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Bretton Woods Fixed Exchange Rate System versus Floating Exchange Rate System

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Abstract:

One of the most important issues of monetary policy is to find out whether the state should intervene among the exchange rates, taking into account the fact that changes in the exchange rates represent a significant transmission channel of the effects generated by the monetary policy.
Taking into consideration the failure of fixed exchange rate regimes and the recent improvement of financial markets, the return in the near future to such a regime – as for example the Bretton Woods system – is probably almost impossible.

Key Words: Fixed exchange rate; floating exchange rate; Bretton Woods system

JEL Classification: E42, F31

One of the main aspects of the monetary policy is represented by the selection of an optimum system of the exchange rate.

States have been long experimenting distinct international systems regarding payments and exchange rates. The early experience of international monetary systems was exclusively founded on fixed systems. Fifteen years ago, the international specialized literature treated almost exclusively the international regulations based on a fixed exchange rate since there were few experiences, globally, generated by free floating exchange rate regime.

Beyond the development of the exchange rates, the issue to be raised is to find out whether the state should intervene among the exchange rates, taking into account the fact that changes in the exchange rates represent a significant transmission channel of the effects generated by the monetary policy.

The essential characteristic of a fixed exchange rate regime lies in the fact that the level of the exchange rate is established by the state, each foreign currency displaying an official exchange rate which may be different from the commercial exchange rate determined on the currency market. For this type of regime, the central bank plays an extremely important role as the entity which must intervene on the foreign exchange market in order to influence the commercial exchange rate and determine it to approach, as much as possible, the official exchange rate. In the course of time, the level of the official exchange rate was differently established, starting from the convertibility of currencies in gold. The fixed exchange rate regime was promoted by the international monetary system from Bretton Woods but this was the last system implemented by the

Occidental countries; it was effective until the 15th of August 1971 when the convertibility of gold into dollars was suspended. One of the main arguments in favour of the fixed exchange rate regimes is the fact that the stability of the exchange rates stimulates the international trade – if the fluctuations of the exchange rates are limited the international trade will be more dynamic.

Secondly, the stability of exchange rates fosters the internal constancy of economy and the changes in exchange rates generated by various measures of economic policy shall not trouble unnecessarily the economic agents within the fixed exchange rate regimes, the monetary and financial crises could therefore pass almost unnoticed by the relevant public.

Another argument favourable to the fixed exchange rates refers to the fact that these prevent speculative dealings. Friedman denied the idea that speculative operations destabilise the exchange rates showing that the currency market bears a large capacity of self-regulation which manifests in the event of speculative capital

movements as the currency market approaches the theoretical concept of "efficient market".

The essential characteristic of a flexible (floating) exchange rate regime resides in the fact that the level of the exchange rate is freely established on the exchange market, without the intervention of the state.

The exchange rates are flexible as long as changes in demand and supply take place. Within a flexible exchange rate regime this feature determines that the adjustment of an eventual monetary imbalance should be performed in a manner different from the fixed exchange rate – namely gradually, through continuous variations of prices (costs) of foreign currency, though limited in size. The flexibility of the exchange rate turns this economic variable in significant means of regulating the economy as an exchange rate fulfils two functions:

1) The function of buffer which consist in interrupting or attenuating the process of conveying currency imbalances from a country to the other. If within an international currency system based on fixed exchange rates, the currency imbalances are handed over from a country to the other, in a floating exchange rate system the increase of the monetary mass in a certain country shall no longer generate the effect of propagation and spreading but, on the contrary, the exchange rates serve as a buffer allowing the absorption of asymmetrical shocks.
2) The function of developer which consists from the information provided by the level and evolution of the exchange rate;

Robert Mundell showed certain signs of doubt as regards the floating exchange rates and he even reached, during the period when he collaborated with the International Monetary Fund, a sceptical conclusion in connection with their application in certain situations but he never expressed his opinion against them as a principle. Mundell actually sympathized with the idea of using these exchange rates as an adjustment mechanism drawing the attention that the idea according to which the floating exchange rates assign a high degree of freedom is completely wrong.

The objections raised by regarding the floating exchange rates are exempted in two different cases. The very instable countries, usually as a result of large budgetary deficiencies financed by bank systems cannot have fixed exchange rates. This is also valid in the event a large country is situated within a region which does not benefit from an International Monetary System. The largest economy, the USA economy, does not unilaterally opt for a fixed exchange rate.

The respective experience changed dramatically in 1973 when the Bretton-Woods international monetary system regarding the fixed exchange rates fell down. At the

moment, the majority of developed economies within the main countries allowed their currencies to float at large and the exchange values were determined on a private market based on the demand and supply rather than on the basis of governmental decree. Even when the Bretton-Woods system crashed and the participating countries had the intention to re-establish a new improved system of fixed exchange rates their intention never materialized. The countries rather engaged in a series of experiments with different types of fixed and floating systems.

Some states established their currencies in relation with the currencies of a main commercial partner, other states decided to link their currency to a basket of currencies composed of the currencies used by several principal commercial partners. Some countries implemented a crawling peg by regularly adjusting the values of the exchange rates while other countries implemented a controlled exchange rate system within which the value of the currency is mostly determined by the market but influenced by the periodical intervention of the central bank in order to determine the increase or the reduction of the currency value. Finally, some countries, such as USA, permitted, solely on rare occasions, an almost absolute floating regime with interventions on behalf of the central banks.

Unfortunately, the results of these multiple experiments are combined. On some occasions the system of floating exchange rates functioned impeccably. On some other occasions the floating rates modified vertiginously abandoning the traders, the investors and the government to a continuous fight of accommodation to their changing character. Similarly, the fixed rates represented the rescue solution for a certain country by helping to reduce the persistent inflation. In some other instances, the countries which adopted fixed exchange rates had to import the excessive inflation from the country possessing reserves.

There were also circumstances when the fixed exchange rates rather resulted in an increase of inflation than in a reduction of it. At the end of '60 and in the beginning of '70, when most of the developed countries were guided by the principles set forth within the Bretton-Woods international monetary system regarding the fixed exchange rates, the rapid increases of the monetary mass in USA led to an inflationary pushing in the Unites States which forced the other countries, which adopted the dollar as their reserve currency, such as Great Britain, Germany, France and Japan, to circulate the surpluses of the balance of payments in order to maintain their exchange rates at a fixed value. These surpluses of the balance of payments led to the increase of the monetary mass in each of these countries which therefore generated, in turn, the increase of inflation. Thus, the inflation in the United States was essentially exported towards several countries due to the fixed exchange rate system.

The conclusion drawn is that sometimes fixed exchange rates tend to generate the decrease of inflation, while some other times they converge towards an increase in inflation. The solution consists in establishing an exchange rate in compliance with a standard rate of which value is not susceptible of rising too fast.

The regime of floating exchange rates experienced similar changes. One of the essential advantages of floating rates is the autonomy over the monetary policy which the central bank of a state displays. When showing good sense and wisdom, the discretion applied within monetary policy could provide a useful mechanism for directing a national economy.

Interestingly, the monetary autonomy represent both a negative characteristic for countries which chose fixed exchange rates in order to escape from inflation and a positive feature for countries which intend to have more control over their national economies. Consequently, it results that the key of success, both for the fixed exchange rate regime and for floating exchange rate regime depends on prudent monetary and fiscal policies. The option of fixed rates enables the countries to accelerate a more prudent monetary policy while the choosing of floating rates represent a blessing for those countries which have already implemented a prudent monetary policy.

When prudent national policies would have been instituted a floating exchange rate regime will function excellently. The fixed exchange rate systems are more appropriate when a state is forced to undergo recovery in a more accelerated rhythm towards a more prudent direction of the monetary policy.

Taking into consideration the failure of fixed exchange rate regimes and the recent improvement of financial markets, the return in the near future to such a regime – as for example the Bretton Woods system – is probably almost impossible. Currently the majority of the world countries practise an impure floating system, which means that the mechanisms determining the establishment of the exchange rates are theoretically free but the monetary authorities intervene sporadically in order to rectify the changes in currency rates. Although the temptation that global central authorities reach an agreement on their interventions on the currency market is very strong this is not possible to put into practice as the world countries display extremely different economic visions.

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