London
Business
School

Floating exchange rates at fifty

‘From There to Here: 1973 Expectations and 2023 Reality’

Richard Portes
London Business School

PIIE 23 March 2023

What's the same? an asymmetric system

- US resisted breakdown of BW exchange-rate mechanism because it seemed an *instrument of US hegemony*.
- And some feared losing the link would bring an era of worldwide unbridled fiat money issuance with inflationary consequences.
- Indeed there was significant inflation in the 1970s – but much of that due to loose fiscal (especially UK) and oil shocks. And then tight monetary policy (eventually inflation targeting) brought it down.
- But *USD still dominant currency*, US financial system still centre of global financial system, US is world banker
- Why not €? Why not China? Financial sector…

Why is system still asymmetric?

- Characteristics of fiat money – network externalities, reliance on credibility – lead to dominant player, and those are tied to depth of financial system and its integration with global economy
- Perhaps also go back to hegemonic stability story *in reverse*: the need for stability drives acceptance of hegemon.
- Will this change? That's part of the (highly questionable) 'deglobalisation' story. But falling weight of US economy in global economy – must that eventually translate into more symmetry, multipolarity in global financial system? And if there is merit in hegemonic stability, maybe we should want asymmetry.

The macroeconomics: not much change

- We still have ‘global imbalances’, at least as important as pre-1973 – we seem to live with them, but a significant cause of GFC.
- The multi-century global downward trend in real interest rates has continued: low in 1973, sharp further fall for a couple of years, big but brief rise early 1980s, steadily down since.
- We still observe major role of distance in cross-border financial intermediation – portfolio flows and FDI – despite internet etc.

What’s new?

- Crises? What kind of crises?
- Latin American debt crisis, Mexican crisis, Russia, Argentina, Asian financial crisis, then Global Financial Crisis – breakdown of BW exchange rate system was *not* a financial crisis.
- These crises exhibited features Barry Eichengreen and I stressed in ‘Anatomy of Financial Crises’ (1987) – interconnections between exchange rate crises, bank failures, debt defaults. Sonot so new?
- What was role of floating rates? Not obvious! Could argue that fixed rates forced adjustment – but that doesn’t fit many of these cases. (Note: pre-1973 forced devaluations were not financial crises (UK 1967).) And GFC had a key new element: extreme counterparty risk.

Interest rates and global liquidity

- Very low real interest rates – continuation of long historical trend, with sharp fall 1973-76, then return to trend, then sharp rise early 80s, then return to downward trend arriving at zero.
- Major expansion of global financial assets, global liquidity relative to GDP.
- Is the system irreparably fragile? No shortage of investible assets (‘safety’ is a multidimensional continuum). Is that a consequence of floating rates? Or of low interest rates, search for yield, buildup of vulnerabilities? In periods of extreme tension, major central banks can support global liquidity when necessary with currency swaps and intervene as market makers of last resort.
- Increasing role of non-bank financial intermediation relative to banks, in particular in cross-border finance. No obvious relation to floating rates. But maybe to low interest rates.

No one could have expected…

- Crypto. Doubts about fiat money as well as exchange rate uncertainty did contribute to crypto enthusiasm, although crypto has not been a good inflation hedge.
- Maybe CBDCs (and could argue that blanket deposit guarantees make bank money into central bank money and make banks into state banks). Not clear why this should increase ‘confidence’ in fiat money.
- What of this could we reasonably say is attributable to breakdown of BW exchange-rate system? Not a lot…