1 INTRODUCTION

The collapse of the Bretton Woods system of fixed but adjustable exchange rates in 1973 marked the end of a comparative calm in exchange-rate theory as well. In the typical textbook of the time, the balance of payments in a fixed-exchange-rate system was explained by income and expenditure on the current account as a function of the rate of exchange, among other things, plus net capital imports as a function of the rate of interest or of the rate of interest plus national income (the Mundell-Fleming model). In a flexible-rate system, the rate of exchange was explained in a similar way, by putting the balance identically equal to zero (e.g. Branson 1972, Ch. 15). A slightly more elaborate portfolio model of capital movements could be grafted onto the basic (IS/LM type) model, such that account could be taken of stock adjustments (Grubel 1968). After a change in the data of the system, there will be a short-term impact following from a readjustment of existing portfolios, apart from a permanent influence on net capital flows. Short-term elasticities of capital flows are consequently higher than long-term elasticities, in this approach. The current account was the centrepiece in most explanations of exchange rate movements and consideration of capital flows by and large only served to make intelligible deviations from the norm implicit in current-account balance. It was thought, for instance, that exchange-rate movements in a flexible-rate system would first of all reflect differences in inflation rates between countries. A system of flexible exchange rates would also enable governments to exploit the Phillips-curve trade-off between unemployment and inflation (cf. Artus and Young 1979). Capital movements were not expected to throw a spanner in the works and flexible rates would insulate countries from external disturbances.

Things turned out differently when the Bretton Woods system of fixed but adjustable exchange rates finally foundered in 1973, after having tottered and been patched up in 1971. Exchange rates apparently went their own merry way,
unrelated to differences in inflation rates between countries or the balance on the current account. Capital movements now take place on such a scale that they seem to totally swamp international payments on account of trade in goods and services. In the experience of one banker, international payments originate for only about one-tenth in the current account of the balance of payments (Oort 1987, p. 65). It is said that the volume of foreign exchange traded daily in early 1986 was about $90 billion in London, $50 billion in New York and $48 billion in Tokyo (De Vries 1986, p. 13). It is not clear, however, to what extent conversions of one currency into another are involved. Part of the transactions volume relates to interbank movements of Eurodollars, Euroyen, etc. Anyhow, the experience since 1973 has been characterised by a dominance of capital movements over payments on the current account. Consequently, international economists were sent back to their studies to rethink exchange rate theory. The result has been a spate of models that venture to explain the erratic behaviour of exchange rates after 1973. The variety of models is quite bewildering and even a treatise of monographic length could hardly do justice to most of them (cf. Krueger 1983). In a survey article there is not much else one can do than paint with a broad brush. In order to discern some method in the model madness, or to impose some method on it, we will follow De Roos (1985) and group the various theories according to the period for which their explanation of the exchange rate is relevant. First, there is a very short period, during which exchange-rate movements are explained by capital flows. In the short period, the movements of the rate of exchange are explained by both capital flows and payments and receipts on the current account. The same goes for the long period, but there is an additional equilibrium condition in this case, namely that the current account and the capital account separately be in equilibrium. Finally, in the very long period, Purchasing Power Parity is assumed to prevail and factor prices are internationally equalised (see also the attempt by Sauernheimer 1982 to capture the effects of monetary policy over, successively, the very short period, a Keynesian short period and the very long period in one model; one of the restrictions of his model is the assumption of uncovered interest parity, cf. section 2.1). The rates of exchange that follow from the longer-term models can be regarded as trends around which movements take place that are explained by shorter-term models. One idea is dealt with separately, as it is not a model in its own right but an approach that cuts across the boundaries of the periods in our classification, namely the idea of cash in advance.

2 THE VERY SHORT PERIOD

In the very short period, only capital movements explain exchange rate changes. It can be imagined that changes in the data of the system that bear on capital flows may influence the rate of exchange within hours or even minutes or seconds, whilst the current account needs more time to react. The rate of ex-