Exchange rates &
International Financial
System

- **People trade currencies for two *primary* reasons**
  - **To buy and sell goods and services**
  - **To buy and sell financial assets**

Exchange Rate Systems

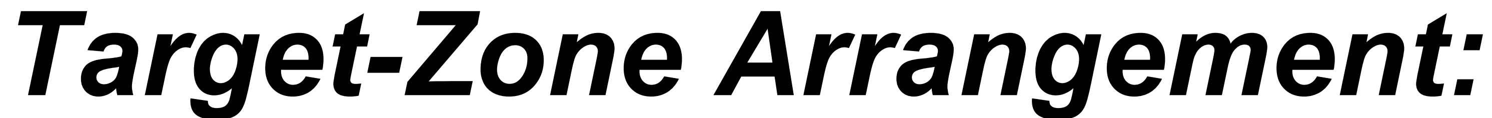
There are an enormous number of exchange rate systems, but generally they can be sorted into one of these categories

- **Freely Floating**
- **Managed Float**
- **Target Zone**
- **Fixed Rate**

- **price levels**
- **interest rates**
- **economic growth**

Managed Float ("Dirty Float")

- **Market forces set rates unless excess volatility occurs, then, central bank determines rate by buying or selling currency.**
- **Managed float isn't really a single system, but describes a continuum of systems.**



- Countries agree to maintain exchange rates within a certain boundaries.

- What makes target zone arrangements special is the understanding that countries will adjust economic policies to maintain the zone.

Fixed Rate System:

Government maintains target rates and if rates threatened, central banks buy/sell currency.

- **Advantage: stability and predictability**

- **Disadvantage: At some point a fixed rate may become unsupportable and one country may devalue. As an alternative to devaluation, the country may impose currency controls.**

A Brief History of the International Monetary System

- **1875-1914: Classical Gold Standard**

- **1915-1944: Interwar Period**

- **1945-1972: Bretton Woods System**

- **1973-Present: Flexible (Hybrid) System**

The Intrinsic Value of Money and Exchange Rates

- **At present the money of most countries has no intrinsic value (if you melt a quarter, you don't get $.25 worth of metal). But historically many countries have backed their currency with valuable commodities (usually gold or silver) .**

- **When a country's currency has some intrinsic value, then the exchange rate between the two countries is fixed. For example, if the U.S. mints $1.00 coins that contain 1/35th ounces of gold and Great Britain mints £1.00 coins that contain 4/35th ounces of gold, then it must be the case that £1 = $4**

The Classical Gold Standard ***(1875-1914)***

- **Nations fixed the value of the currency in terms of gold.**
- **Gold is freely transferable between countries**
- **Essentially a fixed rate system (Suppose the US announces a willingness to buy gold for $200/oz and Great Britain announces a willingness to buy gold for £100. Then £1=$2)**

Interwar Period

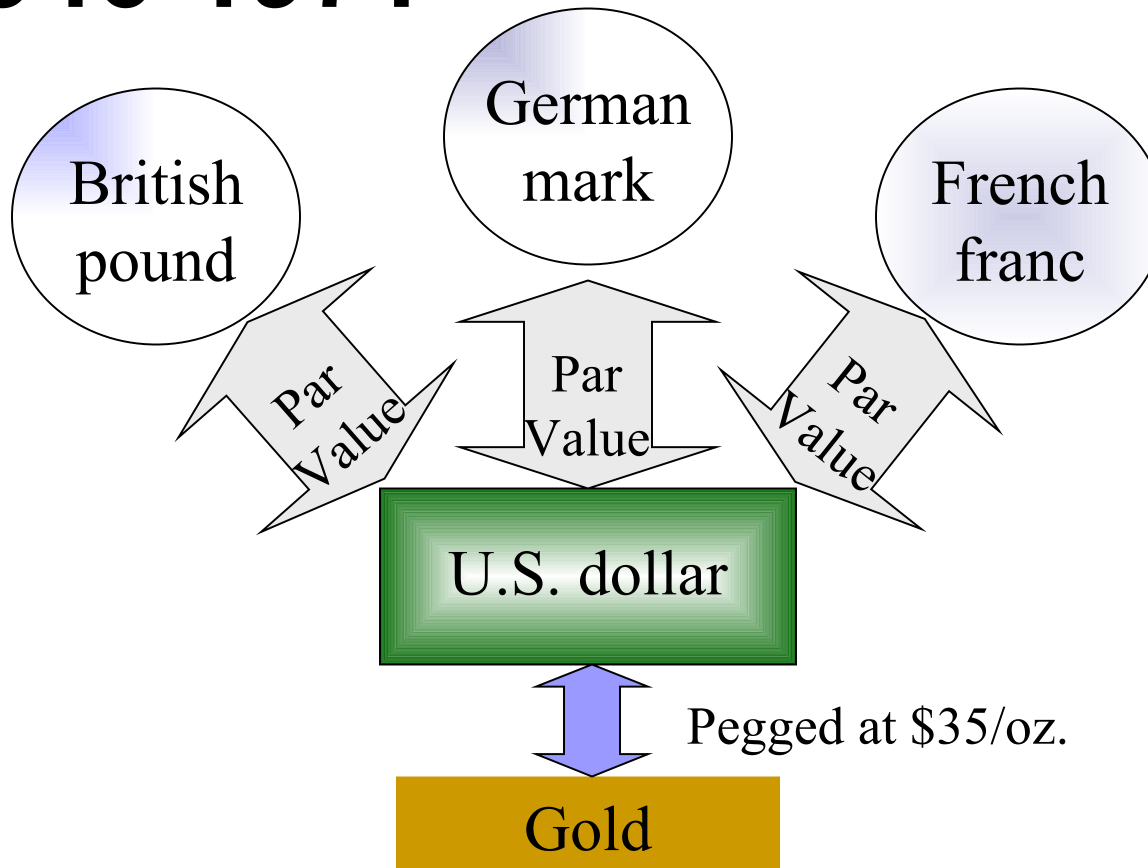
- **Periods of serious chaos such as German hyperinflation and the use of exchange rates as a way to gain trade advantage.**

- **Britain and US adopt the gold standard adjustment mechanism.**

The Bretton Woods System (1946-1971)

- **U.S.$ was key currency valued at $1 = 1/35 oz. of gold**
- **All currencies linked to that price in a fixed rate system.**
- **In effect, rather than hold gold as a reserve asset, other countries hold US dollars (which are backed by gold)**

Bretton Woods System: 1946-1971



Collapse of Bretton Woods (1971)

- **U.S. high inflation rate**
- **U.S.$ depreciated sharply.**
- **Smithsonian Agreement (1971) US$ devalued to 1/38 oz. of gold.**
- **In 1973 The US dollar is under heavy pressure, European and Japanese currencies are allowed to float**
- **Gold abandoned as an international reserve**

Current Exchange Rate Arrangements

- **The largest number of countries, about 49, allow market forces to determine their currency's value.**
- **Managed Float.   About 25 countries combine government intervention with market forces to set exchange rates.**
- **Pegged to another currency such as the U.S. dollar or euro (through franc or mark). About 45 countries.**
- **No national currency and simply uses another currency, such as the dollar or euro as their own.**