What's On The Menu?

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

The Choice of an Exchange Rate Regime

- The monetary policy instrument:
  - can be useful to deal with cyclical disturbances
  - can be misused (inflation).
- The fiscal policy instrument:
  - can also deal with cycles but is often politicised
  - can be misused (public debts, political cycles).

The Choice of an Exchange Rate Regime

- Exchange rate stability:
  - freely floating exchange rates move ‘too much’
  - fixed exchange rates eventually become misaligned.

The Old Debate: Fixed vs Float

- The case for flexible rates:
  - with sticky prices, need exchange rate flexibility to deal with shocks
  - remove the exchange rate from politicisation
  - monetary policy is too useful to be jettisoned.

The Old Debate: Fixed vs Float

- The case for fixed rates:
  - flexible rates move too much (financial markets are often hectic)
  - exchange rate volatility: a source of uncertainty
  - a way of disciplining monetary policy
  - in presence of shocks, always possible to realign.

The New Debate: The Two-Corners Solution

- Only pure floats or hard pegs are robust:
  - intermediate arrangements (soft pegs) invite government manipulations, over or under valuations and speculative attacks
  - pure floats remove the exchange rate from the policy domain
  - hard pegs are unassailable (well, until Argentina's currency board collapsed…).

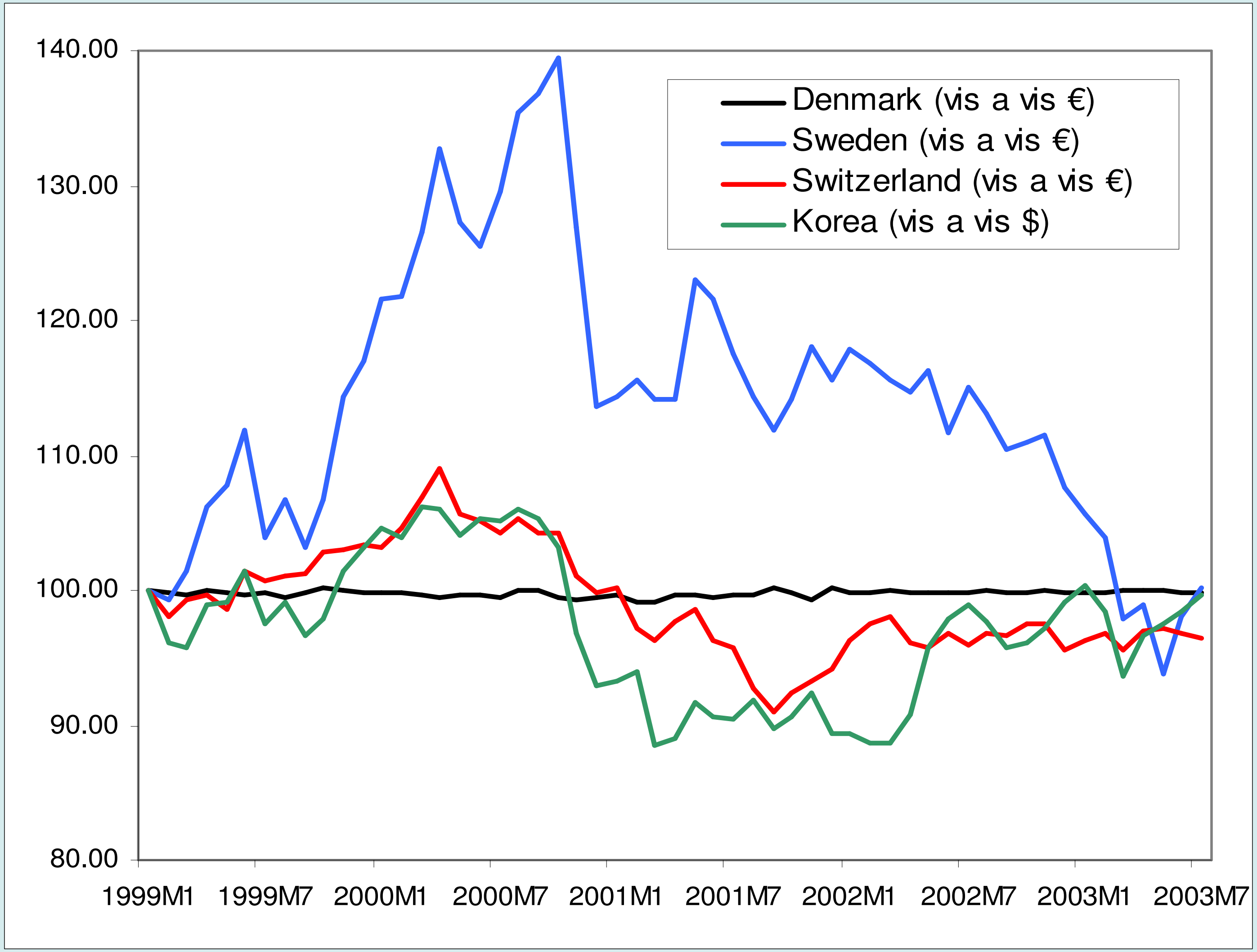
The New Debate: The Two-Corners Solution

- In line with theory:
  - soft pegs are half-hearted monetary policy commitments, so they ultimately fail.

The Two-Corners Solution and The Real World

- Fear of floating:
  - many countries officially float but in fact intervene quite a bit.
- Fear of fixing:
  - many countries declare a peg but let the exchange rate move out of official bounds.

Fear of Floating



The Two-Corners Solution and The Real World

- Fear of floating is deeply ingrained in many European countries.
- Fear of fixing partly explains the disenchantment with the EMS and some reluctance towards monetary union.

Conclusions

- A menu hard to pick from: trade-offs are everywhere.
- All of this takes the view from a single country.
- Systems involve many countries and rest on agreed upon rules, including mutual support.
- Since the end of Bretton Woods, there is no world monetary system.
- This leaves room for regional monetary systems. Enters Europe’s experience.

The EMS: Past and Present

- The EMS was originally conceived as the solution to the end of the Bretton Woods System.
- Over the years, its nature changed and it became a kind of DM area, with the Bundesbank very much in command.
- This, and the speculative crisis of 1993, made the monetary union option attractive.
- Now the EMS is mostly the entry point for future monetary union members.

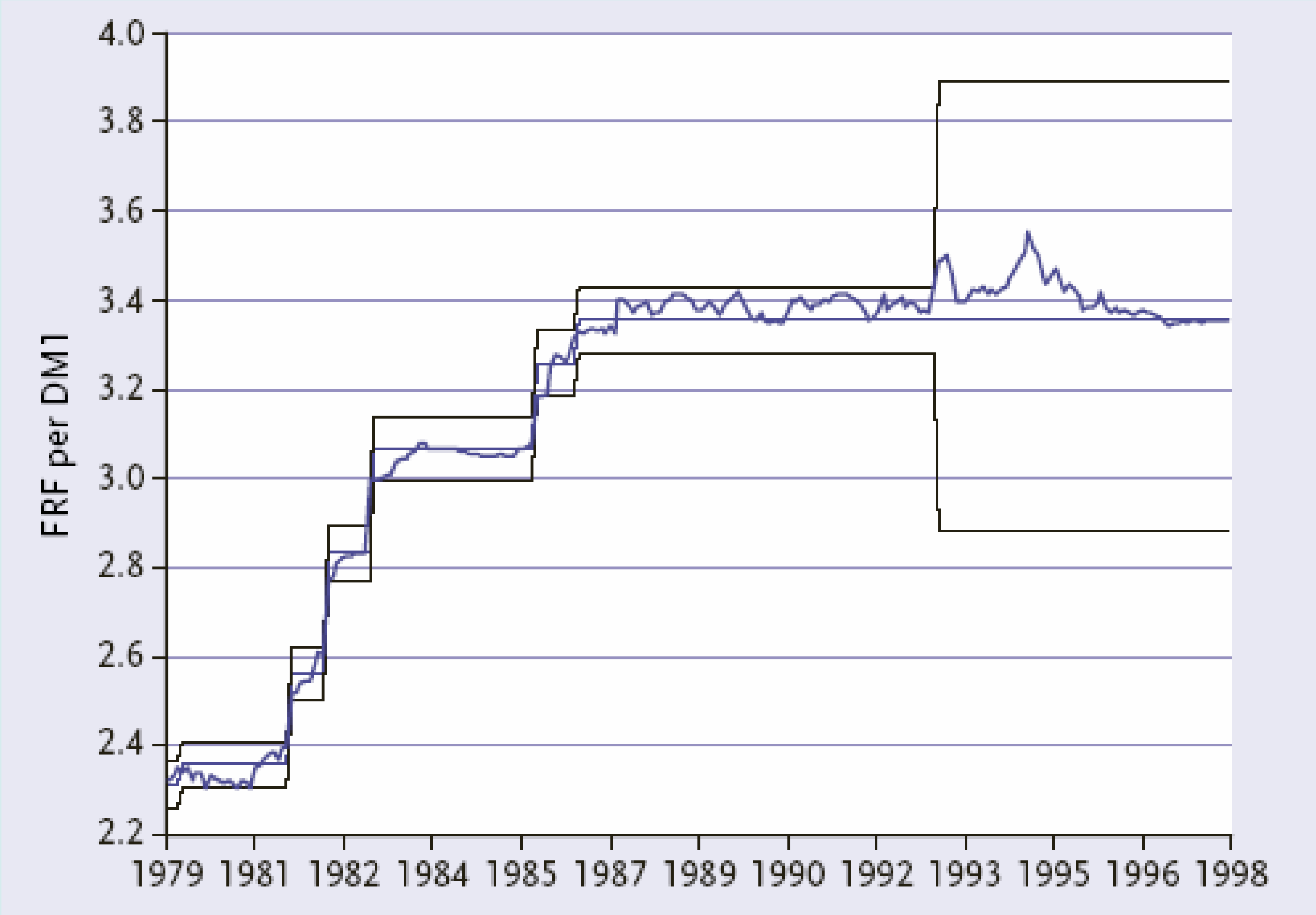
A fine distinction: EMS vs. ERM

- EMS = European Monetary System
  - A EU arrangement: all EU members are part of it
- ERM = Exchange Rate Mechanism
  - An agreement to fix the exchange rate
- The UK and Sweden do not want ERM membership
- All the others want and will adopt ERM sooner or later

Preview: The Four Incarnations of the ERM

- 1979-82: ERM-1 with narrow bands of fluctuation (±2.25%) and symmetric.
- 1982-93: ERM-1 centered on the DM, shunning realignments.
- 1993-99: ERM-1 with wide bands (±15%).
- 1999- : ERM-2, assymmetric, on the way to euro area.

Four Incarnations of the EMS



The ERM-1: Key Features

- A parity grid:
  - bilateral central parities
  - associated margins of fluctuations.
- Mutual unlimited support:
  - exchange market interventions
  - short-term loans.
- Realignments:
  - tolerated, if not encouraged
  - require unanimity agreement.
- The E.C.U.:
  - not a currency, just a unit of account
  - took some life on private markets.

The ECU

A basket of all EU currencies.

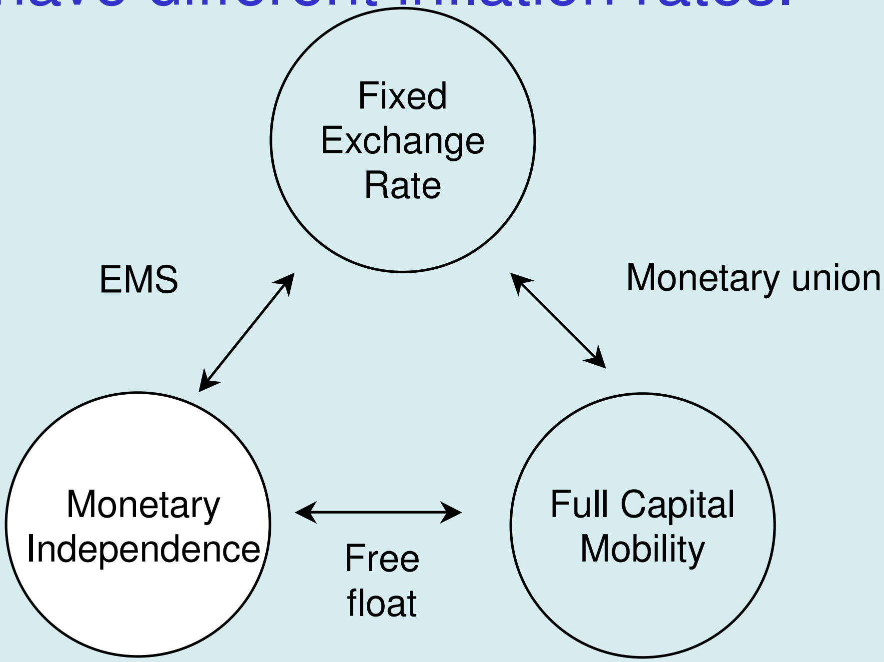
	Amount in ECU 1	Weight (%)
Belgian franc	3.43100	8.71
Danish krone	0.19760	2.71
Deutschemark	0.62420	32.68
Dutch guilder	0.21980	10.21
French franc	1.33200	20.79
Greek drachma	1.44000	0.49
Italian lira	151.80000	7.21
Irish punt	0.00855	1.08
Portuguese escudo	1.39300	0.71
Spanish peseta	6.88500	4.24
UK pound sterling	0.08784	11.17

The ERM: Interpretation and Assessment

- Improving on the Snake to stabilise intra-European exchange rates:
  - mutual support
  - realignment unanimity rule.
- Respecting the EU equalitarian approach:
  - no centre currency
  - bilateral interventions by strong and weak currency central banks.
- No role for the US dollar: Europe on its own.

The ERM: Interpretation and Assessment

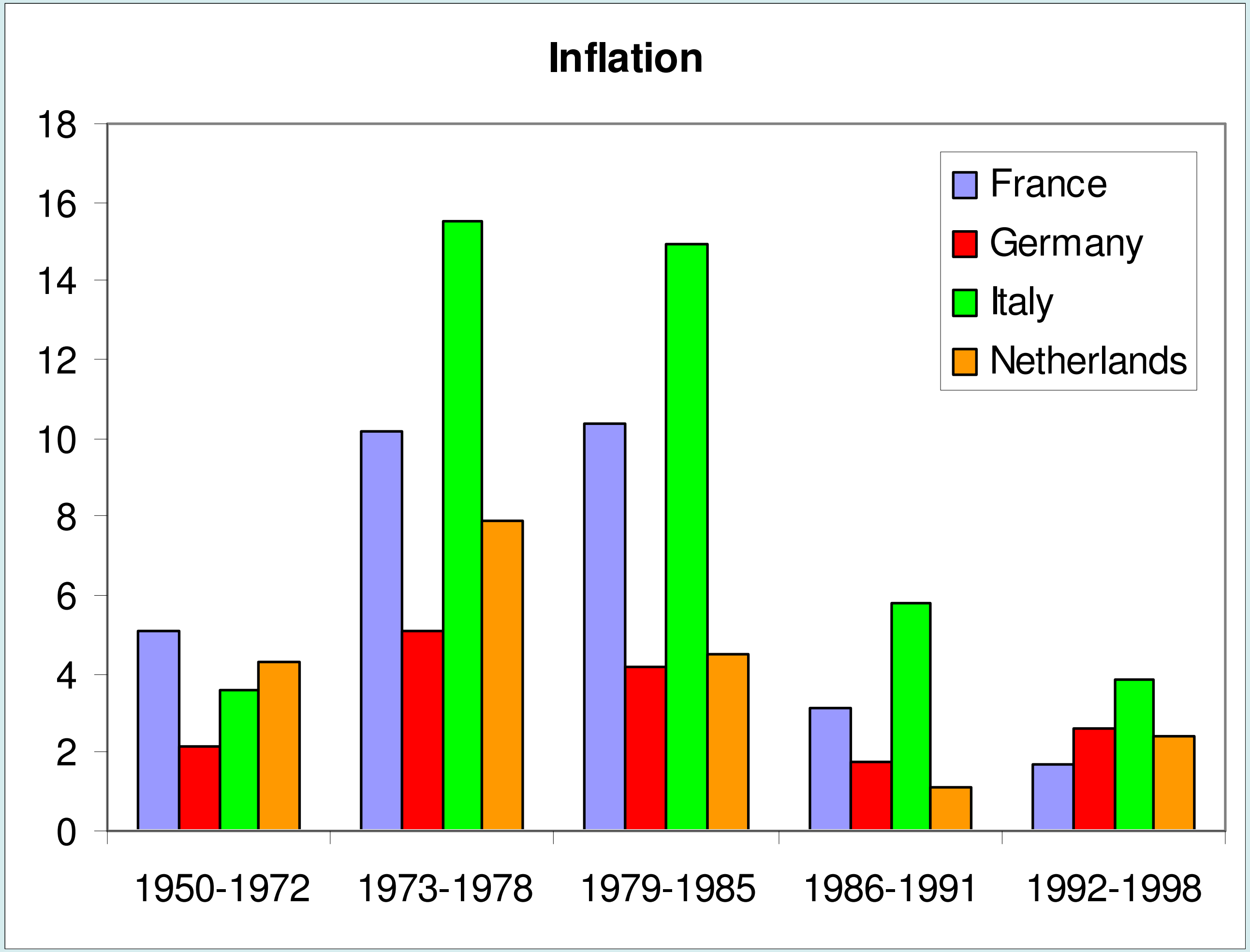
- Is monetary policy independence lost?
- The Impossible trinity:
  - widespread capital controls to preserve at least the ability to have different inflation rates.



Evolution: From Symmetry to DM Zone

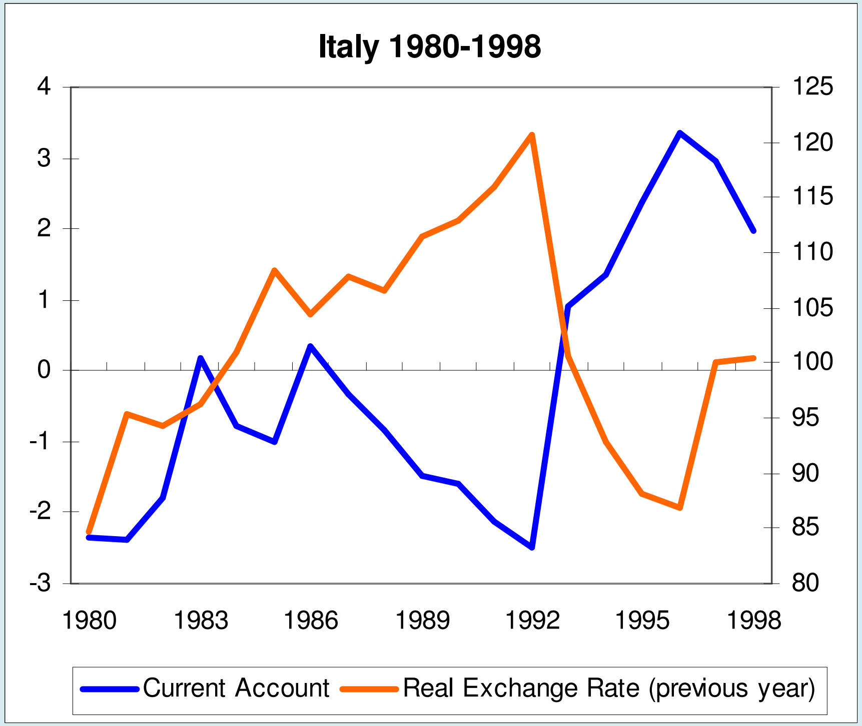
- First a flexible arrangement:
  - different inflation rates: long run monetary policy independence
  - frequent realignments.

Evolution: From Symmetry to DM Zone



Evolution: From Symmetry to DM Zone

- But: realignments:
  - barely compensated accumulated inflation differences



Evolution: From Symmetry to DM Zone

- But: realignments:
  - barely compensated accumulated inflation differences
  - were easy to guess by markets
  - put weak currency/high inflation countries on the spot:
    - Continuing current account deficits
    - Speculative attacks.
- The symmetry was broken *de facto.*
- The Bundesbank became the example to follow.

The DM Zone

- What shadowing the Bundesbank required:
  - giving up much what was left of monetary policy indepedence
  - aiming at a low German-style inflation rate
  - avoiding realignments to gain credibility.

Breakdown of the DM zone

- Bad design:
  - full capital mobility established in 1990 as part of the Single Act: ERM in contradiction with impossible trinity unless all monetary indepdence relinquished.
- Bad luck:
  - German unification: a big shock that called for very tight monetary policy
  - the Danish referendum on the Maastricht Treaty.
- A wave of speculative attacks in 1992-3:
  - the Bundesbank sets limits to unlimited support.

Lessons From 1993 (1)

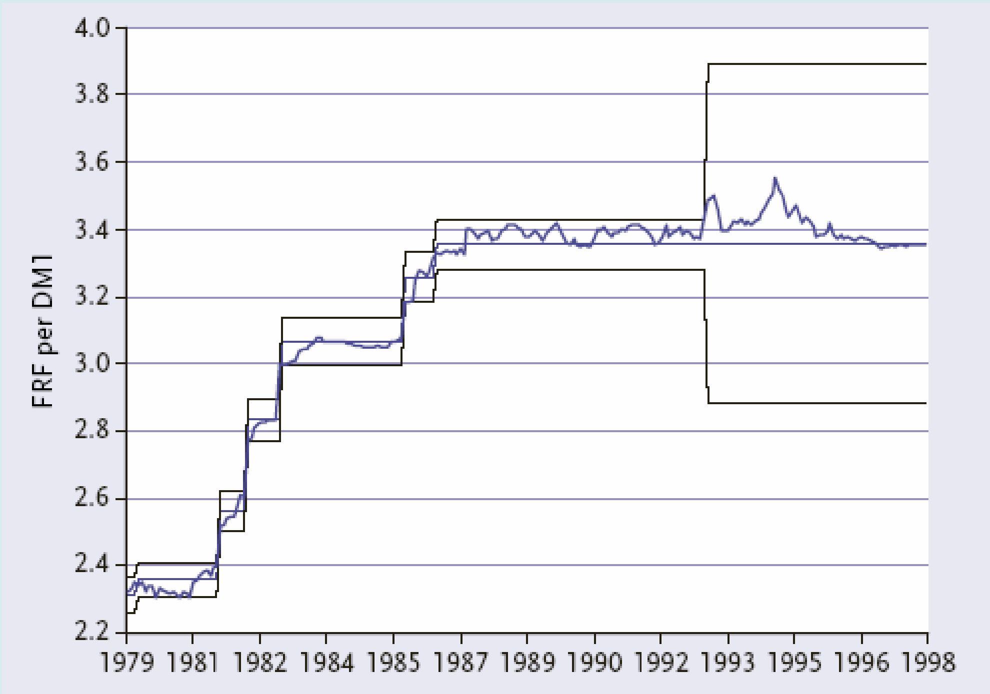
- The two-corner view:
  - even the cohesive ERM did not survive
  - go to one of the two corners (pick one!).
- The ERM should be made even more cohesive:
  - the monetary union is the way to go.
- The ERM was a bad idea:
  - float is the future.
- Unlimited interventions cannot be unlimited:
  - need more discipline and less support.

Lessons From 1993 (2)

- The Bundesbank's selection of countries to be supported:
  - left scars (e.g. Britain)
  - raises question on who decides what.
- Speculative attacks can hit even robust systems and properly valued currencies (suggesting self-fulfilling crises).
- Both facts strengthen the two-corner view, providing arguments for each corner.

The Wide-Band ERM

- Way out of crisis:
  - wide band of fluctuation (±15%)



The Wide-Band ERM

- Way out of crisis:
  - wide band of fluctuation (±15%)
  - a soft ERM on the way to monetary union.

McGraw Hill Education

ERM-2

- ERM-1 ceased to exist on 1 January 1999 with the launch of the Euro.
- ERM-2 was created to:
  - host currencies of existing EU members who cannot/don’t want to join euro area:
    - Denmark and the UK have a derogation, but Denmark has adopted the new ERM
    - Sweden has no derogation but has declined to adopt the new ERM
  - host currencies of new EU members before they are admitted into euro area:
    - already seven of ten new members
    - potentially ten new members.

How Does ERM-2 Differ From ERM-1?

ERM-1	ERM-2
Symmetric, no anchor currency	Asymmetric, all parities defined vis a vis euro
Margin explicitly set	'Normal' (±2.25%) and 'standard' (±15%) bands
Automatic unlimited interventions	ECB explicitly allowed to suspend intervention

A Revival of The EMS?

- In principle, ERM membership is compulsory for the all new members.
- They must stay at least two years in the ERM before joining the euro area.

Current ERM membership

Country	Joined	Fluctuation band
Denmark	Jan-99	+/- 2.25%
Estonia	Jun-04	+/- 15%
Lithuania	Jun-04	+/- 15%
Slovenia	Jun-04	+/- 15%
Cyprus	May-05	+/- 15%
Latvia	May-05	+/- 15%
Malta	May-05	+/- 15%
Slovakia	Nov-05	+/- 15%

A Revival of The EMS?

- In principle, ERM membership is compulsory for the all new members.
- They must stay at least two years in the ERM before joining the euro area.
- They must also eliminate all capital controls.
- The impossible trinity says that they will have to fully give up monetary policy.
- The risk of self-fulfilling crises says that may not be enough to avoid trouble.