

Finance and economics: Currency dilemmas

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No exchange-rate system is ideal. Whether governments fix, float or "manage" their currencies, problems arise. Today's preference for the extremes-pure float or absolute fix-is overdone

ARGENTINA fascinates exchange-rate mavens. Its currency, the peso, is fastened to the dollar in an arrangement that provides the strongest fix you can imagine short of outright dollarisation. The country has a currency board, which in effect promises, if need be, to swap dollars for pesos at the stated parity without limit. In the end, in other words, the government is willing not merely to tolerate but to facilitate the dollarisation of the economy, should it come to that. The reward for this stark clarity is, or ought to be, monetary stability: zero expectations of devaluation and, therefore, lower interest rates than would otherwise prevail.

This clarity is much in fashion. After the collapse of Europe's exchange-rate mechanism in the early 1990s and then, even more dramatic, the East Asian debacle of 1997-98, many economists concluded that exchange rates which were sort of fixed, but not quite, were a big mistake. These days it is very much the orthodoxy that, thanks to the might of global capital markets, the muddled middle way will not do. You must adopt one of the "corner solutions", choosing at one extreme either to let your currency float freely, or at the other to fix it for good and all, either in a monetary union (as in Europe) or by means of a currency board. The first preserves a country's ability to conduct its own monetary policy; the second surrenders that power in return for a stable exchange rate. Efforts to have a bit of both are, according to the new view, doomed, because they create the conditions for financial crises.

This thinking helps to shape current IMF advice-and the conditions which the Fund attaches to its loans. The United States is especially keen to encourage other countries to follow one path or the other. Many developing countries have done so, and have now floated their currencies. Argentina is an example, rare as yet, of a country that has chosen the second recommended approach.

Unfortunately, all is not well in Argentina. It is currently arranging a loan from the IMF and from other official lenders that will be the biggest external bail-out since Brazil's in January 1999. The rate of unemployment is 15%, wages are falling and output is stagnant. As for monetary stability, interest rates on Argentina's bonds have lately been ten percentage points higher than the US equivalent-reflecting not fears of a devaluation, but

the risk of default. Part of the reason for this distress is that the strong dollar has dragged the peso to damaging heights; also, with monetary policy foreclosed, it is hard for the authorities to stimulate demand.

Interior design

Does this show that the currency-board regime was a mistake? All things considered, in fact, no. Given the country's history of hyperinflation and its correspondingly depleted economic choices, the currency board was Argentina's only hope. Things would be worse, probably much worse, if Argentina had not dared to break so decisively from its earlier fiscal and monetary profligacy. But what its present difficulties do show is that the currency board was not the easy option that many of its more enthusiastic advocates had claimed-and that the sacrifice of monetary independence involves real economic costs.

Meanwhile, all is not as it seems at the other end of the currency-regime spectrum. It turns out that few if any of the developing countries that now claim to have freely floating currencies really do. A new study* by Guillermo Calvo and Carmen Reinhart looks at how developing countries describe their currency regimes, and compares this with the facts. The labels mean little: some "floating" currencies (India's, for example) have been curiously stable, not much less so than some "fixed" ones (such as Thailand's up to 1997). Governments often use interest rates or currency intervention to influence their supposedly floating exchange rates. Officially, countries may bow to intellectual fashion, but in their behaviour most still evince what the researchers call "fear of floating".

With good reason, because the pure-- float extreme has drawbacks just as does the pure-fix extreme. And either of these extremes, in many countries under most circumstances, may be less satisfactory than that outmoded middle.

For years one of the most steadfast and convincing advocates of a particular kind of "intermediate" regime has been John Williamson of the Institute for International Economics. In a new pamphlet, he makes the case again, as persuasively as ever^. The emerging-market countries are right to be reluctant floaters, he says, because the foreign-exchange markets have repeatedly demonstrated their ability to drive currencies into serious medium- and longer-term misalignment, with severe consequences for growth. At the other extreme, currency boards may produce currency misalignments too (as Argentina demonstrates). Nor are the "comer solutions" immune to crisis, as often supposed-although Mr Williamson concedes that a floating rate helps to discourage excessive capital inflows.

The middle is unjustly neglected, and dangerously so in view of the IMF's current zeal for the extremes. It is right to talk of the "impossible trinity"-to note that these days, much as you would like to, you cannot have all three out of perfectly mobile capital, monetary independence and a stable currency. But it is a straightforward fallacy to conclude that you must therefore choose only two of the three, rather than opting (as most countries do in practice, whatever they may claim) for a blend that makes compromises in one or more respects. As a rule, economics prefers interiors to comers, and trade-offs to all-ornothing choices.

Footnote

* "Fear of Floating." Available at www.bss.umd.edu/econ/ciecrpn.pdf.

^"Exchange-Rate Regimes for Emerging Markets: Reviving the Intermediate Option." See www.iie.com.

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