to the US dollar, those differences **would have required Canada to deflate** relative to the United States, with unfortunate consequences for Canada that would have strained, to put it mildly, the trade relations between the two countries, and have put strong pressure on Canada to devalue or float.”

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## What “Experts” Recommend

– Robert Mundell:

“Exchange rate **uncertainty imposes a cost** of trade much like a tariff ... If Canada and the United States shared a stable common currency or an irrevocably fixed exchange rate, Canada’s real income would soar, closing a large part of the gap between the two countries’ GDP per capita.”

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## What “Experts” Recommend

- “Bradford DeLong, an economic historian at the University of California at Berkeley, explains the debate to his students this way:

To Mr. Friedman, an **exchange rate is a price**; therefore, it is an infringement on human freedom to peg it. To Mr. Mundell, an **exchange rate is a promise**; to change it is to default on a commitment.



” (WSJ)

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## What “Experts” Recommend

- Allan Meltzer (Carnegie-Mellon): “The best you can say of what economic research has produced is:

- You **can make a case for freely floating** exchange rates if you’re willing to live with the consequences.
- You **can make a case for fixed** exchange rates if you’re willing to live with the consequences.
- You **can’t make** much of a case for **anything in between.**”



(WSJ)

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## What “Experts” Recommend

- Where they agree: An “adjustable peg” is worse than both fixed and floating rates
  - Friedman: “The reasons why a **pegged exchange rate is a ticking bomb** are well known.”
  - Mundell: “I have **never** nor ever would **advocate** a general system of “**pegged**” rates. Pegged rate systems always break down.”

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