The Economist

Exchange rates

Fix or float, sink or swim?

Volatile currency markets claimed the scalps of two emerging economies'finance ministers this week. How should such countries manage theirexchange rates?

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THESE are jittery times for emerging-market currencies. Having survived an onslaught from speculators last month, the Thai baht plunged on June 19th after the resignation of the country's finance minister, Amnuay Viravan. The previous day Mr Amnuay's Israeli counterpart, Dan Meridor, had quit after a quarrel over how best to tame the soaring shekel. A few weeks ago the Czech Republic was forced to float the koruna (and lost its finance minister as well). Its neighbour Slovakia is now thought to be in the market's sights.

These episodes are a lesson that global capital markets do not leave macroeconomic mistakes unpunished for long: the Thais ran up a current-account deficit of 8% of GDP last year, the Czechs 8.6% and the Slovaks 10.1%. But, more than this, they raise a broader question: should emerging economies fix their exchange rates at all?

The debate about whether it is better to fix exchange rates or let currencies float is one of the longest-running in economics. Both approaches have their merits. A floating rate can help a country cope with a sudden drop in the price of its exports or a surge of foreign capital. This should be attractive to emerging economies, which are especially vulnerable to such shocks.

Yet many emerging economies peg their rates one way or another. One reason is that a commitment to a fixed rate, or a close cousin of one, can help to cut inflationary expectations. It might also promote prudent macroeconomic policies: with a fixed rate, slack policies automatically lead to a fall in foreign-exchange reserves. Eventually, policy must be tightened or the exchange rate abandoned. And a fixed exchange rate may mean a less volatile environment for investors and traders, boosting growth.

These arguments have spawned a variety of systems. At one extreme countries such as Argentina fix the value of their money with currency boards: pesos are backed by hard currency. Others have less rigid regimes. The baht tracks a basket of currencies dominated by the American dollar. The Slovak crown can move 7% above or below a peg that is weighted 40% by the dollar and 60% by the Dmark. Still other countries have a “crawling peg”, under which the currency depreciates at a preset rate. The Israeli shekel trades in a “crawling band”.

Fixed rates have proved invaluable in cutting inflation where it had been out of control. A few years ago, Latin America and Eastern Europe were ravaged by inflation. Now, in Argentina, for instance, inflation is expected to be about 1% this year, compared with 27% a month in early 1991.

Yet exchange-rate straitjackets can become increasingly uncomfortable. Some countries have seen their real exchange rates (ie, the rate once inflation differentials are taken into account) rise sharply, hurting the competitiveness of their industries, in part because inflation does not fall overnight to the levels of rich countries. In the Czech Republic, the real exchange rate strengthened by 42% between January 1993 and February 1997; in Brazil, it has risen by 26% since June 1994 (see chart (economist:image=/images/19970621/cfn810)).

To some extent, these troubles can be ascribed to faults in the design of the exchange-rate regime. A crawling peg can help hold down the real exchange rate. And Thailand suffered in part because the dollar, to which the baht was closely linked, rose; had the baht been linked to a basket of currencies better reflecting the pattern of Thai trade, its woes would have been less acute. Some difficulties might be rectified by redesign. On June 18th, despite Mr Meridor, Israel doubled the width of the band in which the shekel can trade against other currencies.

A bigger worry is the huge inflow of foreign capital that a newly stabilised country often attracts. By expanding the domestic money supply, foreign inflows can fuel inflation. Yet if the capital suddenly flees, these countries face a painful downward adjustment of domestic wages and prices.

Dealing with such volatility can be difficult. One popular approach has been to impose controls on capital inflows by, say, introducing a tax on foreigners purchasing equities. According to a recent study by the World Bank, most emerging markets that received lots of foreign money in the 1990s used such controls, with temporary success. But the Bank says they are unlikely to work as emerging economies become more integrated in global capital markets.

More extreme controls, such as those recently introduced in Thailand, are unlikely to be any more successful. Thai banks are prohibited from selling baht to foreign investors suspected of speculation, and foreign investors can no longer obtain baht by selling Thai equities. But since such controls deter future foreign investors and distort domestic financial markets, their long-term costs seem likely to outweigh their short-term benefits. And in any case the baht came under attack again after Mr Amnuay went.

Monetary policy also has its limitations. While emerging economies can temporarily negate the inflationary impact of capital inflows through “sterilisation” (selling government bonds to absorb the extra cash), this is expensive and eventually can prove ineffective. Conversely, high interest rates can stop capital flooding out. But a prolonged period of sky-high interest rates, which may be necessary to defend the exchange rate, can wreak havoc with a country's banking system. Fear of domestic financial problems is why, in the end, many countries with overvalued exchange rates are forced to devalue.

In the long term, living with a fixed exchange rate demands wage and price flexibility. Fiscal policy can help. Under fixed exchange rates, governments should tighten fiscal policy when money floods in, in order to dampen aggregate demand. But rigid exchange-rate rules do not always promote fiscal prudence. Indeed, Brazil's currency regime may have made much-needed fiscal adjustment harder: now that Brazilians have conquered inflation, they are loth to push through painful budgetary reforms. And therein lies the rub. Fixed exchange rates make fiscal prudence that much more important. If a country does not improve its fiscal policy, a fixed-rate system may simply store up trouble.

But surely, their fans may say, fixed exchange rates have one important advantage: they are less volatile than floating rates. And this matters especially in the thin currency markets of emerging economies. However, this risk can be overblown. In industrial countries, remarkably little evidence exists to suggest that the volatility of floating exchange rates does in fact harm trade or investment. Both traders and investors can learn to hedge. Indeed, a forced devaluation may do much more harm to investor confidence than continuous exchange-rate fluctuations. And “pure” floating is rare: central-bank intervention can limit volatility and yet allow more flexibility than a fixed system.

Neither fixed nor floating rates are substitutes for sound macroeconomic policies. Either can work if a country shows sufficient commitment. And for countries with an acute history of inflation, the rigour of a currency board may be the best medicine. But for those with less historical baggage, more flexibility may make sense. Flexible rates will not eliminate the volatility that emerging economies face. But they may make it easier to deal with.

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