UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

THE EXCHANGE RATE: ECONOMIC POLICY TOOL OR MARKET PRICE?

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No. 157
November 2001

DISCUSSION PAPERS

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I am grateful to Yilmaz Akyüz, Wolfgang Filc and Jörg Mayer for their helpful comments on the first draft.

UNCTAD/OSG/DP/157

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JEL classification: F310, F410 and F420.

Contents

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United Nations Conference on Trade and Development, Geneva

Preface

In November 1999 Barry Eichengreen and Ricardo Hausmann wrote: "Curiously, early contributions to post-Asia literature … said little about the choice of exchange rate regime, focusing instead on transparency, prudential supervision, policy toward capital flows, and IMF reform. The emphasis in recent writings is different; there, the exchange rate has taken centre stage" (Eichengreen and Hausmann, 1999: 1). This shift in emphasis, called by the authors a "maturation" of the debate, is indeed remarkable. In the post-Asian and ante-Brazilian crisis prevention debate, my attempts in the autumn of 1998, in my capacity as German G-7 Deputy Finance Minister, to shift the focus of attention to the exchange rate regime failed ruefully. Lacking the support of eminent economists such as Barry Eichengreen, I was denounced a priori as a "pure macroeconomist" trying to avoid the hard and complex "structural" questions. In the next round my pleas to make the exchange rate regime in developing countries more flexible without returning to the outdated regime of pure floating earned me the name of "Mr. Target Zone". At that time the new paradigm of corner solutions – choosing either absolutely fixed rates or free floating – had quickly been adopted by the United States administration and the International Monetary Fund, without waiting for the results of the commencing scientific debate.

In the new millennium the academic debate on an appropriate exchange rate regime for emerging economies seems to be reaching a new stage. The painful experiences with hard pegs, such as the once famous currency boards on the one hand and the "fear of floating" (G. Calvo) on the other hand have forced the debate back to solutions between the corners. However, many officials as well as the international financial institutions still adhere to extreme solutions. This is not surprising, given that the corners seem to offer a strictly unilateral approach. If emerging economies could just have the choice of fixing their rates permanently by dollarizing or floating them, countries with reserve currencies could avoid international commitment. Furthermore, if the exchange rates of the Group of Three (G-7) are to be set by market forces, the efficient allocation of international resources would appear to be guaranteed. Political initiatives by other G-7 countries are rare (France and Japan, 2001) and barely successful, as long as the majority of economists shares the view that only the corners of the continuum of possibilities can prevent crises and provide unilateral solutions to a problem which is multilateral by definition.

Abstract

The paper reconsiders the failure of mainstream economics to come up with a consistent and valid exchange rate theory. There has been broad consensus among economists for decades that changes in the value of money over time cannot be used as an economic policy tool because people would be quick to learn to adapt to any attempt to exploit the money illusion by inflationary policy. Paradoxically, the majority of economic analyses have never questioned the ability of policy makers to exploit money illusion over prolonged periods of time if the subject is the change in the value of money in space, i.e. exchange rate changes. The paper argues that the latter have to be treated in the same way as the former if economic theory is to be consistent. As a consequence, exchange rate changes can only be used to compensate for inflation differentials between countries, and nothing else. The paper draws on the European experience up to monetary union, as well as on experience in developing countries with different exchange rate regimes. It strongly rejects the idea of offering unilateral corner solutions for the exchange rate regimes of developing countries in a multilateral world.

I. INTRODUCTION

For economists brought up in the 1970s the controversy of fixed versus flexible exchange rates was every-day bread and butter. The collapse of the Bretton Woods soft peg system of fixed but adjustable rates required a quick political solution. The countries of the industrialized world were split into two groups: the large, closed ones opted for floating, while most of the smaller ones opted for a new peg with different anchors. Europe, with Germany as the anchor, formed the largest of these new soft peg groups. In economic theory, fixed versus flexible rates were part of the general fight of fading Keynesianism versus upcoming monetarism. Monetarism fought for a clear market solution and expected "stabilizing speculation", whereas most Keynesians mistrusted the "animal spirits" of the market and feared herd instincts and bandwagon effects.

Nevertheless, the different schools were united regarding one important aspect of the international monetary order: all admitted that any monetary system would have to assure sufficient flexibility of prices, expressed in an international currency, to avoid fundamental external disequilibria in trade. Although the monetarist school of thought expected domestic prices and wages to be flexible enough to adjust to real and monetary policy shocks, they advocated an additional exchange rate flexibility as a substitute for the lack of international price and wage flexibility.[1] The Keynesian approach was based on stickiness of wages and prices. With insufficient flexibility of wages and prices in general, the Keynesian approach asked for a buffer to smooth international shocks or to avoid domestic misalignments leading to external imbalances. Thus, in a Keynesian approach too, exchange rates should be flexible: flexible enough, if not floating freely, to avoid real cost inhibited by adjustment to unforeseen external events.[2]

The aspects of flexible versus fixed prices – an essential ingredient of the former remarks – have virtually disappeared in the modern debate on exchange rate regimes. The current approach centres around the capital account, with the current account being an appendix or result of capital transactions. The main topic of the former debate – how to avoid high and rising current account deficits and thus unsustainable capital inflows – has been replaced by the question of how to sustain high and even rising capital inflows. As Summers (2000) recently put it: "When well capitalized and supervised banks, effective corporate governance and bankruptcy codes, and credible means of contract enforcement, along with other elements of a strong financial system are present, significant amounts of debt will be sustainable". Given this "first" element of an effective national strategy for minimizing the risk of a capital account crisis, the second one follows:

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[1] Friedman (1962) and Sohmen (1967).

[2] Keynes argued against the return of Britain to the gold standard at the pre-war parity. The optimum currency area criteria of Robert Mundell and others were based on the idea of avoiding huge real costs by depreciating a currency which, due to a negative demand side shock, is overvalued.

> … the choice of appropriate exchange rate regime, which, for economies with access to international capital markets, increasingly means to move away from the middle ground of pegged but adjustable fixed exchange rates towards the two corner regimes of either flexible exchange rates or a fixed exchange rate, supported, if necessary, by a commitment to give up altogether an independent monetary policy". (Summers, 2000: 8)[3]

As a consequence, Summers concludes that the choice between the poles "has less to do with Robert Mundell's traditional optimum-currency-area considerations than with the country's capacity to operate a discretionary monetary policy in a way that will reduce rather than increase variance in economic output". Eichengreen and Hausmann (1999) attempt to solve the exchange rate question along the same lines by investigating the relationship between financial fragility and the exchange rate, rather than between the latter and prices and wages as well as interest rates.

The focus on the capital account in the recent debate explains the results. If the main target of economic policy in emerging economies is to sustain debt and stable capital inflows, instead of preserving competitiveness or high employment and living standards, the therapy may indeed be sought in the corners. Absolutely fixed as well as fully flexible rates may reduce the risk of destabilizing speculation and of moral hazard ("the time bomb waiting to explode") (Eichengreen and Hausmann, 1999: 2). The crucial question, however, is how to achieve simultaneously both internal and external equilibrium, as Eichengreen and Hausmann call it, remains unsolved. Even worse, with the corner solution hypothesis in place, and countries choosing the proper exchange rate regime by mainly considering the short-term capital account logic, economies may err in terms of effective adjustment to fundamental current account disequilibria or their domestic economic policy targets. For example, if a country with rather rigid wages and prices chooses a currency board, it may achieve in the short run the capital account results promised by the corner solution hypothesis. However, it is in deep trouble if prices and unit labour costs in the anchor country and its competitors rise less in terms of an international currency, and it is faced with competitive shocks and unable to restore competitiveness by means short of a full-fledged deflation. Its inability to respond to these shocks will sooner or later trigger a loss of confidence in the capital markets, and it will have to pay with high and rising interest rate spreads, thereby aggravating the fundamental imbalance. On the other hand, countries with relatively flexible prices and wages choosing floating may end up with too much flexibility if both flexible prices and flexible exchange rates move in the same direction.

Hence, as the recommendations of the different schools are contradictory, we are left to decide who was right: i.e. the economists of the old or those of the new generation. If the dominant problem in the international trade of goods, services and capital is still the inflexibility of wages and prices as well

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[3] See also Calvo and Reinhardt (2000b) and Fischer (2001) for similar views. The Meltzer Commission said in its Report (2000: 8): "Maintenance of stabilizing budget and credit policies is far more important than the choice of exchange rate regime", and recommends the corners "as neither fixed nor fluctuating rates are appropriate for all countries and all times". The fact that in the recent literature the "lender of last resort" is addressed as one of the most important problems is also based on pure capital account logic. In a broader view, the critical question is how to solve economic problems in emerging markets without net lending from abroad.

as the need to preserve competitiveness, the corner solution theory can hardly make sense. In this case a country choosing an exchange rate regime without taking into account its own degree of wage and price flexibility, together with that of its competitors, will not escape crisis, even if the financial system as such is strong and transparent. It is only if this still important but outdated problem can be solved somehow or other that the corners may be feasible. But, as will be shown below, the modern view does not prove the irrelevance of the old problem. In its obsession with the capital account, it does not address the pressing questions posed by the existence of different national labour market arrangements or different growth rates in countries with open trade and capital accounts. Even more astounding, the capital account approach leaves aside the obvious inconsistencies arising if trading partners choose the opposite corner, as was the case between Brazil and Argentina following Brazil's switch to a flexible rate in the aftermath of its crisis.

This paper follows some very simple considerations concerning the role of exchange rate changes in the globalized economy. After a brief discussion of the root causes of the modern corner solution view (section I) and of the different types of crises in different exchange rate regimes (section II), the various functions attributed to exchange rate changes are examined. The main questions provoked by the corner solution view are obvious: is the exchange rate a normal price like any other price on goods or the capital market? If yes, absolute fixing must be difficult to reconcile with a market economy (section III). Is the exchange rate a substitute for flexible prices and wages? If yes, can a priori recommendations for a corner solution be justified without a thorough investigation into the differences in wages and the price inertia of countries involved in international trade and free exchange of capital (section IV)? Is the exchange rate, as some observers believe, a normal tool of economic policy? If yes, is it sensible to leave it to the market or forsake its service by permanently fixing it? Do exchange rate changes efficiently buffer real shocks? If yes, should this adjustment mechanism be sacrificed for the sake of stable capital flows and reduced risk in international capital transactions (section V)? The last question was posed by critics from the United States before the European Monetary Union (EMU) had entered its final stage. Is this objection obsolete now, along with the indisputable benefits the anchor approach in the European Monetary System (EMS) brought about as a device to fight inflation (section VI)? What have been the causes of inertial