

## ECONOMICS FOCUS

## Economics focus

**Fix or float?**

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**A developing country's economic institutions may matter more than its exchange-rate regime**

FROM Latin America to South-East Asia, emerging economies that peg their exchange rates have suffered financial crises with alarming frequency in the past few years. Advisers of all sorts have urged them to let their currencies float on the foreign-exchange markets, and instead direct their monetary policy towards an inflation target. Swayed also by the success of inflation targeting in many developed countries, since 1998 at least ten emerging economies have taken this advice and have formally adopted inflation targets.



Purists point out that several of these converts do not really believe in their new religion, but are merely unreformed exchange-rate fiddlers in inflation targeters' garb. South Korea, they say, is one country that keeps its currency artificially low by continually stocking up on dollars. Yet such intervention may make perfect sense, says a recent paper by Corrinne Ho and Robert McCauley, of the Bank for International Settlements\*. Because exchange-rate fluctuations have a bigger impact on inflation, trade and financial systems in emerging economies than they do in developed ones, intervention may help those countries achieve their inflation objectives.

The authors find that the "pass-through" from exchange rates to domestic prices is greater in emerging markets than in developed ones, because of poorer countries' often greater dependence on commodity trade. For instance, the proportion of a year's change in the consumer-price index that can be explained by fluctuations in the exchange rate is 41% in Indonesia and 48% in Hungary, but only 2% in the United States. Moreover, a lot of many emerging economies' trade is with one big partner, usually America or the euro area, making them more vulnerable to bilateral exchange-rate movements. Ms Ho and Mr McCauley also find that pass-through is higher in countries with a history of high inflation

and currency crises.

Financial markets, which are underdeveloped in many emerging economies, are vulnerable to wild exchange-rate fluctuations. Large capital inflows that put upward pressure on real exchange rates are usually accompanied by too much borrowing and investment, and steep increases in asset prices. If investors lose confidence, these flows can go suddenly into reverse and the exchange rate falls. This means trouble: because investors are unwilling to lend in emerging-market currencies, local banks and companies end up laden with debts denominated in dollars and euros, while their assets are in the cheapened national currency. Defaults follow, and economic recovery can be slow.

Emerging countries' governments may be able to find ways of reducing their dependence on capricious foreign capital. One possibility is to pursue closer regional financial integration: the recently launched Asian Bond Fund, a scheme by 11 East and South-East Asian countries to facilitate the reinvestment of the region's capital locally rather than in America or Europe, is one such initiative. Further options might include the development of more intra-regional trade, in order to reduce dependence on a single, big trading partner, or the fostering of domestic demand, perhaps through local consumer-credit and mortgage markets.

However, such remedies are for the long term. Until they appear, say Ms Ho and Mr McCauley, it is fine for monetary authorities in emerging-market economies to manage their exchange rates, even if these are theoretically free-floating and there is an inflation target. They point to tools that should permit some dabbling in the currency markets without compromising the fight against inflation. If necessary, the central bank can use "sterilised" intervention: after selling its own currency and buying dollars to hold the exchange rate down, it can sell bonds to mop up the extra domestic currency, rather than let it seep into the money supply and thus risk higher inflation. Or, to the dislike of some purists, governments can impose capital controls.

## First, design your institution

Maybe the arguments over whether exchange rates should be fixed, free or managed are beside the point. According to another recent paper<sup>†</sup>, by Guillermo Calvo, of the Inter-American Development Bank, and Frederic Mishkin, of Columbia University, the choice of monetary regime matters less than the creation of good monetary, fiscal and financial institutions. Messrs Calvo and Mishkin argue that when governments run up huge debts, banks are poorly supervised and the central bank prints money willy-nilly, people can have no faith in the real value of money.

Governments might therefore fix the exchange rate in the hope that a tie to a strong currency will give them credibility and build confidence in the value of the national money. Then again, they might follow the advice of those who favour floating exchange rates, because then monetary policy should have the flexibility to deal with domestic economic concerns. However, none of this means much without good institutions. For example,

central banks ought to be independent in more than name only. In theory, Argentina's central bank might appear more independent than Canada's; yet Argentina, not Canada, replaced a respected central-bank president with a government lackey in 2001, the year the country defaulted on its debts.

Like governments, monetary-policy regimes are rarely ideal, and the best system may vary from one country to the next. But, claim Messrs Calvo and Mishkin, governments should worry first about setting up institutions on which their citizens and investors can rely, and only then ponder the finer points of which variables should be the target of their central-bank boffins.

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\* "Living with Flexible Exchange Rates: Issues and Recent Experience in Inflation Targeting Emerging Market Economies". BIS Working Paper no. 130, February 2003.

† "The Mirage of Exchange Rate Regimes for Emerging Market Countries". NBER Working Paper no. 9808, June 2003.

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