LECTURE TEN - PART FOUR

Floating Versus Fixed Exchange Rates

- In the examples thus far, the value of the various currencies we discussed were allowed to freely move in response to market conditions.
- This type of monetary system is called a floating exchange rate system.
- However, not all countries of the world allow their currencies to float.
- Instead, some use a fixed exchange rate system.

Fixed Exchange Rates

- A country "pegs" its currency to the value of another – most often the U.S. dollar or a basket of currencies.
- The country makes the necessary adjustments to maintain the value of that peg.
- To better understand these two starkly different systems – floating versus fixed – let's take a trip through time.

The Gold Standard

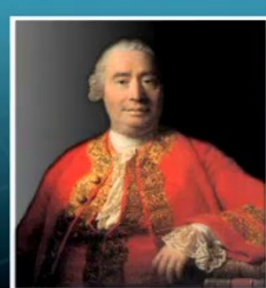
- Between 1867 and 1933 (except W.W.I), most nations were on the gold standard.
- Under the gold standard, the currency issued by each country had to either be gold or redeemable in gold.
- Once a country agreed to be on the gold standard, its currency was convertible into a fixed amount of gold.

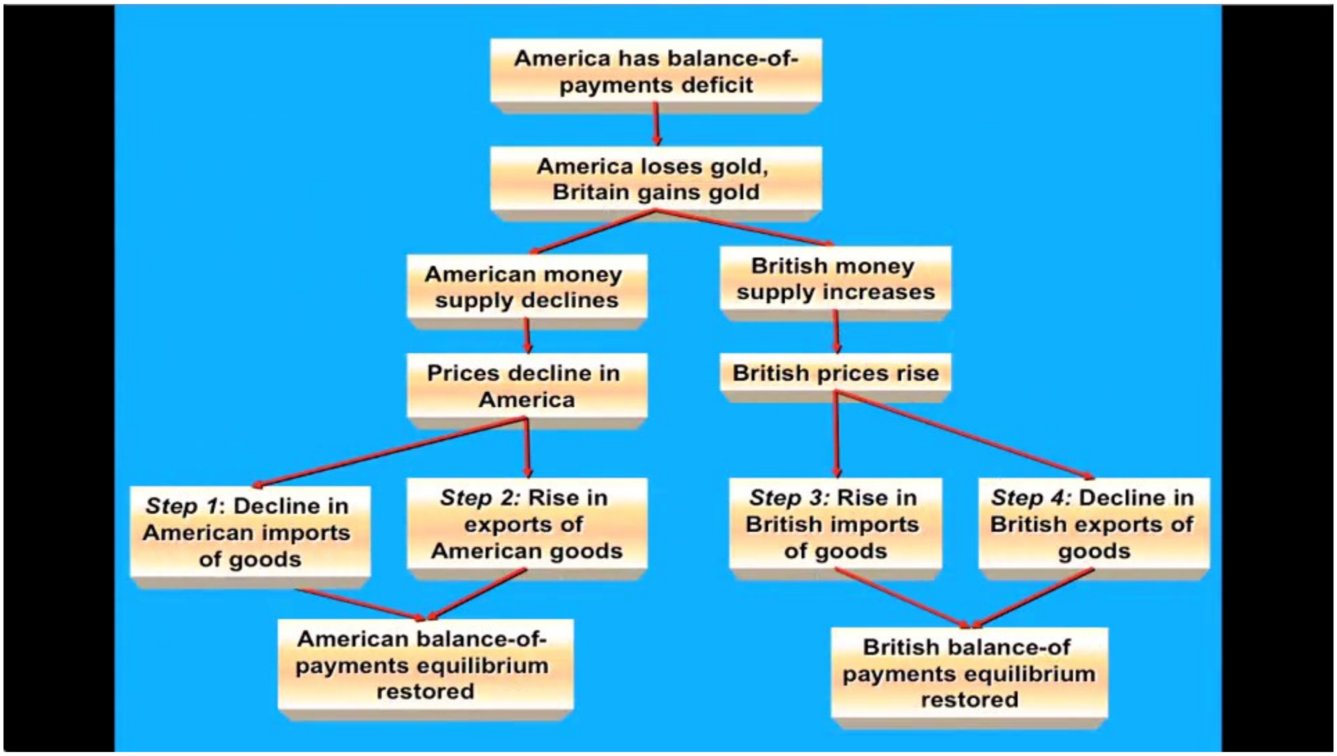
Fixed Exchange Rates & Trade Deficits

- If a nation ran a trade deficit, it had to use its gold reserves to buy currency to prevent the value of the currency from falling.
- If a nation ran a trade surplus, it accumulated gold.

Hume's Adjustment Mechanism

- Why was the gold standard popular?
- The answer: The gold specie flow mechanism.
- First described by Scottish philosopher and economist, David Hume, in 1752.





Does Hume's Mechanism Work?

- The gold standard worked well at stabilizing the currency markets up until World War I.
- During the war, many nations temporarily abandoned the gold standard to finance their war efforts.
- This led to inflation AND to differing rates of inflation in different countries.

Differing Rates of Inflation

- Differing rates of inflation distort the relative value of currencies.
- When peace returned and nations returned to the gold standard, the old exchange rates no longer reflected the true value of the different currencies!

The Examples of France & Britain

- Back on the gold standard, the French franc was significantly undervalued.
- So France enjoyed an "export-led" boom and accumulated large surpluses of foreign currencies.
- In contrast, Britain had sustained lower inflation rates so its currency was overvalued.
- Britain found it difficult to sell its exports and found itself overwhelmed by cheap imports.

Why The Gold Standard Collapsed

- By 1930, Britain was so drained of its gold reserves that it had to abandon the gold standard.
- At that point, the U.S. dollar came under similar attack.
- France, in particular, began to unload large amounts of its surplus dollars for U.S. gold.

Herbert Hoover and the Depression

- The Hoover Administration first stemmed this gold flow by raising domestic interest rates.
- This contractionary monetary policy helped push the U.S. further into the Great Depression.
- In 1933, President Roosevelt followed the British in abandoning the gold standard.

The Economic Origins of WWII

- With the gold standard's collapse, desperate countries engaged in "competitive devaluations."
- They devalued their currencies to boost exports and reduce imports and thereby create jobs at the expense of neighbors!
- This "beggar thy neighbor" behavior destabilized the economic and political environment and helped lead to World War II.

Bretton Woods & the Dollar Standard

- These harsh lessons of the 1930s set the stage for Bretton Woods.
- In 1944, 44 countries designed a new international monetary system.