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How to Choose an Exchange Rate Arrangement

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The choice of the appropriate exchange rate regime for any country is an issue that has been extremely important in the past and still is today. It is a policy decision that, to a large extent, conditions the macroeconomic framework of a country. This chapter discusses a number of issues related to this important decision. First it discusses the importance of choosing the exchange rate regime. It then analyzes the implications of the degree of exchange rate rigidity or flexibility for the domestic economy, particularly for other macroeconomic policies. Then it discusses the specific case of the euro area. Finally, it explores the side effects associated with the choice of an exchange rate regime.

There is hardly a more important economic decision that a country has to make than choosing its exchange rate regime. There are at least two reasons for that:

- First, such a decision conditions the scope and flexibility of the rest of the macro policies that the country can implement. Certainly this consideration alone makes choosing the exchange rate regime an extremely relevant decision.
- Second, such a choice affects the country's economic relationship with the rest of the world.

The conditioning effects of the choice of an exchange rate regime imply very difficult trade-offs that policymakers have to evaluate with utmost determination and care when deciding on the exchange rate regime that best suits their country's economy.

In particular, the decision boils down to establishing the degree of flexibility that the exchange rate should have, that is, how much the relative value of the domestic currency can vary with respect to other national

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currency or currencies. Usually when defining an exchange rate regime, authorities refer to the relative price of the domestic currency with respect to the currency of its main trading partner and/or the currency that dominates in the region.

In principle, it can be said that the less flexibility that is allowed for the exchange rate, the more rigidity the country imposes on the rest of its policies. For instance, when a country fixes its exchange rate, it sacrifices monetary policy as an independent policy instrument, because to a large extent, the country imports the monetary policy of the country that it fixes the value of its own currency against. Under these circumstances, the ability of the national central bank to perform its duty as lender of last resort to the banking system or the sovereign is severely compromised. Furthermore, the sustainability of the regime also imposes restrictions on fiscal policy and makes it essential to preserve a healthy financial system.

In fact, insofar as fixing the exchange rate imposes very strong conditions on the rest of the macro framework, choosing such a regime usually has been used as a commitment device. That is, for a country to make a specific exchange rate sustainable, it has to observe all the constraints such a regime entails. Put differently, the stronger the policy commitment, the more credible the exchange rate regime will be.

Nevertheless, for decades the real challenge for most countries has been to acquire and preserve the ability and political will to remain true to such commitments and keep the exchange rate regime credible. Time after time it has been seen that eventually, after some years, sometimes even after months, these commitments tend to be ignored, and the exchange rate regime collapses. The way that authorities handle a regime switch is also very important since if the switch is mishandled, it has the potential to generate negative consequences for growth and development for years to come.

It should be noted that establishing a flexible exchange rate regime imposes other types of restrictions and exposes the country to other types of risks. Under such a regime, the main challenge is to construct an effective nominal anchor for the economy. There is a broad range of options in this regard, ranging from the adoption of monetary aggregate objectives to inflation targeting. Recent events have shown the limitations of infla-

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tion targeting, in particular the fact that central banks should not ignore asset-price inflation so that they can preserve financial stability.

Regarding fixing the exchange rate, there are many different ways to implement it. The simplest alternative is to fix the value of a given currency with respect to another currency. The "ultimate" fix would entail establishing a currency union in a region, allowing national currencies to disappear altogether in favor of adopting a single currency such as the euro. The sustainability of such a complex regime imposes very strict and demanding conditions on all the member countries. With respect to the euro area, the real question is how effective it has been as a whole in fulfilling those conditions in a credible way. In this setting, a lot has been left to be desired; therefore, important efforts through policy adjustments have to be made not only to preserve the credibility of the regime but also to enhance it, so that the possibility of the breakdown of the euro is taken out of the picture for good.

There is another very important dimension to to exchange rate regimes, related to the fact that an exchange rate is the relative price of two currencies. Therefore, from a national perspective, such a relative price can be affected by the actions (monetary expansion, capital controls, etc.) that other countries may undertake, such actions often having negative unintended (or intended) consequences on the exchange rate. Thus, the domestic currency can appreciate or depreciate in response to actions taken by another country, giving rise to debates encapsulated by phrases such as "currency wars" or "beggar thy neighbor policies."

With respect to this point, it has recently been argued that monetary policies in some advanced countries have generated huge capital inflows to other economies, particularly emerging and developing ones, consequently generating substantial real exchange rate adjustments. Some of these adjustments are nonequilibrium appreciations, affecting the tradables sector and the growth potential of emerging economies. This is a typical example of a spillover effect of an advanced economy's monetary policy action. Furthermore, such an effect can trigger or lead to different types of reactions, including some form of retaliation, leading to net deadweight losses for the world as a whole.

To deal with these issues, international coordination might be attempted around a set of exchange rate objectives. This has been done

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with the help of the IMF in the past. A valid question is whether the international community should try to do this again.

In sum, the choice of an exchange rate regime is a fundamental decision that a country has to make. Such a decision has important implications for the economy as a whole, as it affects the degrees of freedom of other policies, as well as the relationship of the domestic economy to that of the rest of the world. Therefore, the huge political economy implications that the election of the exchange rate arrangement entails makes it a highly relevant topic. To illustrate this, I will finish on a lighter note, with an anecdote: At the beginning of the 1990s, Mexico was facing a major crisis, and for practical purposes its only option was to go from a fixed to a flexible exchange rate regime. Society was not supportive at all. The then central bank governor was summoned by the senate to explain the rationale for Mexico going from a very unsuccessful fix with recurrent adjustments, with often tragic consequences, to a flexible exchange rate. And he couldn't get the point across that for Mexico, the best decision was to go to a flexible exchange rate regime.

Finally, the governor had a brilliant idea to explain such a move by using an analogy. He said to the senators, Imagine that you have the task of painting a house. Now, you can do it in two ways. One way would be to place the paintbrush in a fixed position and move the house, which would be the equivalent to fixing the exchange rate. The alternative is to keep the house in its position and move the paintbrush. With a steady hand, it is very likely that the task could be completed in a cheaper, more beneficial, more efficient way with a flexible brush.

This simple analogy convinced the senate, and since then we have had in Mexico a flexible exchange rate, and it has worked very well.

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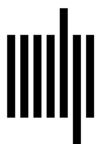

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