Occasional Papers
No. 63

Exchange Rate Regimes: Some Lessons from Postwar Europe

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Published by
Group of Thirty©
Washington, DC
2000

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I. Introduction

For decades the range of choice for an exchange rate regime consisted of fixing the exchange rate to an anchor currency or basket of currencies or allowing it to float, with or without intervention in the process. Now a more extreme option has emerged, hard pegs. Once considered as exotic, such arrangements as currency boards (Ghosh et al., 2000) or dollarization (Calvo, 1999), involving the surrender of all national discretion over the exchange rate, are now spreading. There is also serious talk about setting up regional monetary unions, in particular in the Mercosur area and in Southeast Asia (the Chang Mai initiative).

In parallel a new conventional wisdom has emerged under the rubric of "hollowing out." The hollowing-out view holds that there is no workable middle ground between floating and hard pegs. Traditional fixed exchange rate regimes, involving some degree of discretion and intervention, fall in the unworkable middle. Although still in place in more than half of all countries, these regimes are doomed in a world of unfettered capital flows. Full capital mobility, in turn, is taken as a Darwinian step in mankind's evolution.

As the hollowing-out view gains ground, Europe's evolution is often seen as a blueprint for the emerging market economies. Over the last half-century, the European countries have moved from pegged exchange rates backed by capital controls to full capital mobility and a monetary union. Along the way, they have intensified their economic integration, eventually establishing a thorough

common market. And they are now pursuing an agenda of gradual political integration. The record is broadly one of peace and prosperity.

Is Europe a model? In order properly to answer this question, one has to look at the particular circumstances that brought about success, as well as the setbacks and costs incurred along the way. Were the costs worth it? Are the same characteristics present elsewhere in today's developing world? Is it not the case that the "European strategy" is made obsolete by the globalization phenomenon and the information technology revolution?

These questions motivate the present paper as it revisits Europe's postwar experience with exchange rate regimes. A key aspect is Europe's unflinching commitment to fixed exchange rates, indeed to the point of ultimately sharing the same currency. The paper argues that behind Europe's commitment to exchange rate stability lies a widely shared belief that it is a pre-condition for trade integration as it is the only way of establishing a level-playing field for international competition. This concern has led European countries to take various protective measures, including capital controls, until they were ready to adopt a common currency.

The following section sets the stage; it describes the exchange rate regimes adopted in Europe over the last 50 years. Section III argues the case that trade was a key concern behind the commitment to exchange rate stability. Having noted that fixed exchange rate regimes are inherently unstable, Section IV looks at the various measures that were adopted in an effort to increase the chance of survival of the fixed exchange rate arrangements. These measures at times severely constrained the financial markets, both domestic and external. But is not the case that such measures are costly and inefficient? The fifth Section attempts to answer that question and, surprisingly perhaps, finds no such evidence. Quite to the contrary, in Europe at least, domestic financial repression seems to have supported growth. The last section attempts to distill the lessons of Europe's experience. It argues that the choice of an exchange regime cannot be dissociated from the choice of a regime of capital mobility. Countries that are open, or country groupings that aim at deepening trade integration, may indeed opt for a fixed exchange rate regime. Hard pegs are an option, but not the only one once financial repression is no longer viewed as sinful.

II. Overview of Exchange Rate Developments

Fixed exchange rates were adopted in Europe in the immediate postwar period within the broader Bretton Woods agreement. It provided indirectly for fixed exchange rates within Europe but it was not a joint undertaking, nor was it intended to further any specific European goals. It matched European interests but also those of the United States since they were equally preoccupied with the restoration of trade links. Faced with an acute shortage of dollar balances, European countries did not move to establish currency convertibility from the outset. Rather they concentrated on developing bilateral payment settlement agreements, both among themselves and with non-European countries. Yet, early on within the Bretton Woods framework, they started to work out their own arrangements:

- The European Payments Union (EPU) was set up in 1950 to simplify the cumbersome web of some 200 bilateral payment agreements that had been set up. The EPU worked as a multilateral clearing system, focusing on the overall balances of payments of its member countries vis a vis the Union. The Bank for International Settlements (BIS) acted as agent for the EPU. Limited credit facilities were based on IMF-type quotas. They were extended to some countries that faced speculative pressure, for example during the Korean War in 1951-52, or in 1957-58 when France and the United Kingdom (UK) started to

run large deficits because their currencies had become overvalued due to accumulated inflation. As member countries grew less concerned about payments, they gradually lifted their extensive trade restrictions. Generally considered as a success, the EPU is credited with helping to restore intra-European trade. The EPU had some drawbacks, mainly its tendency to encourage trade amongst its members, discriminating against non-members. Over time the dollar shortage disappeared, lessening the need for the EPU which, in any case, had been explicitly created as a temporary arrangement.

- The restoration of currency convertibility in 1958 was a joint move. It was decided alongside the adoption of the Treaty of Rome, the foundation of Europe's Common Market. It also coincided with the end of the EPU. Convertibility only applied then to the current account. For many more years the financial account remained subject to fairly draconian restrictions in most countries.

Over the next decade, the arrangement provided for a high degree of exchange rate stability, with few realignments. The first major depreciation, by the UK, did not occur until 1967. It was followed by a depreciation of the French franc and a revaluation of the Deutschemark (DM), both in 1969. By the time the Bretton Woods system collapsed during 1971-73, further imbalances had accumulated inside Europe. After a series of realignments, most European countries undertook to maintain limited margins of fluctuation for their bilateral exchange rates while the other developed countries let their currencies float. The resulting arrangement, "the Snake," was a mixed success; most countries were able to adhere to the arrangement, but speculative pressure forced others—mainly France, Italy, and Sweden—to exit the Snake. Outside of Britain, no country seriously questioned the wisdom of keeping exchange rates pegged.

The main setback from monetary integration during this period was the abandonment of the Werner Report. Completed in 1970 and endorsed by the Council of Ministers in 1971, the Werner Report recommended the rapid adoption of a common currency. Three stages were envisioned, including the pooling of foreign exchange reserves for joint interventions. The turmoil surrounding the breakup of the Bretton-Woods system led the larger countries

to aim at more modest steps, partly out of pragmatism, partly as a pretext to escape a move that was clearly ahead of policymakers' thinking. The smaller countries, which were seeing their own policy autonomy decline, were frustrated but unable to shake the domination of the larger countries.

Monetary integration soon took another direction, though. The European Monetary System (EMS) was agreed upon in 1978 and launched in 1979. Eight of the then-nine members of the European Community became active members of the exchange rate mechanism (ERM). When the euro was launched in January 1999, all members of the European Union were part of the ERM, with the exception of Sweden, the UK and Greece. Greece joined the ERM later that year. Among European countries not members of the EU, Switzerland has traditionally steered its own currency alongside the DM, even though it has always been very careful not to declare an official linkup, and has occasionally used the exchange rate as a tool of monetary policy.

During its first ten years of existence, the ERM was buffeted by frequent crises. By the early 1980s its survival was very much in doubt, especially as a series of attacks affected the French franc in the wake of the election of President Mitterrand. The policy reaction turned out to be another show of support for fixed exchange rates as monetary authorities rededicated themselves to a new ERM, one where the DM would play the role of central currency. This "greater DM area" gradually asserted its credibility and became such a success that policymakers grew emboldened to move to the next logical step, monetary union.[1]

Success was concealing a buildup of tensions, however. Inflation rates had not converged and yet realignments were seen as *passé* on the road to monetary union. The combination of accumulated imbalances and a major policy mistake—denial that German unification would require a DM revaluation—triggered a round of violent speculative attacks. Two countries (Italy and the UK) left the ERM and many were forced to devalue, some of them several times. The ERM was radically changed when its margins of fluctuation were widened to the point of irrelevance. While, for all practical purposes ERM currencies were officially closer to floating, unofficially the monetary authorities endeavored to keep currency fluctuations within narrow margins, in fact quietly mimicking the defunct

ERM. By then, monetary union had been decided and its start date firmly set.

Summarizing, since the early 1950s, with the notable exception of Britain, the European countries have continuously sought to tie their exchange rates to a fixed regime. The Bretton Woods system initially provided an adequate framework that did not require an additional, explicitly European, initiative. When it fell apart, Europeans promptly moved to develop their own arrangements, starting with the rather informal Snake, moving on to the more structured and cohesive EMS, and ending at a full-blown monetary union. This history reveals a strong commitment to exchange rate fixity, even as most other developed countries, including the UK, were moving in the opposite direction of increased flexibility.

III. Why Fixed? The Trade Connection

There are several reasons for adopting a fixed exchange rate regime. The most commonly cited reasons are: the lack of sufficiently deep financial and exchange markets; a strategy of importing monetary discipline; and a quest for stability for trade purposes. Investigating policymakers' true motives is generally a hopeless task, and this is especially the case for exchange rate management. Nevertheless, the approach taken here is that a policy that is upheld consistently over a long period must reflect true intentions. The approach does not assume that each and every policy outcome reflects intentions. For a variety of reasons (unexpected shocks, policy mistakes, or changing policymakers' views) outcomes may be wholly unintended. However, these are occasional and temporary disturbances that cancel out on average over a long period of observation. This is the strategy adopted here.

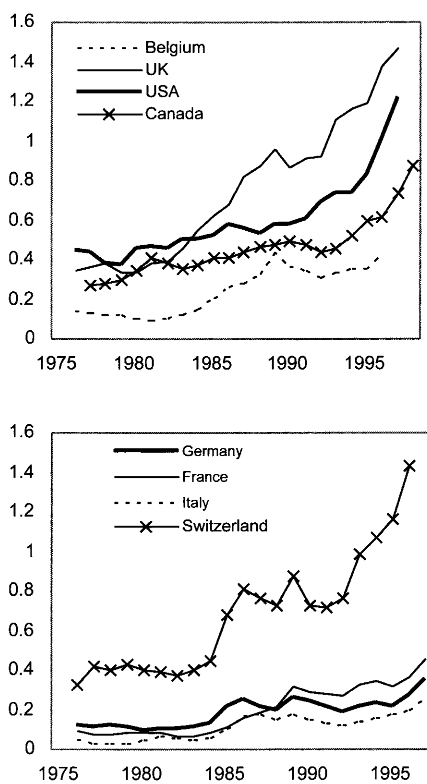
Illiquid markets

There is little doubt that financial and exchange markets were shallow in Europe in the 1950s, partly intentionally so, as explained in Section IV below. Allowing exchange rates to float freely under such conditions may result in excessive volatility. After the move to current account convertibility in 1958, capital account restrictions remained widespread, partly motivated by the belief that they

would assist the operation of the fixed exchange rate system. The question then arises: when did domestic financial markets reach a sufficient stage of development, permitting exchange markets to deepen enough, that exchange rates could be allowed to float if that were deemed desirable?

Figure 1 presents an indicator of financial depth: stock market capitalization as a proportion of GDP. The figure indicates that stock markets have traditionally been small in Europe, with the notable exceptions of Switzerland and the UK. Interestingly enough, Britain and Switzerland are the two countries that have demonstrated the least interest in a fixed exchange rate regime, and actually let their currencies float after 1973, with the exception of Britain's brief period of ERM membership. On the other side, a comparison with the perennial floater Canada shows that, for quite some time, Europe probably has had deep enough markets to operate reasonably stable exchange markets.

Figure 1. Stock Market Capitalization (ratio to GDP)



Source: World Bank

Monetary discipline

Fixed exchange rates discipline monetary policy when the peg is taken as the central bank's main target. The currency peg provides a nominal anchor that is as stable as the currency to which the domestic currency is fixed. Europe first used the US dollar as its reference currency and then gravitated towards a DM anchor. The discipline argument predicts that Europe's inflation rate should have remained close to that of the US early on, and then declined toward the lower German rate. It also predicts a contrast with other industrialized countries which have been floating for most of the post-Bretton Woods era (Japan, the UK, Switzerland and Canada; and more recently Australia and New Zealand). Figure 2 does not bear out these predictions. If fixed exchange rates were used as an anchor, it did not work. Europe (excluding the floaters, Switzerland and the UK) has, on average, had the worst inflation performance in the OECD area.

In many respects, the view that exchange rates can be used as an anchor is fairly recent, at least in European official thinking. When the EMS was created, reference was explicitly made to nominal exchange rate stability, not to anchoring inflation to best practice in Germany. Most ERM countries maintained other monetary targets alongside the exchange rate, mostly credit aggregates. Importantly, these multiple targets were not usually set consistently with respect to each other, or to Germany. Rather, they aimed at domestic objectives, mostly the level of interest rates and investment.[2] Realignments were not only possible but actively undertaken and always justified as a "correction" of accumulated inflation differentials.

In fact, the EMS was explicitly set up as a symmetric system, with no center currency. Its rules carefully avoided adopting the Bretton Woods presumption that high inflation-weak currency countries would bear the burden of adjustment in case of misalignment and market pressure. Responsibility for exchange market interventions was strictly bilateral, with unlimited support from the strong to the weak currency country. Applying the inflation-anchor argument to the setting up the EMS is a revisionist interpretation, building on the evolution that followed the currency crises of 1983 and the eventual adoption by France of the "Franc fort" strategy.

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As the hollowing-out view gains ground, Europe's evolution is often seen as a blueprint for the emerging market economies. Over the last half-century, the European countries have moved from pegged exchange rates backed by capital controls to full capital mobility and a monetary union. Along the way, they have intensified their economic integration, eventually establishing a thorough

common market. And they are now pursuing an agenda of gradual political integration. The record is broadly one of peace and prosperity.

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These questions motivate the present paper as it revisits Europe's postwar experience with exchange rate regimes. A key aspect is Europe's unflinching commitment to fixed exchange rates, indeed to the point of ultimately sharing the same currency. The paper argues that behind Europe's commitment to exchange rate stability lies a widely shared belief that it is a pre-condition for trade integration as it is the only way of establishing a level-playing field for international competition. This concern has led European countries to take various protective measures, including capital controls, until they were ready to adopt a common currency.

The following section sets the stage; it describes the exchange rate regimes adopted in Europe over the last 50 years. Section III argues the case that trade was a key concern behind the commitment to exchange rate stability. Having noted that fixed exchange rate regimes are inherently unstable, Section IV looks at the various measures that were adopted in an effort to increase the chance of survival of the fixed exchange rate arrangements. These measures at times severely constrained the financial markets, both domestic and external. But is not the case that such measures are costly and inefficient? The fifth Section attempts to answer that question and, surprisingly perhaps, finds no such evidence. Quite to the contrary, in Europe at least, domestic financial repression seems to have supported growth. The last section attempts to distill the lessons of Europe's experience. It argues that the choice of an exchange regime cannot be dissociated from the choice of a regime of capital mobility. Countries that are open, or country groupings that aim at deepening trade integration, may indeed opt for a fixed exchange rate regime. Hard pegs are an option, but not the only one once financial repression is no longer viewed as sinful.

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Success was concealing a buildup of tensions, however. Inflation rates had not converged and yet realignments were seen as *passé* on the road to monetary union. The combination of accumulated imbalances and a major policy mistake—denial that German unification would require a DM revaluation—triggered a round of violent speculative attacks. Two countries (Italy and the UK) left the ERM and many were forced to devalue, some of them several times. The ERM was radically changed when its margins of fluctuation were widened to the point of irrelevance. While, for all practical purposes ERM currencies were officially closer to floating, unofficially the monetary authorities endeavored to keep currency fluctuations within narrow margins, in fact quietly mimicking the defunct

ERM. By then, monetary union had been decided and its start date firmly set.

Summarizing, since the early 1950s, with the notable exception of Britain, the European countries have continuously sought to tie their exchange rates to a fixed regime. The Bretton Woods system initially provided an adequate framework that did not require an additional, explicitly European, initiative. When it fell apart, Europeans promptly moved to develop their own arrangements, starting with the rather informal Snake, moving on to the more structured and cohesive EMS, and ending at a full-blown monetary union. This history reveals a strong commitment to exchange rate fixity, even as most other developed countries, including the UK, were moving in the opposite direction of increased flexibility.

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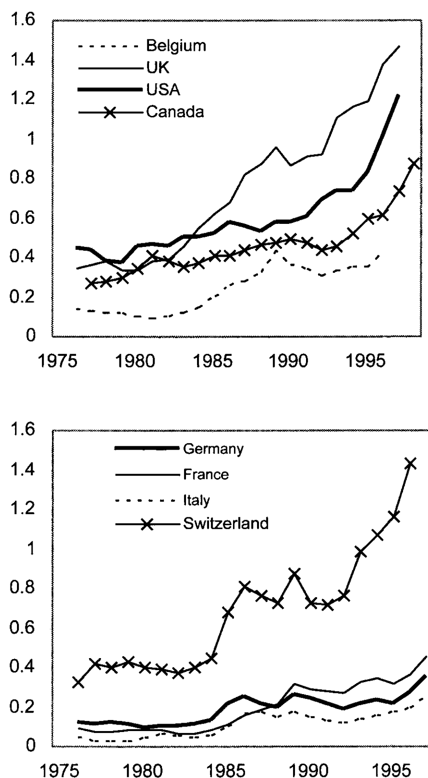

Source: World Bank

Monetary discipline

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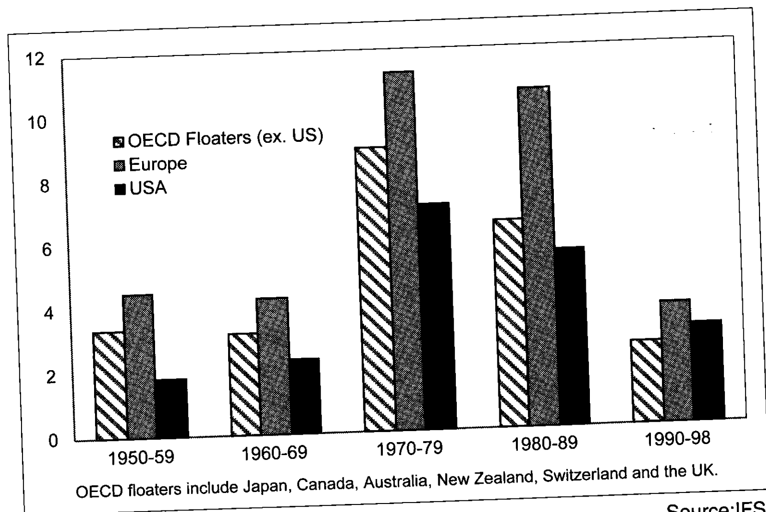
Figure 2: Inflation in the OECD Area



Trade

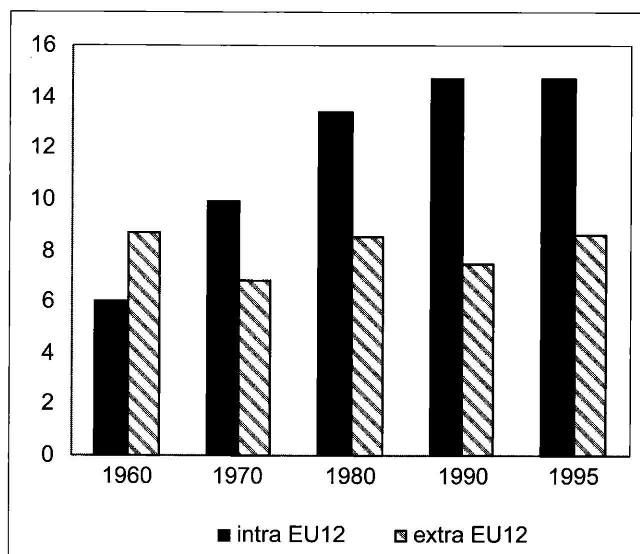
Fixed exchange rates are sometimes seen as a way of reducing relative price uncertainty for international traders, thus promoting commerce. This argument has no theoretical support (uncertainty can either encourage or discourage international trade depending on assumptions) and limited empirical support. See, for example, Kenen and Rodrik (1986) for a sample of industrialized countries and de Grauwe (1988) for the European Union; a recent review and more weak evidence is provided by Flam and Persson (2000), with stronger evidence in Rose (2000). Yet, this motivation has been crucial. Policymakers happened to believe that nominal exchange rate stability mattered for trade, in spite of the theory and evidence, and possibly for good reasons.

Most of the empirical evidence is based on high frequency (typically from one month to one year) fluctuations in the exchange rate. At such frequencies, there exist cheap hedging instruments, so that it is not surprising that the effect of exchange rate volatility is weak or non-existent. For technical reasons (chiefly the lack of enough observations), the literature does not deal with lower frequency changes, in particular with often deep, multi-year currency cycles. For example, the yen depreciated by 47% against the dollar

between 1978 and 1985, then appreciated 52% between 1985 and 1988, to depreciate again by 28% until 1990, and appreciate by 48% by 1995. Similar fluctuations can be found for the DM, which experienced a 92% depreciation between 1979 and 1985, followed by a 52 % appreciation by 1987. Such fluctuations cannot be insured against, at least not cheaply or conveniently.[3] They simply wipe out established competitive positions. It is difficult to believe that they do not hurt trade.

Two pieces of evidence support the view that trade has been an essential motive in shaping European governments' attitude towards exchange-rate regimes. First, as shown in Figure 3, since 1960 the intensity of intra-European trade relations has deepened significantly, in contrast to trade with the rest of the world. The assertion here is not that fixed exchange regimes have allowed intra-Europe trade to increase by a factor of 2.5. The creation of a Common Market, and continuous and successful efforts at dismantling trade barriers, clearly lie behind trade integration. Rather the point is that trade integration has been a central objective pursued through all means available. If exchange rate stability is one such means, or if it was simply perceived as a means, it would be surprising that it was not used as well.

Figure 3: Intra- and Extra-European Trade (Average Imports + Exports as Percent of GDP)



Source: European Commission