Chapter 13

A Monetary History of Europe

Mc Graw Hill Education

Why Studying History?

- Monetary union is the controversial end of a long process. History helps understand.
- Since paper money was invented, Europe's monetary history has been agitated. Each bad episode carries important lessons.
- Before paper money, Europe was a *de facto* monetary union. Understand how it worked helps understand how the new union works.

Metallic Money

- Under metallic money (overlooking the difference between gold and silver) the whole world was really a monetary union.
- Previous explicit unions only agreed on the metal content of coins to simplify everyday trading.

The Interwar Period: The Worst Of All Worlds

- Paper money starts circulating widely.
- Yet the authorities attempt to carry on with the gold standard but:
  - no agreement on how to set exchange rates between paper monies
  - an imbalanced starting point with war legacies
    - high inflation
    - high public debts.

The Interwar Period: Three Case Studies

- The British case: a refusal to devalue an overvalued currency breeds economic decline.
- The French case: devaluation, under-valuation and beggar-thy-neighbour policies, until others retaliate and the currency becomes overvalued.
- The German case: hyperinflation, devaluation and, finally, evading the choice of an appropriate exchange rate by resorting to ever-widening non-market controls.

Lessons So Far

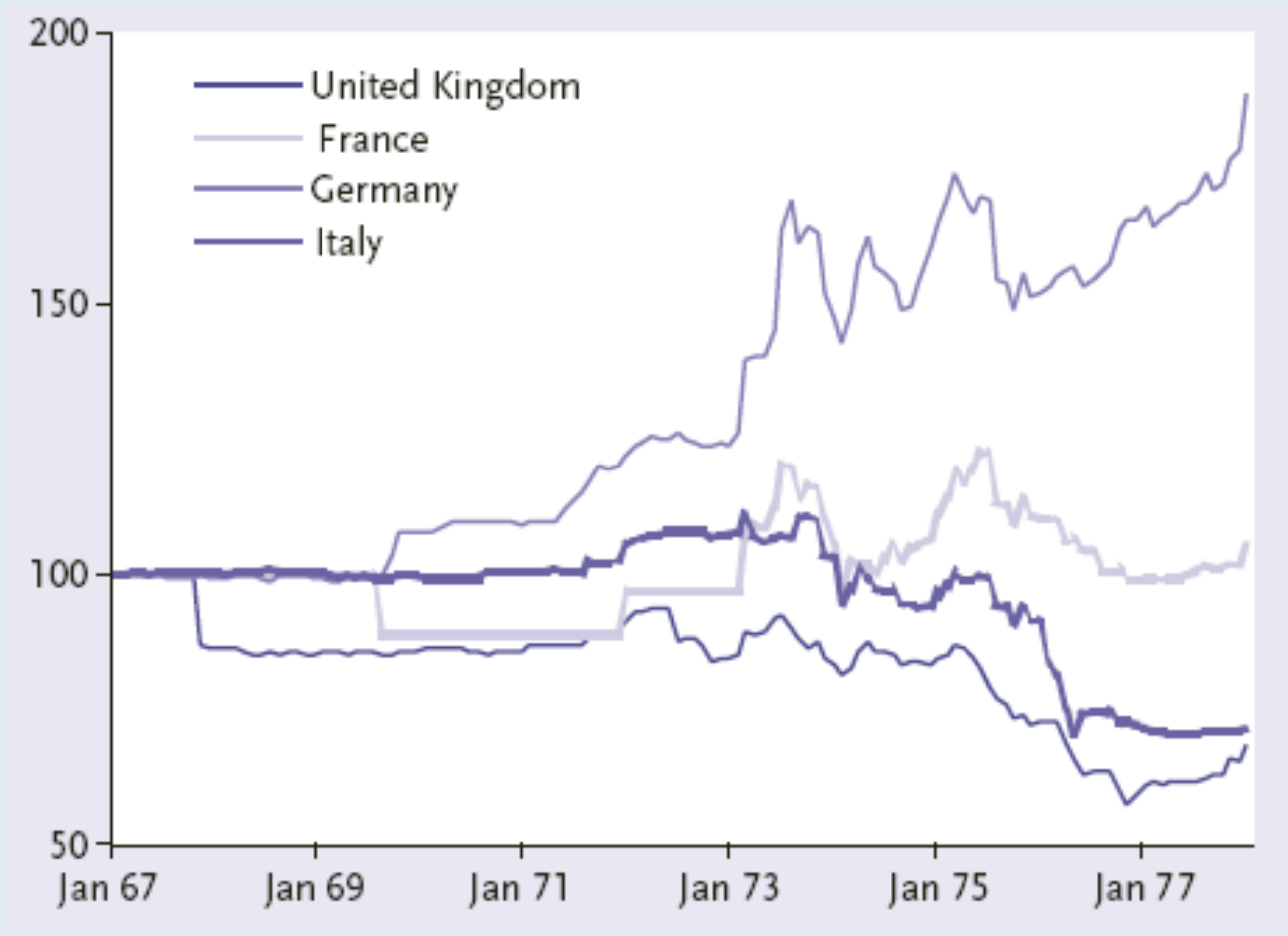
- We need a system, one way or another.
- The gold standard – monetary unions – delivers automatic return to equilibrium, but at the cost of booms and recessions.
- No agreement leads to misalignments, competitive devaluations and trade wars.
- Agreements require ‘rules of the game’, including a conductor.

European Postwar Arrangements

- An overriding desire for exchange rate stability:
  - initially provided by the Bretton Woods system
  - the US dollar as anchor and the IMF as conductor.
- Once Bretton Woods collapsed, the Europeans were left on their own:
  - the timid Snake arrangement
  - the European Monetary System
  - the monetary union.

The Bretton Woods System Collapse

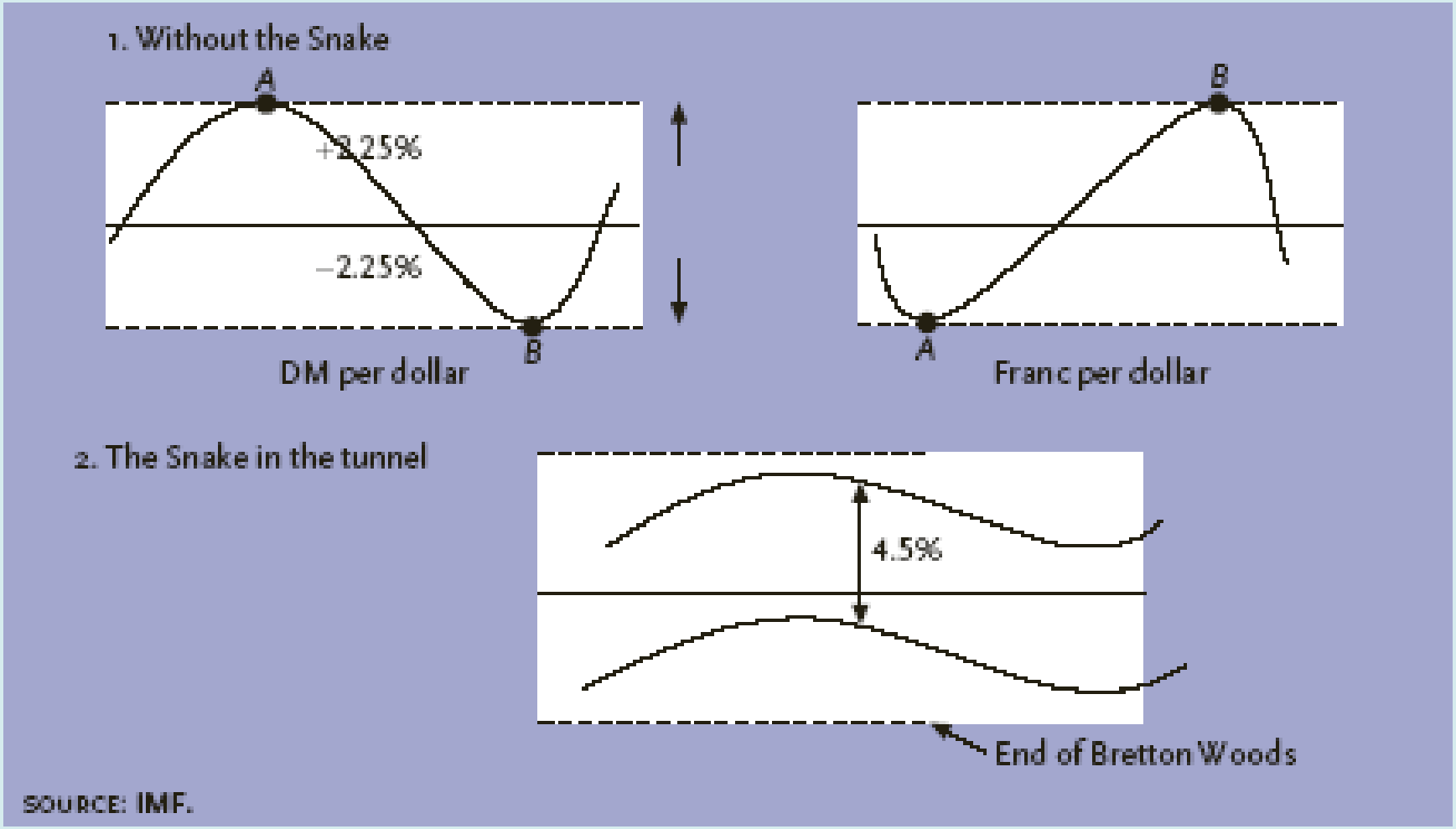
- Initial divergence.



The Snake Arrangement

- Agreeing on stabilizing intra-European bilateral parities.
- No enforcement mechanism: too fragile to survive.

The European Snake



The EMS: Super Snake

- Complements bilateral exchange rate commitments with a support mechanism.
- Allows for prompt realignments to avoid misalignments.
- Emergence of the Deutschemark as the system's anchor.

Lessons From History

	Gold Standard	Inter-war	Bretton Woods	EMS	EMU
Long-lasting misalignments must be avoided	✓		✓	✓	
Systems need to be built coherently	✓		✓	✓	✓
Policy misbehaviour must be ruled out					✓
Systems must be robust				✓	✓
Any monetary system needs a conductor	✓		✓	✓	✓

Chapter 14

The Choice of an Exchange Rate Regime

Mc Graw Hill Education

Background theory

- A quick refresher on basic macroeconomic principles
- Application of these principles to the question of exchange rate regimes
- Europe's monetary integration is a history of seeking exchange rate stability. Why?

The Question and The Answer

- The question: what to do with the exchange rates:
  - viewpoint of an individual country, in contrast with Chapter 13 which looks at systems
  - underlines the principles to evaluate the merits of a monetary union.
- The answer: there is no best arrangement:
  - a matter of trade-offs.

Three Basic Principles

- Long term: neutrality of money.
- Short term: non-neutrality of money.
- Interest parity condition.

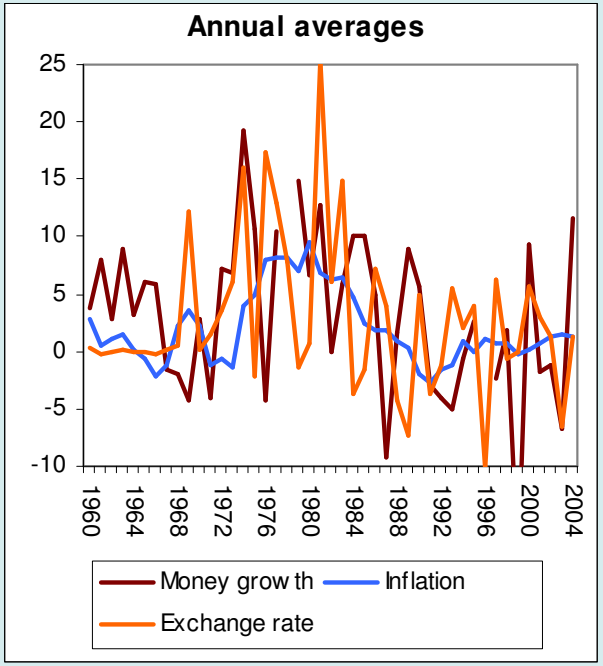
Long Term: Neutrality of Money

- In the long run, money, the price level and the exchange rate tend to move proportionately.

Long Term: Neutrality of Money

Comparison between France and Switzerland

Growth rate in France less growth rate in Switzerland



Year to year:
Nothing really visible

Long Term: Neutrality of Money

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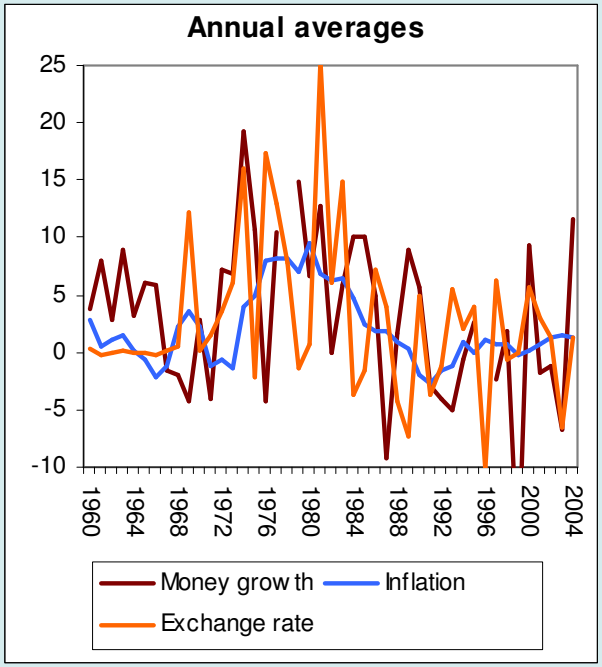

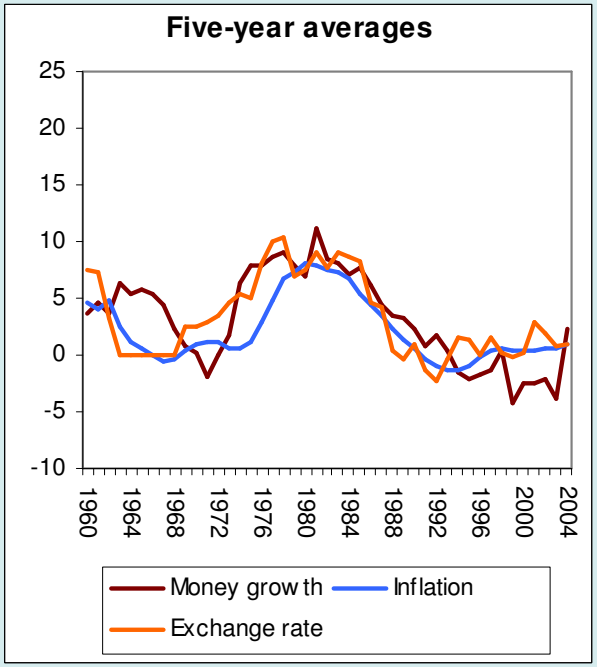

Five-year averages: Something emerges

Long Term: Neutrality of Money

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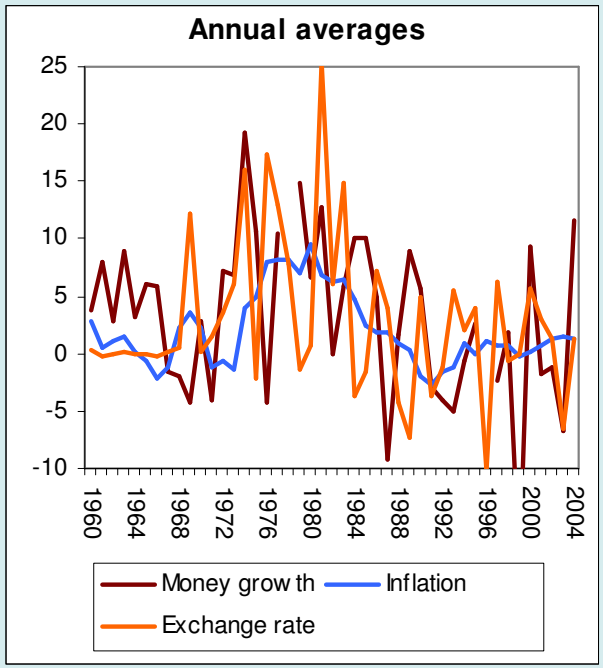
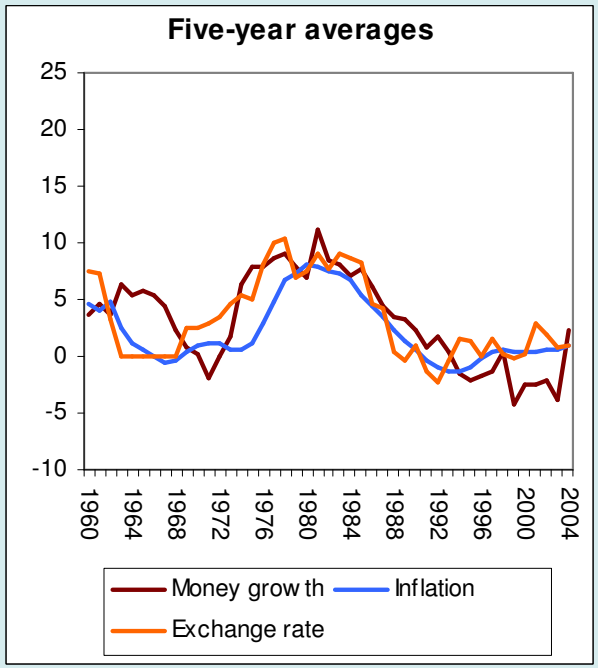
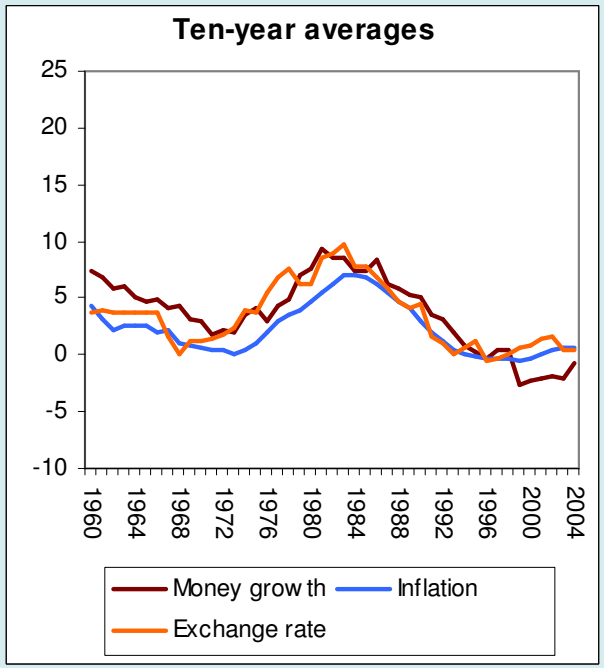
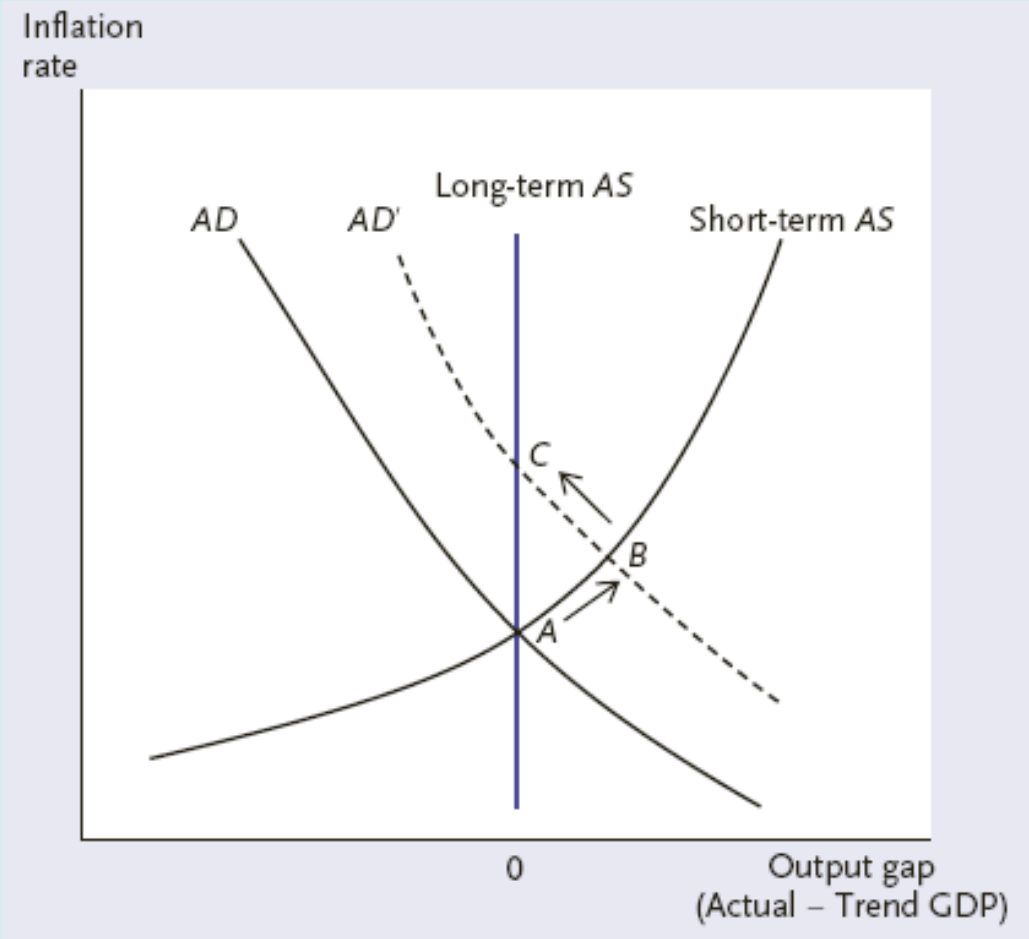






Long Term Neutrality of Money: Theory

- The aggregate demand and supply framework: the vertical long-run aggregate supply schedule.



PPP: An Implication of Long Term Neutrality

- The real exchange rate:
  - defined as $\lambda = EP/P^*$
  - PPP: E offsets changes in P/P*
  - so λ is constant.
- Equivalently: $$\frac{\Delta E}{E} = \frac{\Delta P^*}{P^*} - \frac{\Delta P}{P}$$
- Many caveats, though.

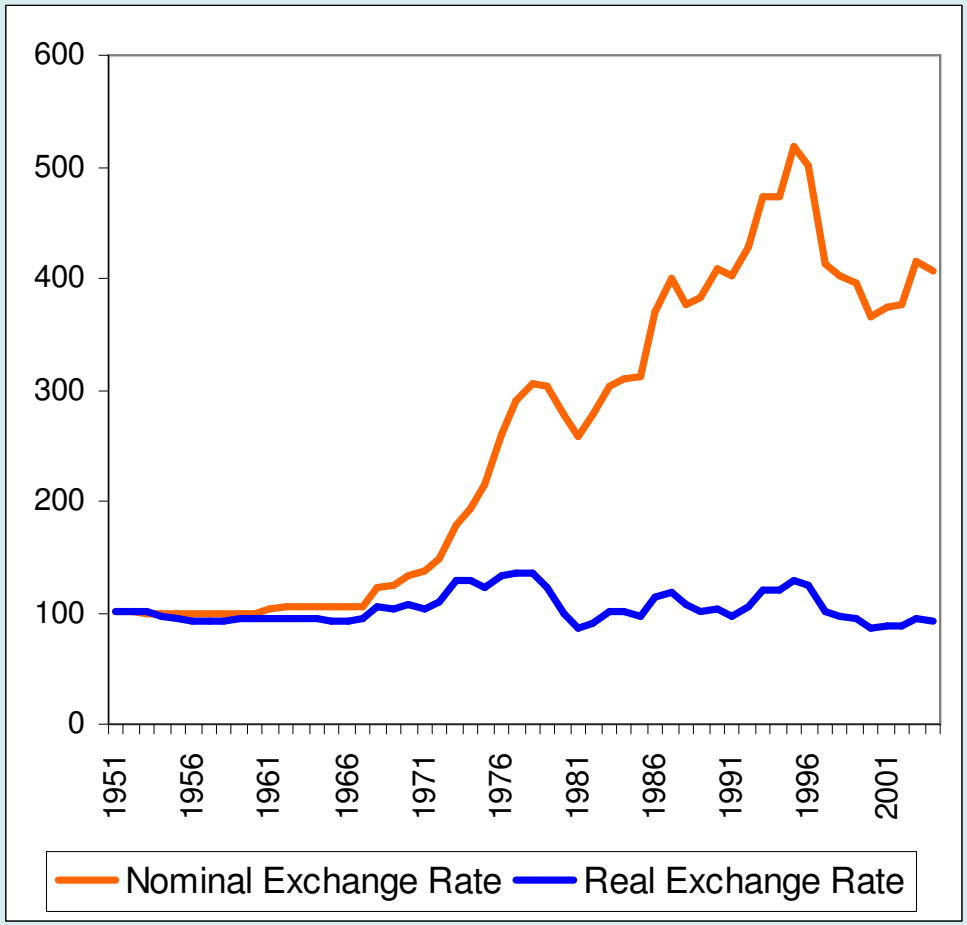
PPP: An Implication of Long Term Neutrality

France and Switzerland: averages 1951-2004

Average money growth: France less Switzerland	2.5
Average inflation: France less Switzerland	2.4
Average appreciation CHF vs. FRF	3.0

PPP: An Implication of Long Term Neutrality

Germany and the UK (1951-2004)



Caveat:
The Balassa-Samuelson Effect

Average annual changes *vis-à-vis* the Eurozone
(1993-2005, % per annum)

	Czech Rep.	Hungary	Poland	Slovak Rep.
Real appreciation	4.4	3.4	2.9	3.5
Inflation differential	3.6	10.3	8.7	4.2
Nominal appreciation	0.8	-6.9	-5.8	-0.7

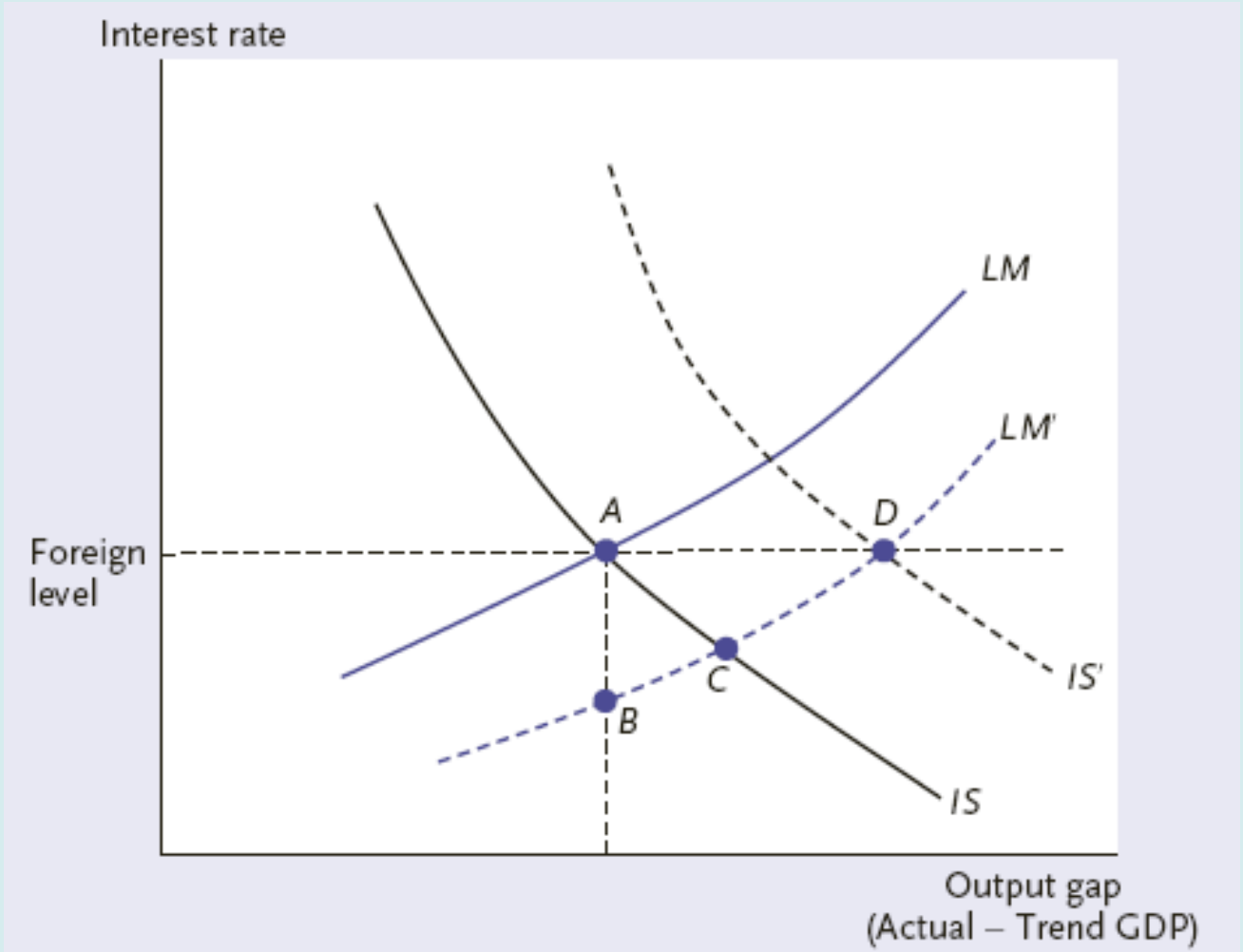
Short Term Non-Neutrality of Money

- From AD-AS: the short-run AS schedule.
- So monetary policy matters in the short run.
- Channels of monetary policy:
  - the interest rate channel
  - the credit channel
  - the stock market channel
  - the exchange rate channel.

Exchange Rate Regimes and Policy Effectiveness

- Fixed exchange rate: no independent monetary policy:
  - money is endogenous.

Exchange Rate Regimes and Policy Effectiveness



Exchange Rate Regimes and Policy Effectiveness

- Fixed exchange rate: no independent monetary policy.
- Flexible exchange rate: no effect of fiscal policy:
  - the exchange rate offets fiscal policy effects.

Exchange Rate Regimes and Policy Effectiveness

	Monetary policy	Fiscal policy
Fixed exchange rate	Ineffective	Effective
Flexible exchange rate	Effective	Ineffective

When Does the Regime Matter?

- In the short run, changes in E are mirrored in changes in $\lambda = EP/P^*$: P and P* are sticky.
- In the long run, λ is independent of E: P adjusts.

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- In the short run, changes in E are mirrored in changes in $\lambda = EP/P^*$: P and P* are sticky.
- In the long run, λ is independent of E: P adjusts.
- If P is fully flexible, the long run comes about immediately and the nominal exchange rate does not affect the real economy.
- Put differently, the choice of an exchange rate regime has mostly short-run effects because prices are sticky.

What's On The Menu?

- Free floating.
- Managed floating.
- Target zones.
- Crawling pegs.
- Fixed and adjustable.
- Currency boards.
- Dollarization/euroization.
- Monetary union.