

## FIXED VERSUS FLOATING EXCHANGE RATES

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In the 1990s, a new consensus emerged regarding exchange rate regimes. Governments must choose between flexible exchange rates and firmly fixed exchange rates. Pegged rates of the adjustable sort, like those of the Bretton Woods system and European Monetary System (EMS) before 1993, are no longer viable because of their vulnerability to speculative attacks. Note that I have substituted “flexible” for “floating” rates, because many of those who subscribe to the new consensus are not fully convinced that markets know more than governments and do not rule out official intervention to influence market-determined rates. Some, indeed, continue to believe that wide-band target zones or crawling bands are still viable.

I subscribe to the new consensus insofar as it warns against adopting adjustable pegs, whether they be formal as in the case of the EMS or informal as in the case of Asian countries that maintained de facto dollar pegs for their currencies before the recent crisis. The consensus seems also to suggest, however, that firmly fixed rates are both viable and sensible, but I have reservations. For all but the smallest countries, which are economic appendages of larger countries and might as well adopt those large countries’ currencies, flexible rates are more appropriate.

Several arguments have been adduced for fixing exchange rates firmly. All of them have limited validity, but they are not compelling, individually or collectively.

### The Real Costs of Exchange Rate Changes

The first argument is often posed as an objection to flexible rates but applies to adjustable rates as well. The uncertainty produced by exchange rate changes acts as a tax on trade and, more importantly, a

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tax on investment in traded-goods industries. Although it is possible to hedge against exchange rate risk by using derivative instruments, you cannot hedge risk perfectly unless you know the size of your foreign currency exposure. An exchange rate change, however, affects not only the domestic currency values of your future foreign currency receipts and payments but also affects their foreign currency values by affecting the volume and value of future trade flows. Empirical work on exchange rate uncertainty has not found strong adverse effects on trade flows or investment, although studies concerned with developing countries have found stronger effects than studies concerned with industrial countries. In most of this work, however, including my own, exchange rate uncertainty is measured by the short-term variability of the nominal or real exchange rate, because it is hard to devise an appropriate measure of the more relevant phenomenon, uncertainty about the real rate over a long horizon. Hence, the issue remains unresolved.

A second, related argument for fixed rates asserts that exchange rate changes give rise to protectionist pressures and can thus prevent the realization of the gains from trade. This argument has surfaced periodically in widely different contexts. The decision of the United States to sponsor the Plaza Accord of 1985 is often ascribed to the build-up of protectionist pressures produced by the previous appreciation of the dollar. A decade later, in Europe, protectionist pressures produced by the exchange rate changes of the early 1990s were cited frequently by advocates of monetary union, who said that an irrevocable fixing of exchange rates was the only way to insulate the Single European Market from such pressures in the future. Finally, the depreciation of the Brazilian currency in 1999 caused Argentina to erect trade barriers that stalled and threatened to reverse trade liberalization in MERCOSUR. This argument, like the first, cannot be dismissed out of hand. It must nevertheless be noted that fixing the exchange rate deprives a government of two very valuable policy instruments, the nominal exchange rate and monetary policy, and it may therefore be tempted to adopt beggar-thy-neighbor trade policies to cope with output-reducing shocks.

### Fixed Exchange Rates and Monetary Discipline

The final argument for fixed rates is concerned with the impact of the exchange rate regime on the quality of monetary policy. It has several versions.

The first version says that a fixed exchange rate will neutralize monetary shocks, including those produced by an incompetent cen-

tral bank. A country with a fixed exchange rate will “import” or “export” money automatically whenever there is a shift in demand or supply and thus keep a monetary shock from affecting the real economy. The argument holds fully, however, only with perfect capital mobility. An excess supply of money will then cause a capital outflow and loss of reserves, which will reduce the money supply by just enough to remove the excess supply of money. Similarly, an excess demand for money will produce a capital inflow, and the resulting increase in reserves will raise the money supply by just enough to satisfy the excess demand for money. There are no other effects whatsoever on the domestic economy. The argument holds symmetrically, however, and thus has a dark side. If your central bank is less competent than my central bank, you should fix your currency to mine and thus export the mistakes of your central bank. If your central bank is more competent than mine, however, fixing your currency to my currency will cause you to import mistakes made by my central bank. This, of course, exposes the flaw in the argument. It cannot hold universally, as a reason for worldwide pegging, unless all central banks are equally incompetent and their mistakes are uncorrelated. Each country will then share the consequences of the others’ errors and be rewarded by the right to share its own errors with them.

The second version of the argument is similarly based on the supposition that some central banks are less competent than others and have less credibility. They can, it is said, import credibility from their more competent counterparts by fixing the exchange rate and thus commit themselves explicitly to emulate the monetary policy of the more competent central banks. This strategy was followed by several European countries, which pegged their countries’ currencies to the deutsche mark to import credibility from the Bundesbank. Were they successful? It is hard to say. Inflation rates fell sharply in Europe during the 1980s and reached low German levels in the late 1990s. But inflation rates fell sharply in other countries too, including the United Kingdom and United States, and it has been impossible to show econometrically that there was a significant EMS effect. Furthermore, the logical foundations of the argument are weak. Why should exchange rate targeting be more credible than straightforward inflation targeting? An exchange rate target may be more transparent and less readily manipulated than an inflation target. It is also more fragile, however, because an attack on a fixed exchange rate can force the abandonment of the fixed rate by stripping away a country’s reserves. An inflationary surprise, by contrast, cannot force the abandonment of an inflation target.

This where the case for a currency board comes in. Think of a

central bank has having two hands—one for operating in the foreign exchange market, the other for operating in the domestic money market. The fixed exchange rate ties one hand. The central bank must intervene to keep the exchange rate from changing. By itself, however, the fixed rate does not tie the other hand. The central bank can still conduct money market operations to influence interest rates, bail banks out from liquidity crises, or bail the government out of a fiscal policy mess. A currency board, however, ties the other hand. The central bank cannot buy or sell domestic currency assets; it cannot conduct open market operations, make loans to domestic banks, or make loans to the government. Therefore it cannot sterilize the monetary effects of its operations on the foreign exchange market or even cushion the effects of those operations on the liquidity of the banking system. Accordingly, the attack on the Argentine peso during the Mexican crisis of 1994–95 caused a full-fledged banking crisis. The fixed exchange rate survived. The banks did not. Furthermore, Argentina’s success in keeping its exchange rate fixed did not protect it four years later, when the Brazilian crisis of 1998–99 triggered another attack on the Argentine peso.

### Fixed Exchange Rates and Disinflation

The third version of the argument is linked closely to the second. It says that exchange rate pegging can be used to achieve a large, quick fall in inflation when a country has suffered chronically from very high inflation—even hyperinflation. The argument combines two elements. On the one hand, an exchange rate peg combined with goods-market arbitrage stabilizes the prices of traded goods. Put differently, it exploits the fact that chronically high inflation leads to the widespread indexation of domestic prices based on the exchange rate. But inflation leads to the depreciation of the domestic currency, which then leads to the further increase of domestic prices. Fixing the exchange rate helps to halt this process quickly. On the other hand, the commitment to a pegged exchange rate is implicitly a commitment to monetary and fiscal stability, without which a fixed rate cannot survive. In other words, exchange rate pegging is, as before, a way to buy credibility. This sort of “shock therapy” has worked well in several countries, including Bolivia, Poland, Argentina, and Brazil. In most of them, however, inflation did not stop immediately. The prices of traded goods were stabilized quickly, but the prices of nontraded goods went on rising, along with wage rates. They rose more slowly than before, but by enough to cause a large appreciation of the real exchange rate and a deterioration of the current-account balance. It

was therefore necessary to devalue the domestic currency. Hence, those who continue to recommend this sort of shock therapy are also quick to warn that governments adopting it should also devise an exit strategy—a way to introduce exchange rate flexibility before the real rate appreciates substantially.

## Conclusion

Let me recapitulate by making four strong statements:

- Pegged but adjustable exchange rates are not viable, but the constraints imposed by rigidly fixed rates may be extremely expensive. They impose very tight constraints on monetary policy.
- A single country cannot fix its exchange rate comprehensively unless all other countries fix their rates too. That is what the Asian countries learned in the 1990s, when the dollar appreciated against the yen and what Argentina learned later, when the Brazilian *real* depreciated in terms of the dollar.
- Long ago, however, Robert Mundell warned us that the world is not an optimum currency area. National economies are vulnerable to what we now describe as asymmetric shocks, and many cannot cope with them without changing their exchange rates. It is neither wise nor realistic to advocate worldwide pegging.
- When price stability is the principal objective of monetary policy, using a symmetrical inflation-rate target may be the least expensive and most sensible way to confer credibility on monetary policy.

With more time for me to write and more time for you to read, I would set out the principal arguments for flexible exchange rates. If I did that, however, I would have to attach counter-arguments to each argument, as I have just done for the fixed rate arguments. Flexible rates can be very volatile, because they are driven chiefly by volatile capital flows. They do not necessarily move in line with purchasing power parity, nor do their movements always foster current account adjustment. In fact, they sometimes move in ways that produce current account imbalances. Furthermore, they transmit asset market shocks directly to goods markets.

In 1987, right after the Louvre Accord, I urged the major industrial countries to adopt a wide-band target-zone regime much like the one adopted by the EMS in 1993. I should have recalled what I wrote much earlier, in 1973, during the deliberations of the Committee of the Twenty, which was trying to design what it described as a system of stable but adjustable exchange rates. That was, I said, an oxymoron. Stability is incompatible with adjustability.