Resisting the Lure of Fixed Exchange Rates

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THE TENDENCY TO SEE GREENER grass on the other side of the fence seems as strong in economic policymakers as it is in farmers and suburban gardeners. North Americans gaze wistfully at European labor markets, and the compliment is returned by Europeans gazing back. Reformers in the ex-Soviet bloc push liberalization forward against reams of advice from western advocates of state ownership and heavy regulation. After more than 20 years of generally floating currencies among the world's principal economies, there are many strong advocates for a return to a world of fixed exchange rates.

Familiarity with floating currencies has bred, if not contempt, at least discomfort. Certainly generalized floating has not fulfilled the hopes of those who, looking out over the fences of a fixed-rate world, predicted far easier adjustment, fewer balance of payments problems, and steadier macroeconomic management with floating rates. Now those looking over the fence back to a fixed-rate world see major benefits from greater exchange rate control. Businesses and households will be freed from wild swings of fortune prompted by the whims of money traders. Speculators will be forced into more productive jobs. An end to exchange-rate overshooting will reduce economy-wide and sectoral stresses. The financial and protectionist hazards hampering cross-border trade and investment will also shrink.

These benefits, however, are at least as exaggerated as the more extravagant claims made in support of floating rates. The idea that fixing prices, especially in such complex and sensitive markets as those for foreign exchange, can produce major gains in income and jobs is supported neither by logic nor by experience. A jump toward a pegged-rate world could well leave us in less fertile fields than we now till.

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JUMPING OVER THE FENCE OR SITTING ON IT?

A pegged exchange-rate system is, in fact, more like getting astride a fence than going clean over it. Really green fields, in the form of sizeable one-time gains in economic efficiency, can be had by amalgamating currencies in the extreme, by going to a one-currency world. A world money would do away once and for all with swinging exchange rates, and alter the career prospects of the speculators who swing with them.

To be sure, even the green grass of irrevocable fixes has some brown patches. People of a speculative bent would still find lucrative opportunities in a one-currency or irrevocably fixed exchange-rate world. Lack of an autonomous currency does not necessarily steady a country's bank lending and money creation, its economic growth, or its inflation rate. As with countries on the gold standard a century ago, countries without independent monetary control will find domestic monetary conditions fluctuating with their external balances.

If markets for a key export should collapse, the loss of national purchasing power is just as real in the absence of an adjustable nominal exchange rate. It is simply transmitted to the economy in a different way. The external imbalance created by the collapse will cause gold, the world currency, or whatever serves as the monetary base, to leave the country. Loss of liquidity will slow the pace of lending and deposit creation in the banking system. After a while, domestic demand will shrink; after a longer while, wages and prices will fall relative to those abroad. Eventually, the combination of weaker domestic demand and relatively lower domestic prices will eliminate the imbalance but not before the balance-of-payments-driven interest rate and credit cycle, and its impact on real and financial assets in sectors such as housing, have provided myriad opportunities for those speculators whose unpopularity drives much of the move for greater exchange rate fixity.

In any event, the lush fields of a one-money world are visible only in the binoculars of the wildest visionaries. Money's use in trade, price tags and contracts makes its regulation a key matter of public interest, an interest that, for generations, has been largely expressed through control of its creation by national institutions. As with the merging of other vital national institutions—legislatures and armies, for example—the efficiency gains on offer from consolidation of national currencies need to be weighed against major drawbacks.

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IRREVOCABLE FIXES ARE AN UNLIKELY OPTION

A country without an autonomous currency, either because it has no currency of its own or because its currency is irrevocably tied to another, or in other words, a country without a money-printing central bank, lacks a fundamental economic tool. Very small countries may find the benefits of this tool minimal relative to its costs. And less-than-national entities like Hong Kong, or countries like Argentina whose credibility in economic management has vanished, may find the handcuffs of a currency board, whose issuing and withdrawing of domestic currency proceeds in lock-step with rises and dips in its reserves of a backing currency, an indispensable form of discipline. But for major developed economies, the appeal of an independent currency is hard to resist.

In the front rank of an independent currency's attractions is the capacity of nominal exchange changes to ease adjustments of the kind required by an export collapse. Without one, policy-makers have limited choices. They can try fiscal levers, hiking taxes or slashing spending in search of a

preferred short-term division of pain among economic sectors—an approach that even believers in fiscal fine-tuning would acknowledge is enormously difficult to get right. Or they can simply wait—no doubt reflecting on the adage that the economist's lag is the politician's nightmare—for the knock-on effects of the balance of payments deficit to work their way through the financial sector to output, jobs, wages and prices.

A country with a money-printing central bank has another, highly attractive option. It can maintain the growth of its monetary base in line with its own goals for short-term output and longer-term inflation, while allowing the foreign-exchange value of its currency to fall. Instead of experiencing a general slump, higher unemployment and lower wages, its citizens see higher prices for imported goods and services, and switch their purchases to domestic substitutes. If a country is small and very open to foreign trade, this advantage is less important. But when a country is big and households and businesses buy and sell predominantly domestic goods and services, allowing an external shock to move the exchange rate is far easier than adjusting price tags, contracts, and paychecks throughout the economy. External balance can be restored with a good deal less economic dislocation and a good deal less political pain.

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Along with easier adjustment to external shocks, countries with autonomous currencies gain other tools as well. They can choose their own inflation rates, based on whatever economic and social considerations their governments find compelling, among them the choice as to how much government spending to finance by printing money as opposed to through ordinary taxes. They can bail out financial institutions. And they can experiment with opening and closing the money taps in an iterative game between governments and the private sector, hoping to tease a little more growth out of the economy.

Many economists worry about these tools. Like an adjustable exchange rate, they are easy for even relatively responsible governments to use badly. However, choosing not to have an autonomous currency by irrevocably linking to another country's currency or using it outright gives no protection from their misuse. It simply means that the domestic population will be exposed to the choices—good or bad—of the authorities in the country whose currency is used. On balance, therefore, national currency autonomy is attractive to major countries. Whether the European Union will succeed in abolishing the currencies of many of its members in favor of a single new currency is a matter of considerable doubt. A comparable move that would replace the currencies of all the major economies is all but inconceivable.

For this reason, all discussion of greater exchange rate fixity amounts to advocating a system of pegged exchange rates, in which governments are always free, if they wish, to adjust the peg. (Although currency zones look like another class of option, they in fact amount to another type of fence straddling. When an exchange rate moves to one or the other end of its zone, the regime becomes an adjustable peg. To the extent that the zone is widened to avoid that possibility, the regime simply becomes a free float). It is the grass in a world of adjustable pegs or, perhaps more accurately, the comfort of a perch atop the adjustable-peg fence that ought to be the point of comparison for those dissatisfied with the colour of the grass on which we now stand.

STRADDLING THE FENCE WITH AN ADJUSTABLE PEG

The adjustable-peg fence-straddle is, in fact, much less comfortable than a one-currency or permanently fixed rate world. Even though irrevocably fixed rates or currency unions provide individuals and businesses with certainty about future exchange rate values and may involve fiscal transfers and other buffers against external shocks, dealing with a collapse in export demand is still stressful in a fixed-rate world. But in an adjustable-peg world, holding the line on the exchange rate is far worse. Speculators and more respectable citizens alike know that, faced with a choice between the pain of relative deflation and the quick out of re-pegging at a lower level, a country's political masters will generally opt to re-peg. The result: wild swings in financial markets as households and businesses position themselves in advance of the move, followed by huge profits from a one-way bet.

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An adjustable-peg world is thus a congenial one for speculators, whose lower level of day-to-day activity is handsomely compensated by financial gyrations like those in the fall of 1992 when the first major collapse of Europe's exchange rate system occurred, and at the end of 1994, when Mexico abandoned its peg. It is an uncongenial one for those engaged in cross-border trade and investment, who find that the reduction of day-to-day exchange rate risk is offset by less frequent but much more traumatic crises. The stresses and strains accompanying Europe's exchange rate machinations and Mexico's crisis show how profoundly overshooting can affect economies who adjust their pegs.

GREENER GREENS AND BROWNER BROWNS

Many fans of more exchange rate fixity acknowledge these objections. Like other advocates of price-fixing (the rent control enthusiast deploring the degeneration of an inner-city tenement, or the minimum-wage booster distressed by high youth unemployment), fixed-rate advocates often show devotion to the cause that is unrelated or even inversely related to the persuasiveness of their economic case. The urge to fix gets much of its force from the premise that foreign exchange markets are doing a bad job, and that the grass on our side of the fence is so brown that we simply must go elsewhere.

This sentiment is often no more complicated than the desire to shoot the messenger: governments are notoriously quick to blame foreign exchange traders when markets react straightforwardly to bad policies. Sometimes it is part of a larger agenda for monetary policy: proposals for pegging an exchange rate often involve a devaluation first, which suggests that their inspiration is not to deprive the central bank of its tools of monetary control, but simply to force it to use them, for a while, in a certain way.

More subtle is the discomfort of many economists who are suspicious of the foreign exchange market because of their own inability to explain or predict exchange rate movements. Such objections tend to focus on the apparent primacy of traders' whims and speculative surges in short-term exchange rate movements. Dealers in foreign exchange feed this prejudice themselves with their own focus on market sentiment, and never more so than when a big exchange rate movement that catches many traders off-side prompts loud, self-serving calls for central bank intervention "before the market loses confidence."

An efficient market ought, however, to be unpredictable from day to day. Foreign exchange markets will move up and down as commercial orders come through that may be reflected in official statistics for trade and investment only after weeks and months have passed—or not at all. They will fluctuate as investors make portfolio adjustments based on judgements about future economic and political events that may never be widely shared. The resulting ups and downs in currencies are evidence only that the foreign exchange market is a very sensitive barometer, not that it is driven by irrational whims.

As for the case that the bad job done by foreign exchange markets is harming economic performance generally, the principal evidence, namely that the major economies have grown on average more slowly since the Bretton Woods system collapsed, is no more than a simple correlation that is open, to say the least, to more than one interpretation. Despite considerable effort, the links in the supposed chain of cause and effect have proved hard to find. Cross-border flows of trade and investment ought to be the intermediary between exchange rate volatility and slower growth, yet they have grown much faster than output during the years of generally floating rates. While growth in big countries has been slower, moreover, the fastest sustained economic growth rates on record, those of the Asian tigers, have occurred since the collapse of Bretton Woods. Finally, despite the boost that floating rates are said to give to protectionism, the floating rate era has seen numerous multilateral and regional trade and investment agreements negotiated and implemented. The breadth of current efforts at cross-border commercial liberalization is currently so great that some commentators are warning about overload—not what one would expect in a world where exchange-rate volatility is closing borders.

At least equal skepticism is apt for a second premise in the case for fixing: that governments could do better than markets. The general idea that monetary policy should be geared toward stability in one specific price or subset of prices, commodities, wages of industrial workers, or long-term interest rates is not persuasive. The achievability of exchange-rate stability may be less in question, since central banks do directly control the amount of currency they issue. But why prosperity will be enhanced by targeting foreign exchange prices rather than the general level of prices economy-wide is not at all clear. Public-choice views of government behaviour ought to reinforce these reservations: government-controlled foreign exchange rates have often been set in the interests of specific influential groups, urban consumers of imports, for example, rather than those of the general population.

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Less drastic experiments also call governments' ability to intervene to good purpose in foreign exchange markets into question. Effective intervention would presumably reduce exchange rate volatility, yet the evidence on the question is mixed, with some investigations suggesting that the opposite has occurred. If intervention enhanced welfare by matching buyers and sellers across time, it would presumably be profitable, yet the debate over whether exchange market intervention actually is profitable goes on inconclusively, making the size of the benefits, if not their existence, a matter of some doubt.

In light of this unimpressive record, it seems apt to urge advocates of greater exchange rate fixity to test their convictions with bets—using their own money, rather than that of their compatriots—in the market. This is not a gratuitous challenge: pegging badly is a major mistake. As Britain learned in 1922, and rediscovered 70 years later, too high a peg means needless economic contraction and deflation. Too low a peg, on the other hand, means an unsustainable inflationary boom. And if, as is more often than not the case, the resulting economic and political strain causes the peg to give way, the profits reaped by speculators come straight from the pockets of taxpayers, courtesy of central banks who were obliged to buy high and sell low, or sell low and buy high, trying to defend the indefensible. Economic forecasters are often urged to say where but not when, or when but not where. The would-be pegger must get both right: the majority of citizens will share the loss if the bet is wrong.

TAKING OFF THE GREEN-TINTED GLASSES

A world of market-driven prices inevitably involves discomfort, not only when prices move in directions that disturb us, but when the reasons for their movements are obscure. But seekers of greener grass ought to look before they leap the fence. The fact that currencies are issued by central banks gives a superficial appeal to the idea that their prices against each other should be regulated. People familiar with bond or share markets where issuers actively trade their own securities might find the idea of a market without such intervention unsettling. Yet, most major countries allow the free movement of key factors, such as exchange rates and long-term interest rates. Equity markets, which serve to assess a nation's physical and intellectual capital stock are also allowed to fluctuate. Trying to jump over to fixed prices for bonds and shares would not land us in green grass. There is no compelling reason to view foreign exchange markets differently.

In a world of currencies controlled by governments with full economic agendas, the lush grass apparently on offer from a move to pegged exchange rates is an illusion. Truly large gains in economic efficiency are available from currency unification. If the tradeoffs involved in giving up autonomous currencies are seen as too onerous—the perception that prevails in the major countries—then the alternative to the rather patchy grass of a free-floating world is an uncomfortable perch on the fence of adjustable pegs. Given that choice, a sensible cultivator, and a prudent economic policy-maker, will give priority to the health of the grass on the near side of the fence. ◆