Exchange Rate Choices

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Exchange Rate Choices

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The past five years has demonstrated the challenges that every country has with choosing an exchange rate policy – a policy toward the value of its currency with respect to other currencies. Perhaps the most prominent cases are Greece, Switzerland, Brazil, and Japan, but the issue is widespread. Indeed, the choice of exchange rate policy is perhaps the single most important decision of economic policy for most countries.

Every country (except for non-members Cuba and North Korea) must declare its exchange rate policy to the International Monetary Fund, which duly records them. Perhaps puzzlingly, the IMF provides no guidance as to which policy a country should choose, except in a few cases where a country goes to the IMF in financial difficulty and has a troubling monetary history. These declarations have changed somewhat over the years. During the 1990s countries drifted (on average) toward floating exchange rates (often managed), such that by 1999 101 countries declared themselves to have floating exchange rates, up from 38 ten years earlier. During the 2000s there was some drift back toward some form of fixed exchange rates (of which there is a great variety); by 2012 only 66 countries declared their currencies to be floating. And even some of the countries with declared floating rates managed their floats so heavily that in practice they were more like fixed exchange rates.

The economics profession also has remarkably little agreement on the appropriate choice. Advice ranges from full floating to fixity to some major currency through currency boards to even adopting another country’s currency, depending in part of course on the circumstances of each country, but also reflecting the biases of each adviser. Economists generally favor flexible prices over fixed prices, and some extend this preference to exchange rates, although I have not yet discovered an economist who favors a flexible salary, varying from month-to-month or even from day-to-day with an uncertain mean value, which is the situation with floating exchange rates.

There is the by now well-known trilemma, whereby a country cannot simultaneously maintain a fixed exchange rate, freedom of capital movements, and an independent monetary policy. With a fixed exchange rate and free cross-border movement of capital, the country’s monetary policy will be determined by monetary conditions outside the country. Some variants of fixed exchange rates – those with bands of flexibility or controlled movements of the fixed rate – can restore some freedom of monetary policy, but even that is constrained, not unlimited. Floating exchange rates allegedly restore freedom of monetary policy, but of course at the price of exchange rates that are moved about by many causes, not just by monetary policy.

What is less widely appreciated is that floating exchange rates and freedom of capital movements together pose a sharp dilemma for many countries. The reason is that the exchange rate is
simultaneously a price relevant for production and consumption of goods and services in any open economy – probably the most significant single price for most economies. But it is also an asset price for all but the largest economies, in that it responds to foreign and domestic sentiment with regard to inward and outward investment from the country. Like all asset prices it can jump suddenly in response to changes in expectations, which in turn can be influenced by news or even plausible rumors. Yet when it jumps, it disrupts the market for goods and services, where predictability, while never perfect, is important for decisions, particularly for decisions regarding investment for future production. It is an asset price especially for those countries whose financial markets are small relative to the global financial market -- that is, for most countries.

Economists have emphasized the useful role that flexible exchange rates can play as shock absorbers for various kinds of disturbances that may hit any national economy, arising from changes in world demand for the country’s products or from technical changes that either improve or diminish the competitiveness of a country’s products. But the dual role of flexible exchange rates, as asset price as well as price for goods and services, means that movements in exchange rates can also introduce disturbances into the market for goods and services, as sentiments regarding financial investments around the world change, leading to shifts in the composition of portfolios. There are many kinds and motivations for cross-border capital movements, some involving long-term commitments, some involving short-term arbitrage transactions, some intending to be long-term but ending up being short-term due to real or rumored events. Some capital movements, it must be acknowledged, respond to fashion, which can change quickly; and some are skittish, which can reverse on slight provocation.

So cross-border capital movements can be highly volatile. Where two currencies are involved, they can lead to large changes in exchange rates – large at least relative to the margins on many traded goods, typically only five to ten percent. Should volatile capital movements be allowed to jerk around the prices (or margins) of internationally traded goods and services? That depends on the social value (as distinguished from private profit) of the capital movements compared with the social costs of the disruptions to the market for goods and services. If the latter costs exceed the former benefits, there are two ways to reduce or eliminate the discrepancy: to stabilize (perhaps around a trend) the exchange rate through official action, or to inhibit or prevent volatile capital movements through official discouragement, or some of each.

There are well-known disadvantages to official actions to stabilize exchange rates. They may stabilize around the “wrong” rate, although it has to be said that economists are not entirely clear as to what is the right rate. And it may encourage speculative movements of capital insofar as the market believes the official rate is too high or too low, thus creating a “one-way option” for speculative gain. These disadvantages have not kept 76 counties from adopting a “soft peg” for their exchange rate, and another 12 from adopting a hard peg in the form of a currency board (thus accepting loss of effective control over domestic monetary policy).

Another disadvantage of official action to stabilize an exchange rate is that an inward surge of capital will lead to a corresponding build-up of foreign exchange reserves and perhaps also to unwanted domestic monetary expansion. The reserves are typically invested in liquid foreign assets with low
yields, usually denominated in US dollars or euros, with smaller amounts in some other currencies. Indirectly, the country is financing prospectively high yield foreign private investments with low yield official investment – hardly a sensible strategy for any country, but especially for those that are short of capital. Yet it has occurred on a massive scale: the foreign exchange reserves of developing countries grew from $1147 billion at end 2000 to $7871 billion at end 2013 (from $982 billion to $4032 billion if China is excluded). A large part of this build-up, it is true, arose from current account surpluses; but a large part also accrued through net private capital inflows.

The second way to prevent volatile capital movements from jerking around prices for goods and services is to inhibit or even prevent volatile capital inflows and outflows. It will be argued that inhibiting international capital movements will prove detrimental to growth in the recipient countries. The results of empirical research on the influence of liberalization of international capital movements on growth or productivity in developing countries is a mixed one, with different studies, each framed somewhat differently, showing different results. An emerging consensus suggests the influence of capital account liberalization is positive, but that it may take several years to show its positive effects, since the impact effects may be weak or even negative. Moreover, while the accumulated stock of foreign equity, whether direct investment (i.e. involving foreign control) or portfolio investment, is positive, the effect on productivity of outstanding foreign debt is negative. We will not digress here to speculate on why that might be so, if indeed it is so. Our primary concern is not with foreign capital per se, but with volatility in flows of foreign capital -- in particular with sudden withdrawals, although even a sudden drop in net inflows can be disruptive if a recipient country’s current account has adjusted to expectations of a continuing net inflow.

What we know from experience is that liberalized capital flows are neither necessary nor sufficient to ensure vigorous economic growth. Japan, South Korea, China, and India all restricted inflows of foreign capital (and outflows of resident capital) during their periods of most rapid growth, and it would take a bold analyst to argue that they could have grown more rapidly than they did had they liberalized capital movements – which Japan and South Korea both eventually did, but only after their periods of rapid growth had passed. Mexicans have had liberalized movement of capital, inward and outward, for over two decades, and Mexican growth, while respectable, has been slower than many Mexicans and outsiders both hoped and expected. And freely flowing capital permitted Greece to avoid hard but necessary fiscal choices, as it did in Argentina in the late 1990s. But necessity and sufficiency are strong standards, and it is probably the case that inflows of capital, under appropriate conditions, can contribute to growth. But it is highly doubtful that volatile capital movements make a positive contribution, and much more likely that their contribution is negative. A country must either hedge against them, at some cost (e.g. by maintaining large, low-yield foreign exchange reserves) or accept the disruptive consequences to investment and production.

Since the financial crisis of 2008 the International Monetary Fund (2012) has recognized the possible desirability of limiting capital flows. (It is noteworthy, against the background of the 1920s and 1930s, that the designers of the post-1945 international economic system, including creation of the IMF, took for granted that private cross-border capital movements should be restrained. The International Bank for Reconstruction and Development was created to provide official loans for development.) The
IMF declines to offer general prescriptions, since it correctly observes that the detailed circumstances, both regarding potential capital flows and regarding ability to restrain them skillfully, differ significantly from country to country, and actions should ideally be tailored to those circumstances. But it indicates a preference for price-based restrictions (i.e., taxes or unremunerated reserve requirements) over official determination of who can and who cannot invest in the recipient country.

So how to restrain the inflow of potentially volatile capital? Countries should probably welcome an inflow of capital, but only if it stays awhile, not otherwise. Thus, it could impose a tax on repatriation of capital that stays, say, less than a year. Since sharp thresholds are usually undesirable, the tax could be graduated to the length of stay, say up to 18 months, declining from being very stiff if withdrawn within a month to zero after 18 months. Such a tax on any withdrawal within the prescribed period would involve lots of “paperwork,” but that is much easier in these days of electronic communication and record-keeping. Such a tax should not be seen as merely a transitory expedient, but might become a permanent feature of a country’s policy kit, for those countries that want it, although the rates might be changed according to the prevailing macrconomic conditions.

What would be the consequences? First, it would discourage the inflow of potentially turnaround capital, such as that from foreign mutual funds. It would also discourage short-term bank loans (trade credit could be exempt from the tax). Second, it would not prevent foreigners from withdrawing their capital, e.g. after selling securities, but it would require them to pay a penalty to do so, thus encouraging them to maintain their investments (perhaps in different securities) until the taxable period has passed.

It would not of course inhibit the outflow of resident capital; if desired, that would require a different set of procedures, or a different tax. And we know from experience (e.g. Mexico in 1994, Thailand in 1997, Argentina in 2001) that in times of uncertainty resident capital is the first to leave a country. That usually reflects lack of confidence in the underlying domestic policies rather than events abroad, and thus signals a need to change those policies, or at least to be more persuasive about the reasons for continuing them.

A further implication of the proposed tax is that the foreign exchange market in the domestic currency would have to be made by resident banks (or the country’s central bank), since market-making requires the ability to make short-term purchases and sales. That might well reduce the liquidity of the foreign exchange market and perhaps – depending on the degree of competition among domestic banks – lead to higher fees. And of course the country’s currency could not be used as a reserve currency by other countries, since the ability to sell when needed is paramount. (It would not prevent investment in our country by sovereign wealth funds abroad, but their investments would be subject to the same tax if they withdrew early.) Reserve currencies would have to be fully convertible without restraints on capital movements, or alternatively central bank purchases and sales would have to be exempt from the restraints.

What about the movements in exchange rates between currencies used as reserve currencies, especially the US dollar and the euro? The dollar value of the euro has ranged from $1.17 at the
beginning in 1999 to a low of $.83 in 2001, to a high of $1.60 in early 2008, which then European Central Bank chairman Trichet called “brutal,” to $1.21 in 2012 before rising to $1.37 in early 2014. Inflation was both low and well under control both in the United States and in the Eurozone during this period. Such variation can be highly disruptive to production, and to investment planning. Indeed, the Swiss franc appreciated so sharply during the “euro crisis” in 2010-11 that the Swiss authorities drove it down and announced their intention to peg the franc at 0.83 euros, still 22 percent stronger than it had been at end 2008. Similarly, the Japanese yen went from ¥114 per dollar in 2007 to ¥77 in 2011, then to depreciate to ¥103, or by 34 percent, in early 2014.

Some analysts have proposed that these large economies adopt target zones to limit the movements of their exchange rates within a range, necessarily in cooperation with one another. Whatever the merits of this suggestion, it would probably be impossible to agree on the exchange rate in the center of the range, as proved to be the case during the Smithsonian negotiation of 1971, which contributed to the breakdown of the Bretton Woods system of fixed but adjustable exchange rates. (An agreement was reached, but it did not hold, as foreseen by analysts.) And the boundaries would be tested from time to time, requiring potentially large official interventions in the foreign exchange market.

One way to ease into more stable exchange rates among major currencies would be to have monetary policy in each currency zone aim at a common target, which might be an index of prices of standard internationally traded commodities, including refined aluminum, electrolytic copper, diesel oil, certain specified qualities of steel, cotton, wheat, rice, soybean oil, and so on. (In a somewhat different monetary context, Keynes (1930) suggested an index of 62 commodities.) This would anchor monetary policy to the real economy, and would create common expectations in all the major currency areas. Exchange rates might be given a soft target zone, as suggested by McKinnon (1996), and this common framework might create an expectational environment in which movements of exchange rates would be limited, particularly since the currencies involved presumably would be of countries or regions which had financial markets of considerable size relative to the rest of the world. It would mean, of course, that consumer prices could follow somewhat different rates of increase, but that would be no bad thing. Prices of services in the consumer price indices are notoriously poor. Moreover, differential rates of increase in consumer price indices would permit greater relative movements in real wages, affecting international competitiveness, in a world in which downward movements in nominal wages are exceptionally difficult to achieve.

In short, countries wanting to insulate their economies from surges in capital inflows, which may create unwanted macroeconomic booms and, via an appreciating currency, distort real investment and the patterns of production, may want to straddle. The can intervene in the foreign exchange market to limit the appreciation of the currency, and subsequent depreciation as the funds flow out again. But they may also want to limit the capital inflow itself, by taxing foreign capital that resides in the host country for only a short period of time, a year or two.
References

