

## **Appendix II: Fixed vs Flexible Exchange Rates**

There have been discussions about the optimal exchange rate regime for a very long time, reflecting the evolution of the world economy and the conduct of monetary policy. The gold standard, as well as systems tied to other commodities, provided a monetary anchor, as well as a standard for financing international transactions, for many different countries over the centuries. Histories of gold standards recount many periods of financial turmoil and very sharp variations in output and prices.

The Bretton Woods system was established, with the U.S. dollar as the centerpiece, as a system of fixed, but variable, exchange rates.<sup>1</sup> When this system came under stress in the 1960s, older debates of the relative merits of fixed versus flexible exchange rates developed new life and the original Bretton Woods system was replaced by a system of floating exchange rates among the major currencies. The question of the appropriate exchange rate regime for other currencies remained open to debate. In the early 1990s, influential economic arguments supported fixed exchange rate regimes as an anchor to break hyper- and high inflation in many emerging markets. The emerging market financial crises later in that decade, however, prompted a reassessment of these arguments and an emphasis on the virtues of flexible exchange rate regimes for large emerging markets, increasingly integrated into the global financial system. It became clear that economies operating in the framework of a flexible exchange rate system were better able to absorb shocks from open capital markets than economies with a pegged rate.

A few points merit emphasis in any debate about exchange rate regime choices.

- In a pure fixed exchange rate regime, economic activity adjusts to the exchange rate. In a purely floating regime, the exchange rate is a reflection of economic activity. In either case, the economy's "fundamentals" are the chief determinant of whether economic stability and prosperity are achieved, not the exchange regime per se.
- There is probably no universally "optimal" regime. Regime choices should reflect the individual properties and characteristics of an economy.

Both "fixed" and "flexible" regimes have strengths and weaknesses. A fixed exchange rate is generally seen as being transparent and a simple anchor for monetary policy. Countries with weak institutions can "import" monetary credibility by anchoring to a currency with a credible central bank. A conventional view is that a fixed exchange rate has the advantage of reducing transaction costs and exchange rate risk. In countries with less developed financial sectors, economic agents may not have the financial tools to hedge long-term currency risks.

But adjustments under fixed exchange rates can be very gradual and require significant flexibility in prices in the domestic economy, especially in the face of changing capital flows. The inflexibility of fixed exchange rates can place an enormous constraint on monetary policy and create pressures in a downturn for pro-cyclical fiscal policies. Fixed exchange rate regimes in economies where interest rates are higher than rates denominated in the anchor currency can also give debtors an incentive to borrow unhedged in the anchor currency, leaving national

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<sup>1</sup> The dollar was convertible into gold under the Bretton Woods system. Other currencies were defined in terms of the dollar. The U.S. gold window was closed in August 1971.

balance sheets vulnerable to exchange rate changes. To withstand currency pressures under fixed exchange rate regimes, authorities have an incentive to put in place harmful capital controls (to be sure, such pressures can exist under flexible regimes as well).

A country cannot maintain a fixed exchange rate, open capital market, and monetary policy independence at the same time. In recent years more large emerging market countries, increasingly integrated into the global financial system, have begun to adopt policies that target low inflation and establish central bank independence. Flexible exchange rates have the advantage that they allow a country to pursue an independent monetary policy, rather than have its own monetary policy set by an anchor currency country. Experience shows that flexible exchange rates are more resilient in the face of shocks, and are better able to distribute the burden of adjustment between the external sector and the domestic economy. Also, fixed exchange rates have the effect of sharply reducing or eliminating exchange rate volatility. Protection from volatility dampens the incentives for financial markets to develop hedging products and financial instruments, so risk is more likely to be transferred to the public sector effectively.

Against this background, exchange regime choices will vary.

### Major Currencies

It is broadly agreed that the major currencies – the dollar, the euro and the yen – should, and do, float against one another. The economies represented by these currencies account for 42% of global economic activity. Nearly all global trade and capital flow transactions are denominated in one of these three currencies, as are nearly 95% of official foreign exchange reserves. Other large economies with well developed financial sectors, such the U.K., Canada, or Australia should, and do, float as well.

### Emerging Market Economies

Larger emerging market economies should adopt more flexible exchange rate regimes. “Larger” is meant to apply to economies such as, though not exclusively, Mexico, Brazil, South Korea, and China. This is all the more true as these economies become integrated into the global financial system and have increasingly developed financial sectors. Where flexible exchange rates are in operation, economies have proven to be more robust and resilient. Brazil demonstrated this quite well in 2002 when the markets put substantial downward pressure on the Real ahead of the Presidential elections. In the case of downward currency pressure, greater flexibility limits the one-way betting that results in rapid depletion of reserves and allows the external sector to bear a portion of the needed adjustment, rather than imposing an undue burden on domestic demand.

Flexible regimes for “larger” economies cannot solve all problems. In particular, there is no substitute for sound fiscal and monetary policies and resilient institutions. Economies with a flexible exchange rate need an alternative anchor for monetary policy, such as central bank independence and inflation targeting, and they should take steps to put in place a sound system of bank regulation.

China is a clear case where increased trade and financial integration have shifted the balance strongly towards the need for a more flexible exchange rate:

- Large capital inflows have fueled credit growth, leading to huge increases in investment in 2003 and 2004 and an overheating economy.
- Chinese authorities cannot effectively use monetary policy to control inflation, but instead, monetary policy is inexorably linked to that of the anchor currency, regardless of domestic developments in China itself. This creates pressure to use administrative controls.
- Financial sector development and openness have reduced the effectiveness of administrative controls for adjusting monetary conditions and smoothing investment cycles. But the peg precludes the ability of monetary authorities to adjust interest rates.
- The U.S. and China economic cycles are not synchronized so that monetary conditions in the U.S. may not be appropriate for the Chinese economy.
- China's transition to a more market-based economy where private agents adjust to price signals is hampered by constraints on the movements of interest rates and exchange rates.
- In addition to being in China's own interest, greater flexibility of the yuan would allow other Asian economies that are concerned about their relative competitiveness vis-à-vis China, to have more flexible exchange rates. This would help facilitate orderly adjustments of global imbalances and lessen protectionist pressures.

### Lower-Income Economies

Lower-income economies with less developed monetary and financial sectors, and less credible institutions, on the other hand, can face special problems. For some of these economies, a very hard peg to a major currency can improve monetary stability and improve the efficiency of commercial transactions. Typically, these economies, where credibility in existing institutions is not yet strong, still have underdeveloped financial sectors and supervisory systems, suffer from higher rates of inflation, and are in need of anchors for monetary policy.

### The IMF and Exchange Rates

The IMF's Articles of Agreement allow members to adopt the exchange rate regime of their choice. However, the IMF – taken to mean both management and shareholders – has a responsibility rigorously and candidly to assess the consistency of that regime with both country circumstances and the international system. The Fund is not only a trusted advisor to each of its members but the protector of the system as a whole.

The IMF Articles of Agreement recognize the danger of not permitting balance of payments adjustments to take place, and this danger motivated the IMF to establish procedures for surveillance of exchange rate policies. The implementation of these procedures needs to be significantly improved. In general terms, the international financial system would benefit from a multilateral approach to greater exchange rate flexibility. It is in the collective interest of all

economies for the IMF – the world’s central institution for global monetary cooperation – to assume this responsibility.

More specifically, the U.S. Treasury has made four proposals to strengthen IMF surveillance.<sup>2</sup> First, the membership of the IMF should clarify the principles of surveillance over exchange rate policies. Guidelines like “protracted large-scale intervention” and “excessive” reserve accumulation have been undefined for too long. Second, Article IV reports must include more substantial and pointed discussions of exchange rate issues – on a consistent basis, but especially in systemically important countries. The IMF – with its wealth of expertise and experience across the globe – is well positioned to discuss exchange rate policies with authorities and advocate change. Third, such engagement is more effective with credible consequences, and that is the “Special Consultation” mechanism. Consultations would be a more useful tool if designed to enable more regular use. Finally, the IMF should develop its techniques for assessing exchange rate behavior and extend this work more to emerging markets. Although the IMF should not be placed in the position of determining what the “right” exchange rate level is, quantitative efforts at exchange rate determination can be helpful in developing a qualitative assessment of a country’s exchange rate policies.

The IMF Managing Director has since committed to strengthen IMF exchange rate surveillance, both bilaterally and multilaterally, in the context of his Medium-Term Strategy. Further, by bringing together the IMF, countries engaged in questionable currency policies, and countries most affected by those policies, the multilateral consultation process should help promote exchange rate policies that are consistent not only with domestic policies but also with the international monetary system.

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<sup>2</sup> Remarks by Treasury Under Secretary for International Affairs Timothy D. Adams at the American Enterprise Institute, February 2, 2006. “Working with the IMF to Strengthen Exchange Rate Surveillance.” <http://www.treas.gov/press/releases/js4002.htm>