

Beyond the Border

Exchange Rates, Capital Flows and Monetary Policy in a Changing World Economy

Does a country's exchange rate policy influence its economic prosperity? This and other issues were addressed during the Federal Reserve Bank of Dallas' September 14–15 conference, "Exchange Rates, Capital Flows and Monetary Policy in a Changing World Economy." An important focus of the conference was what countries should think and do about exchange rates. For example, a country can fix its exchange rate, as most industrial countries, including the United States, did under the Bretton Woods system for 25 years after World War II. The other extreme among foreign exchange choices is to let the rate float, as the United States has more or less done since 1972. A third option for countries is a policy somewhere in between that's aimed at controlling exchange rate movements within predefined limits.

Do Exchange Rates Make a Difference?

Some economists have argued that nominal exchange rates, those quoted in the daily newspapers, have few effects on the real economy. In the 1970s, economist Milton Friedman advocated floating nominal exchange rates instead of fixed rates. Friedman argued that floating rates would adjust to economic activity and let markets operate more efficiently. Friedman and others believed that only changes in real exchange rates—those adjusted for price changes in each country—would affect real economic activity.

Furthermore, economists have

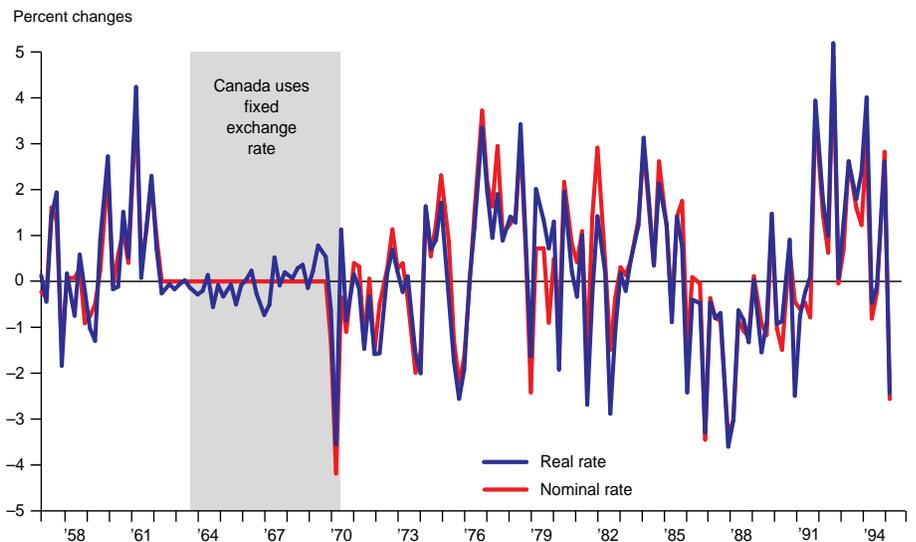
argued that changes in nominal exchange rates would not affect real exchange rates. Prices would adjust to offset changes in the nominal rate. Suppose that France had a small devaluation of the nominal exchange rate against the dollar, so that the dollar bought a few more francs after the devaluation. According to the argument, if a nominal devaluation occurred, France's domestic prices would increase to offset the exchange rate move. As an example, if the exchange rate went from 5 to 6 French francs per dollar, sellers might adjust by pushing up French wine prices from 25 francs to 30. A 25 franc bottle of wine with a 5 franc per dollar exchange rate is \$5. A 30 franc bottle of wine at a 6 franc per dollar exchange rate is still \$5, even though a dollar now buys 6 francs instead of 5. That is why a nominal devaluation would have no effect on the real, inflation-adjusted exchange rates, and there would be no real effects on the economy.

However, if a nominal devaluation occurred without an offsetting increase in France's prices, there would be real effects. A 20-percent

devaluation of the franc with no change in the franc price of French wine, for example, would mean French wine would be 20 percent cheaper in dollars. Americans would most likely buy more French wine and less California wine. That would be a real effect. This scenario more closely resembles how things really work.

The relationship between the U.S. dollar and the Canadian dollar illustrates how changes in nominal rates affect real rates. Chart 1 is a plot of the Canadian dollar/U.S. dollar nominal and real exchange rates during a period of fixed exchange rates—the late 1960s and very early 1970s—and during a period of floating rates—1972 to the present. If changes in the nominal exchange rate had no effect on the real exchange rate, the real rate on this chart would stay flat around zero, no matter how much the nominal rate changed. But that is not what happened. When Canada fixed its nominal exchange rate in the 1960s, real exchange rate volatility declined. But when the Canadians floated their dollar in 1972, real exchange rate volatility also rose. Thus, when the nominal exchange rate moved around a lot, so did the real rate. Clearly, nominal exchange rate changes can have real effects.

Chart 1
Canadian Dollar–U.S. Dollar Nominal and Real Exchange Rates



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Floating Exchange Rates

Despite this finding, many conference speakers expressed support for floating exchange rate systems, citing several advantages. Speaker Michael Dooley, professor of economics at the University of California at Santa Cruz, argued that a fixed exchange rate regime gives short-term insurance for investors. By using a floating rate, these investors bear more investment risk. The result is less movement of the hot in-and-out money some analysts accuse of disrupting many developing economies.

Another advantage of floating rates is they are less likely to move so far out of line with economic fundamentals as to create sudden megadevaluations. For example, the Mexican peso's overvaluation and subsequent crash could have been avoided with a floating exchange rate. Moreover, it may be more difficult today to maintain an overvalued exchange rate with the large size of international capital movements and new innovations, such as derivatives. Conference speaker Peter Garber of Brown University showed how derivatives could render some standard tools for defending a currency, such as raising interest rates to attract new capital, completely ineffective in some cases.

Floating exchange rates also have their problems. Speaker Jeff Frankel of the University of California at Berkeley noted that floating exchange rates have tended to be very volatile, and their volatility may also discourage trade. Vittorio Corbo of the Catholic University of Chile observed that exchange rate volatility may hamper international investment because it makes it more risky. When investment slows, so does overall economic growth. Frankel also explained that exchange rate fluctuations may cause an exchange rate bubble. Bubbles develop when speculators, thinking that a move in a certain direction

might continue, bet on the trend no matter how far out of line with economic fundamentals it actually is. This progressively wider wedge between the exchange rate and economic fundamentals eventually gets corrected, with negative repercussions for financial markets and economic stability.

Fixed Exchange Rates

Heavily controlled exchange rates—those that are pegged at a constant rate, allowed to crawl at a preannounced rate or allowed to fluctuate within a band—received a lot of interest in the 1980s, as World Bank economist Sebastian Edwards pointed out. Many people thought that controlled rates could serve as an anchor that tethered domestic prices to international prices by targeting the exchange rate. The idea was that managed exchange rates would serve as part of a credible anti-inflation policy. Countries with pegged exchange rates, it was believed, would be less likely to dare to expand their money stocks at a faster rate than the countries to which their exchange rates were pegged. Doing so would mean that the exchange rate would have to be abandoned.¹

However, fixed exchange rates have their own their problems, as many conference participants pointed out. Fixed exchange rates, or even currency boards, are not as immutable as some might believe. The collapse of the European exchange rate mechanism and the Mexican peso are two examples. Also, Peter Garber argued that it is getting even harder for countries to defend a fixed rate from speculative attacks and bubbles. Sooner or later, these attacks always seem to come if the exchange rate does not match the economic fundamentals.

Finally, countries that use the exchange rate as a nominal anchor against inflation rarely reduce their inflation rates to the level of the country whose currency they're

pegged to. This can lead to a serious overvaluation, which is what happened in Mexico. Although exchange rate policy contributed to a drastic drop in Mexican inflation, it was not enough to match U.S. inflation. Because inflation in Mexico grew faster than the exchange rate, Mexican products became expensive relative to U.S. goods. Mexican imports rose and capital inflows fell. The result was a balance of payments crisis, an attack on the currency and a large, disruptive devaluation.

Conclusion

One consensus of the conference was that, despite valid circumstances for managing exchange rate movements, floating rates appear to be a more practical policy. The strongest case for fixed exchange rates could be made for very small and very open economies, such as Panama or Bermuda. But even in these cases, periodic exchange rate adjustment could be necessary.

Participants wholeheartedly rejected a return to the Bretton Woods system of fixed exchange rates. Also rejected was explicit monetary coordination between countries if it meant domestic concerns would take a back seat to international objectives. The consensus generally was that countries should look toward domestic stability as their objective, which would reduce long-run exchange rate volatility.

—Beverly Fox
David Gould
Bill Gruben

Note

¹ For small countries, Steve Hanke of Johns Hopkins University and Allan Meltzer of Carnegie Mellon University both endorsed something even stronger—a currency board. Steve Hanke argued that this currency arrangement would ultimately lead to more stable financial markets. For a more detailed analysis of currency boards, see Carlos Zarazaga, "Can Currency Boards Prevent Devaluations and Financial Meltdowns?" *Southwest Economy*, Issue 4, 1995.