On the Floating Exchange Rate System

――in the cases of Latin America and Russia――

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ABSTRACT

Presently, many developing countries and emerging markets are still facing the choice of an exchange rate system that will be most adequate to their economic and monetary conditions. Although there are just few options available, the commitment to be made is a difficult one. Sooner or later you will confront the classical macro policy trilemma according to which it is impossible to maintain (1) full capital mobility, (2) a fixed exchange rate, and (3) an independent monetary and fiscal policy at the same time.

We discuss these problems in the cases of Latin America and Russia.

Ⅰ. Is Managed Floating a Solution?

Presently, many developing countries and emerging markets are still facing the choice of an exchange rate system that will be most adequate to their economic and monetary conditions. Although there are just few options available, the commitment to be made is a difficult one.

If you choose a fixed exchange rate, you must accumulate sufficient foreign exchange reserves and be ready to fight speculative attacks. Moreover, sooner or later you will confront the classical macro policy trilemma according to which

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it is impossible to maintain (1) full capital mobility, (2) a fixed exchange rate, and (3) an independent monetary and fiscal policy at the same time. Only two of the above three political lines are available. That is, a fixed exchange rate system is not compatible with the authorities' maneuvers at the money and capital markets.

You may also adopt a foreign currency as a full-fledged legal tender free circulating in your domestic market. This would be a classical case of "dollarization", "euroization", or whatever else, depending on the currency you choose.[(3)] This option is probably the most controversial not only economically but also politically. Besides that you completely lose control over your monetary policy and depend on the economic situation in the "parent" country, you adopt a currency unfamiliar to your people, which is not associated with the values of the national history or pride. Experience demonstrates that the countries that fully dollarized their economies tended to be small both in terms of their territory and market. They also had strong degree of economic integration with the United States ― the fact that justifies the necessity to use the US dollars for payments and other operations. Clearly, this choice is not ready available and generally acceptable for most countries.

Nevertheless, such country as Mexico is often considered as a successful candidate for dollarization. The degree of economic integration of this country with the United States is very high,[(4)] so that it satisfies the basic precondition of the theory of the optimum currency areas.[(5)] Although this theory is mostly applied to

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(3) Sometimes such policy option is called monetary union, but we will reserve this term for the case of the introduction of a common currency which is not the national currency of any member-country.

(4) Almost 90% of the Mexican foreign trade is with the United States.

(5) For the details see Paul R. Krugman, Maurice Obstfeld. *Macroeconomic Policy and Coordination under Floating Exchange Rates* in International economics: theory and policy. Reading Mass.: Addison-Wesley, 2000, part III, chapter 20, pp. 617-622.

the case of the European monetary unification, it is also advisable for the study of dollarization. The theory demonstrates a positive relation between the degree of economic integration and the benefits from the use of a common currency. If the degree of economic integration were the only variable, Mexico must have already been a fully dollarized economy.

Steve H. Hanke provides a somewhat different argument in favor of Mexico's dollarization.(6) According to him, the attempts of the Banco de Mexico to maintain inflation at a stable rate are paid at a high price of the low economic growth. The mechanism behind it is the following. When dollars come into Mexico, the bank has to issue new pesos, but at the same it issues its own bonds called BREMS(7) in order to sterilize dollar inflows. Although, the bank's foreign reserves increase, its liabilities also grow, so that in the overall costs are higher than benefits. Moreover, the more bonds are issued the less willing the public is to finance the government and consequently the higher are the interest rates. Another negative effect caused by the bond issues is crowding out private sector credit and pushing up lending rates.(8) Clearly, high interest rates slow down the country's economic growth. What is the solution? To continue dollar inflows sterilization and targeting inflation? Or to let pesos circulate freely according to the changes in foreign reserves? Steve H. Hanke recommends an alternative way — dollarization. He argues that the peso's importance is shrinking and that it's time for Mexico to officially dollarize. He contends that remittances of dollars to Mexico have largely increased, and spontaneous dollarization of the country's economy continues. There is no need to maintain the central bank's monetary

(6) See Steve H. Hanke. Americas: It's time for Mexico to dollarize. *Wall Street Journal*; New York, N.Y.; May 30, 2003.

(7) The issue of BREMS started in August 2000.

(8) Alter the Banco de Mexico started issuing BREMS, average lending rates have jumped to 11.4%.

policy which is so harmful for the economy, Mexico must dollarize for dollarization will give Mexicans what they want — dollars.

The author seems to forget that dollarization will inevitably enact the law of one price. If Mexico adopts dollars it will automatically have to adopt the United States price level, and hence Mexican products will lose competitiveness. As a result, the economy will be plumped down to deep recession. Mexicans prefer greenbacks because their value is stable, but what is the point to have them if they do not buy as much as expected? Mexicans do not want dollars, but want employment, income, and stable economic growth. Obviously, the solution is not in substitution of one currency for another. Dollarization is not an elixir for a troubled economy, but is a drug with temporary relief. Mexico should retain the ability to undertake independent monetary policy and make necessary adjustments if required. Thus, dollarization is not an optimal solution for this country.

Another variant is to join a monetary union, like in the European countries' cases. Although the basic idea is also to introduce a new currency, the most important difference is that all member-countries adopt a currency which did not exist before. This means that everybody is committed to the common political goals that are not specifically designed for the economic requirements of any particular member. However, the creation of a monetary union is a long lasting process which may take years or decades of thorough preparations and painstaking negotiations. Clearly, for the countries that are looking for a rapid solution to their economic and monetary problems it is not a feasible system.

Furthermore, even in the long run, it is highly improbable that the numerous conditions required for the European style unification will take place again in a different part of the world. For example, we can argue that it will be a reasonable step for the Latin American countries and Canada to create a monetary union with the United States. Particularly, it may seem desirable for Mexico and

Canada allied with the United States through the NAFTA. But the first problem is the choice of a common currency. It is unthinkable that the United States will abandon the dollar and the consequent merits brought by its role as the international currency, in exchange for some uncertain advantages, if there will be any at all, such as facilitation of trade and financial operations with its partners. Therefore, the monetary integration will surely take place around the United States dollar with great benefits, seigniorage revenues among others, accrued to this country. Another problem is related to the economic predominance of the United States. According to one of the numerous studies on dollarization, "if the United States were to enter into a monetary union with a number of its regional partners, its economic weight in terms of GDP would dominate that union for a far greater extent than any country in the European Monetary Union. This implies that monetary policy in such a union would likely be dominated to significant extent by domestic economic considerations of the United States[(9)]". As the table 1 shows, in a potential monetary union, the United States would represent 76% of the total GDP, with 10% falling on California and 6% on New York. Brazil would represent 8% and Canada 6%, Mexico and Argentina would contribute with 4% and 3% respectively. Obviously, the United States would acquire hegemonic position in such a union, so that other countries will have to move in lines with the United States policy goals. Such an unequal weight distribution will doubtfully result in a sustainable long-term partnership.

Then the logical question would be whether it makes sense for the Latin American countries to create a monetary union without the United States participation? The idea is attractive both politically and economically, but the plausibility that such a union takes place in the short or medium term is very tiny. Unfortunately, the realities which live the leading Latin American countries

(9) Zeljko Bogetic. *Full dollarization: Fad or future?* Challenge; Armonk; Mar/Apr 2000.

at present are not favorable for easy economic integration and monetary unification. Although, the Custom Union between Argentina, Brazil, Uruguay, and Paraguay — the Mercosur, had been quite successful from its creation in 1991 to 1998,[(10)] the Brazilian crisis of 1999 brought it to the end. Moreover, the recent breakdown in Argentina and ambiguity of the economic reforms of the new Brazilian administration illustrate prematurity of any steps toward the creation of a common currency.

TABLE 1
The United States Dominance in Any Potential Regional Monetary Arrangement*

Western Hemisphere*	100%		
Of which:			
United States	76%	European Monetary Union	100%
		Of which: *	
California	10	Germany	33
New York	6	France	22
Texas	5	Italy	18
Illinois	4		
Florida	4		
Ohio	3		
Brazil	8		
Canada	6		
Mexico	4		
Argentina	3		

Sources: Leidy (1999) based on IMF WEO data; and Bureau of Economic Analysis, U.S. Department of Commerce.

* Based on 1997 GDP (at prevailing exchange rates) and estimates of GNP. The sample includes the United States, Canada, and the ten largest economies in Latin America (Argentina, Brazil, Chile, Colombia, Ecuador, Guatemala, Mexico, Peru, Uruguay, and Venezuela).

*This table is quoted from Zeljko Bogetic. *Full dollarization: Fad or future?* Challenge; Armonk;Mar/Apr 2000

(10) The volume of trade between the four members had grown from US$ 5000 millions to US$ 20,000 millions during this period.

Nevertheless, the optimism of the Argentinean and Brazilian leaders, Néstor Kirchner and Luiz Inacio Lula da Silva is remarkable. On the 11th of June 2003, the two presidents signed a document which includes the intention to stimulate economic integration in the region and establish a Monetary Institution for studying the creation of a common currency. The coincidence of this document with the plan to unite the two countries' national selections for football play against the European Union must have a strong symbolic impact.[(11)] If the attempt is successful, it will demonstrate the ability of these countries to take decisions quite independently from the United States and prove the possibility of a second monetary union. We must be realists, however. Brazil represents 68% of the total exports of Mercosur; the number resembles the disproportionate weight of the United States in a potential monetary union mentioned above. This will certainly move the balance in favor of Brazil and cause resentment on the part of other participants.

Thus, a monetary union is plausible if (1) the economies of the potential members are more or less of the same size, (2) economic and political situation in the countries is stable, and (3) there is a strong commitment of the authorities to cooperate and stick to the rules of the game. As the example of a possible monetary unification in the America has demonstrated, the conditions are still not ripe for a serious attempt at the creation of a common currency.

If you choose a floating exchange rate system, you will definitely have more room for manipulating the money supply and public spending, but the threat of a sudden capital flight will be always present. Hence, the freedom of action, which a floating exchange rate can offer is rather a theoretical issue. The reality, however, is quite different. Flexibility in terms of independent economic and monetary policy under a floating rate is a great advantage, but doubtfully so for

(11) Andres Oppenheimer. Integración económica y futbolística. *El Norte*, June 16, 2003

developing countries and emerging markets. If we look at the monetary authorities' behavior in the mayor developing countries that adopted a floating exchange rate, we can notice a very important similarity. Instead of pursuing such national political goals as full employment, high levels of private sector investment, and overall economic growth, governments commit themselves to maintaining low inflation and stable exchange rates, and curtail fiscal expenditures.

Thus, an exchange rate system of free floating really exists only in theory. In practice, it is employed in the form of so-called "managed exchange rate system". The managed exchange rate system is not a new phenomenon, even the international gold standard — a sort of the fixed exchange rate, which arguably had a specific mechanism of the automatic adjustment, had been extensively managed by the central banks of the then leading industrial countries. However, the golden age of the managed exchange rate system came after the collapse of the Bretton Woods System, or more specifically in the last two decades of the 20th century when a strong wave of financial liberalization first seized the industrialized countries and then extended to the developing world. That capital account liberalization can cause devastating effects for the economy has become particularly clear during the financial crisis in Asia and Russia. Financial liberalization increases flows of speculative capital and presses the developing countries' authorities to pursue anti-inflationary policies at the expense of domestic policy goals. Thus, the choice of an exchange rate regime becomes a part of the "be auty contest package" offered to foreign investors. There is no need to go too far to find an example.

Since the collapse of the Soviet Union, Russia has experimented with various foreign exchange systems. First, the ruble was let floating freely but this just increased the overall instability. The specifics of the Russian case were a large fiscal deficit and a liquidity crisis caused by the breakdown of the traditional

payments system. Moreover, the Russian government inherited a huge foreign debt from the Soviet Union era. To be able to service on its debt obligations the government had to build up foreign reserves for which an appreciated ruble was desirable. Furthermore, as the economy was shrinking government's expenditures exceeded its receipts, thus leading to a fiscal deficit that was financed by issuing government bonds. In 1995, following recommendations of the IMF, the ruble exchange rate was fixed by an exchange rate band, which limited movements of the ruble in relation to the US dollar to a specified range. The effect of this step was fixing of the ruble exchange rate at an appreciated level, which, in the first place, went counter the interests of the country's exporting industries, and in the second place, strengthened the possibility of a sudden speculative attack. Although the regime was supposed to curb inflation, and the ruble was allowed to depreciate gradually against the dollar, the subsequent stabilization had been illusionary.

By 1997, the financial liberalization and development of the financial markets made Russia attractive for foreign capital investment. Moreover, in the same year A. Chubais was internationally acknowledged to be the best minister of finance of the year, and this sent a signal to western investors about the economic stability in Russia and raised the government's reputation. However, the apparent financial stability had been just a curtain that temporary hid fundamental economic problems such as fiscal crisis, the balance of payments deterioration, increasing instability of the banking system.

As Asia was hit by the financial crisis, the situation in Russia became critical. To prevent the outflow of capital and massive sale of the government bonds (GKO), the interest rates had been raised to almost 40% per year. Attempts of the central bank to maintain the ruble exchange rate within the limits of the exchange corridor ended with drying up of the official foreign reserves from

$22.9bln to $16.8bln in November 1997, and withdrawal of the bank from the GKO market. In August 1998, as the financial crisis finally burst out, the central bank reserves fell to about $12bln and the ruble began floating.[12]

The Russian experience showed that under the fixed exchange rate system the monetary authorities were stripped off the policy instruments aimed at coordination of the national economy growth. The ruble stability was pursued in order to attract foreign capital and thus facilitate the government debt servicing. High interest rates did actually help to bring foreign investment to the country but at the same time exacerbated existing economic problems.

Indeed, Asian crisis has just triggered financial meltdown in Russia. The system of the exchange rate band instead of economic stabilization provoked euphoria among speculators. It is sad to recognize that the choice of the exchange rate system in Russia was dictated by the external factors, such as the recommendations of the IMF to maintain the ruble value, though the appreciated exchange rate had been counterproductive, and the necessity to attract foreign investment without taking into consideration the speculative nature of this investment.

Ⅱ. Conclusion

A universal exchange rate system that functions equally well in any country has not yet been discovered and it is hard to think that it will ever be. In practice, countries can choose among three types: fixed, floating, and managed exchange rate system. A tendency toward adoption of the managed exchange rate system is somewhat prevailing now. Far from being perfect, this system is rather an inevitable decision taken as a result of malfunctioning of both fixed

(12) See Российская Экономика в 1998 году- Тенденции и Перспективы. Институт Экономических Проблем Переходного Москва 1999.

and floating rates. The most troubling thing is that developing countries and transition economies are not free to use the exchange rate as an instrument to achieve national policy goals. Supposedly independent monetary and fiscal policies of these countries are restrained by international investors' requirements for stable exchange rates. Consequently, as the monetary authorities conditioned by foreign capital movements pursue anti-inflationary policies at the expense of economic growth, the exchange rates do not reflect national economic interest.