Exchange Rate Choices: Discussion

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Richard Cooper's paper is an excellent overview of the history of academic thought, empirical analysis, and practical experience with exchange rate regimes. In my comment, I would like to put the exchange rate regime into the broader policy context and make two points. First, policymakers often wish that the exchange rate regime would solve all their policy dilemmas. But then, in the end, they cannot follow through and let the discipline of the exchange rate regime work. Second, economic theory and policymaking economists are relatively poor at comparing one second-best outcome with another; they also have difficulty assessing the consequences of volatility. Both of these features are inevitable aspects of an exchange rate regime, and they challenge our ability to analyze which regime is "best." In this context, policymakers may think that the decisions with regard to capital account liberalization and choice of exchange rate regime are independent, but in fact they are not.

Exchange Rate as Summary Statistic or Motive Force?

I start by noting that the exchange rate is a summary statistic that *reflects* a host of policy choices and underlying economic fundamentals. Yet policymakers often wish that the exchange rate and the exchange rate regime could *accomplish* three things: First, policymakers wish that the exchange rate regime would discipline the private capital market, that is, make the private market a stabilizing force. In this wish, a credible target zone regime, for example, generates stabilizing financial flows when the

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exchange rate nears the edge of the zone. However, the reality of target zones does not play out according to this dream because both the credibility of the policymakers and their ability to defend the zone almost always are in doubt. The exchange rate regime can be no better a disciplinarian to the market than it is to the policymakers. And the policymakers almost always have a more complex set of issues to address than simply whether to defend the regime, so they usually do not. Consequently, the existence of a particular regime will not discipline the private sector either.

Second, some policymakers wish that the exchange rate regime would discipline other policymakers, either those at home or those abroad. Were this wish to play out, an agreed-upon exchange rate regime would discipline the policy mix of fiscal and monetary policy. However, the experience of the United States in the mid 1980s with the combination of excessive government spending and tight monetary policy and, more recently, the debate between the Bank of Japan and nearly every other policymaker at home and abroad about the appropriate monetary policy stance and action, reveal that internal policy debates are unlikely to be solved by exchange rate regimes. Indeed, the movement in the exchange rate simply reflects that there is an internal policy debate.

Moreover, in thinking about the appropriate stance and mix of monetary and fiscal policy between countries, the exchange rate regime offers little guidance. For example, in the current context of the "weak" euro, should the European Central Bank ease monetary policy to encourage growth, and through this channel hope to encourage capital inflows that would cause the euro to appreciate? Or would this policy strategy weaken the euro further because the short-term interest rates on euro instruments would fall further? The existence of a particular exchange rate regime does not change the economic forces that lie at the bottom of the question.

A third wish is that the exchange rate regime would force broad and substantive changes in the structure of an economy, that is, in how its labor and capital markets function. In this wish, the commitment to a particular exchange rate regime is viewed as sufficient to force liberalization of labor laws or to change the way that private finance is allocated and used throughout an economy. Apparently, the exchange rate regime is supposed to change policies when policymakers themselves cannot. Prognosticators have argued that without such structural changes, Euroland will suffer under the constraints of the single currency. While the euro appears to be changing corporate behavior in Euroland, its impact on labor market policies is less apparent. Nevertheless, perhaps Euroland is a case where the wish is coming true—and perhaps it is coming true because a collective of policymakers from many countries have jointly agreed to the regime, not just a few policymakers from a few countries or a few policymakers within a single country.

All told, though, as the first two of the three wishes suggest, it generally is too much to ask the exchange rate regime to discipline markets, to make policymakers agree on a sensible and coordinated policy mix, or to restructure wholesale the internal workings of an economy. Policymakers are not equal in their effect on the economy, nor in their power to wield their instruments, nor in the extent to which they are willing to let the anonymity of exchange rate pressure change their policy stance. In a policy debate, one side or the other ultimately backs down, but it is not the exchange rate *regime* that forces the change in policy stance—although it might be the exchange rate *movement* that elicits such changes.

Comparing Means and Volatility

In thinking about different exchange rate regimes, economists and policymakers often find themselves implicitly (or explicitly) comparing means and volatility and trying to assess which combination is "best." For example, for a number of years, many policymakers and advisors argued that a fixed exchange rate regime had numerous positive attributes, including providing a stable external price to which domestic actors could respond. Implicitly, the volatility that goes with flexible exchange rates was seen to be costly to an economy in terms of resource allocation by industry. More recently, the view has shifted. Fixed exchange rates, because they can become "misaligned," create the seeds of great economic (as well as political) disruption. At the worst, a nation can no longer defend the fixed rate, capital and reserves flow out of the country, a bailout is necessary, and debts need to be restructured. So some sort of managed floating—which tries to get the best of both worlds—is the careful policy advice; advice, of course, with relatively little policy content.

Even among large industrial countries, floating rates are not without actual or perceived cost; witness the alleged "deindustrialization" that has been the consequence of more than one overvalued exchange rate experienced under a floating exchange rate regime. There is disagreement even here, however. Some analysts believe that the dollar appreciation of the 1980s created the foundation for the current rapid and noninflationary growth of the U.S. economy because that environment demanded that corporations be ever agile in their response to economic forces, whether from global competition or technological change.

It is impossible to compare fixed and floating exchange rate regimes to decide which is "best" without some economic context—both domestic and international—to the discussion. As a general rule, if a country has a flexible set of markets, then the volatility of exchange rates associated with a floating rate is less costly than to a country with rigid markets. A country with rigid markets might prefer a fixed exchange rate regime, and such a regime would appear to raise the "mean" performance of the country while also lowering its volatility. But those rigid markets will ultimately be the Achilles heel of the country. One episode of great volatility—whether it be due to exchange rates or other forces such as technological change or entry into world trade by a competitor—will be very costly. Does the country lose all the benefits it gained under the fixed exchange rate regime on the occasion of that one large shock? How can we tell? At minimum, the counterfactual is hard to define.

Under floating rates, some argue that excessive economic resources are allocated to hedging against exchange rate movements—resources that could be put to better use in real economic activity to raise economic growth. In this view, flexible rates yield both a lower mean return and a higher volatility than fixed rates. A contrary view is that the market participants that are better able to respond to exchange market volatility are those most efficient at using their overall resource set, including the ability to adapt to technological and other types of change in their economic environment. Their ability to succeed faced with flexible exchange rates merely demonstrates their overall economic prowess. In sum, flexible exchange markets are only part of the overall economy-as-laboratory, a composite characterized by volatility.

A specific example of how the difficulty of comparing means and volatility plays out in the policy context is the relationship between exchange rate regime and capital account openness. In considering the options for exchange rate regimes for developing countries (in particular), the exchange rate regime is often decided separately from the degree of capital account openness. But we should not be seduced into thinking that a fixed exchange rate with limited capital account openness is better for an economy than a flexible exchange rate with a lot of openness. The cumulative inefficiencies and distortions caused by the first (China?) may accumulate to greater damage to the economy than the swift (but passing?) crisis engendered by a mismanaged combination of a newly flexible exchange rate regime and capital account liberalization (Korea?).

For the world as a whole, the growth in trade, the reduction in poverty, and the growth in employment and incomes have been greater under the flexible-rate system than under the fixed-rate system. Individual countries and classes of workers have not fared as well as the prototypical average, however. Thus, perhaps the real question is whether the flexible-rate system is sufficiently superior in terms of economic performance to generate enough wealth that, in principle, the disadvantaged could be made whole. Such questions of Pareto-improvement are familiar to economists, even if policymakers only rarely apply the lessons.