Fixed or Floating: Which is Best?

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The Impossible Trinity

Exchange rate regimes pursue 3 goals:

1. Stable exchange rates
2. Monetary autonomy
3. Free capital flows.

Only 2 of the 3 goals are attainable.

The Impossible Trinity

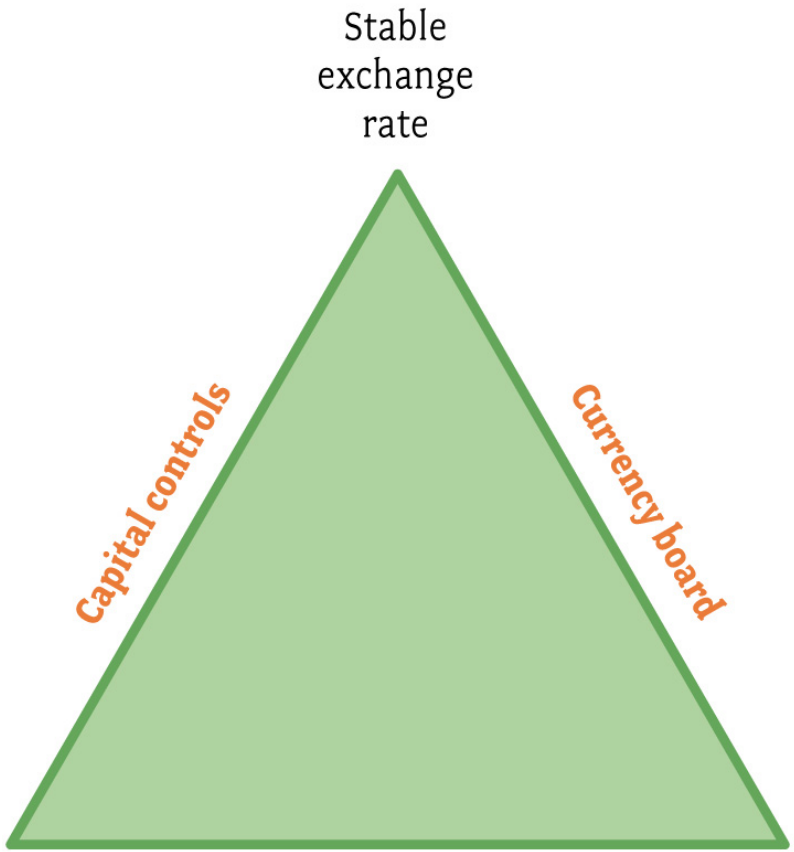


FIGURE 15.6 The Policy Trilemma in Open Economies

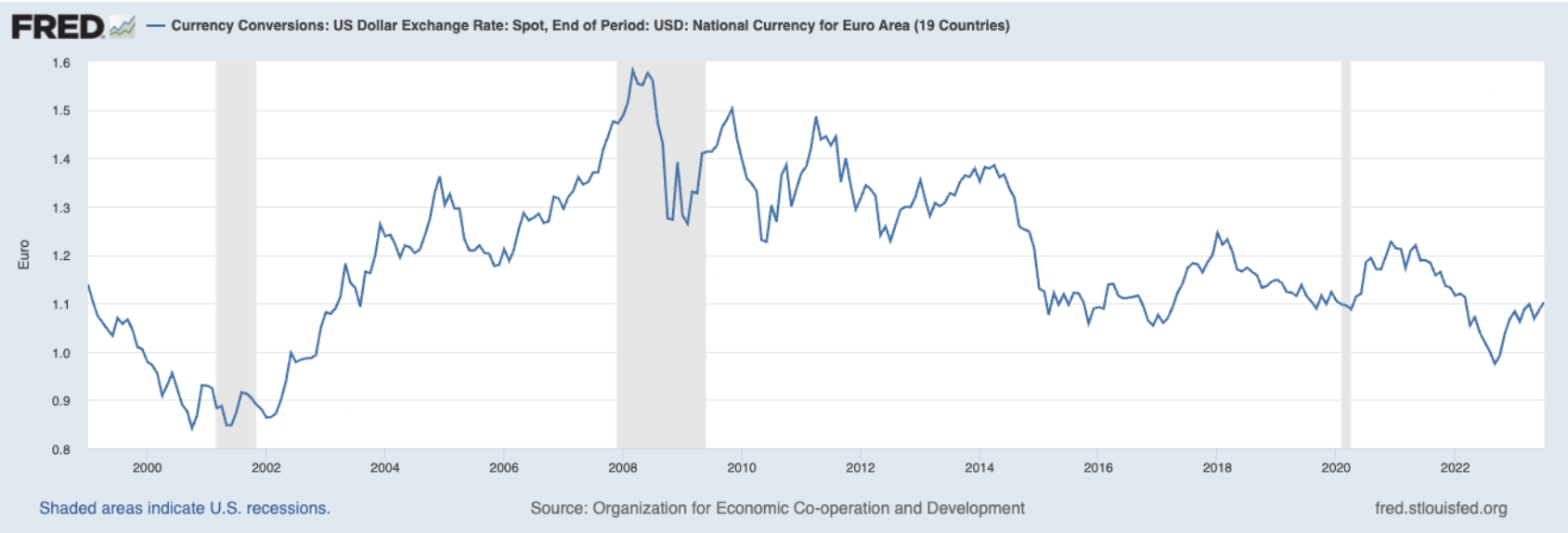
Macroeconomics, Charles I. Jones

Which regime is best?

The answer depends on the characteristics of the country.

	Floating	Fixed
Monetary autonomy	yes	no
Inflation controlled by CB	yes	no
CB can finance fiscal deficits	yes	no
Exchange rates	volatile	stable
Interest rates	stable	volatile

Exchange rate volatility



Even for major currencies, exchange rates fluctuate a lot.

Source: FRED

Which regime is best?

Main drawback of floating: volatile exchange rates

- Large, relatively closed countries usually float.
- Small countries with a major trading partner may want to peg

Main drawback of pegging: loss of monetary policy tools

- But is often also the main benefit ... why?

Overall, pegging looks attractive

- especially for countries with weak central banks

Then why are there so few fixed exchange rate regimes left?

Currency Crises

Currency Crises

Nearly all fixed exchange rate regimes have collapsed

- "speculative attacks"
- traders sell a currency, hoping for a devaluation

As capital flows got larger, CBs found it harder to defend against attacks.

Crisis Examples

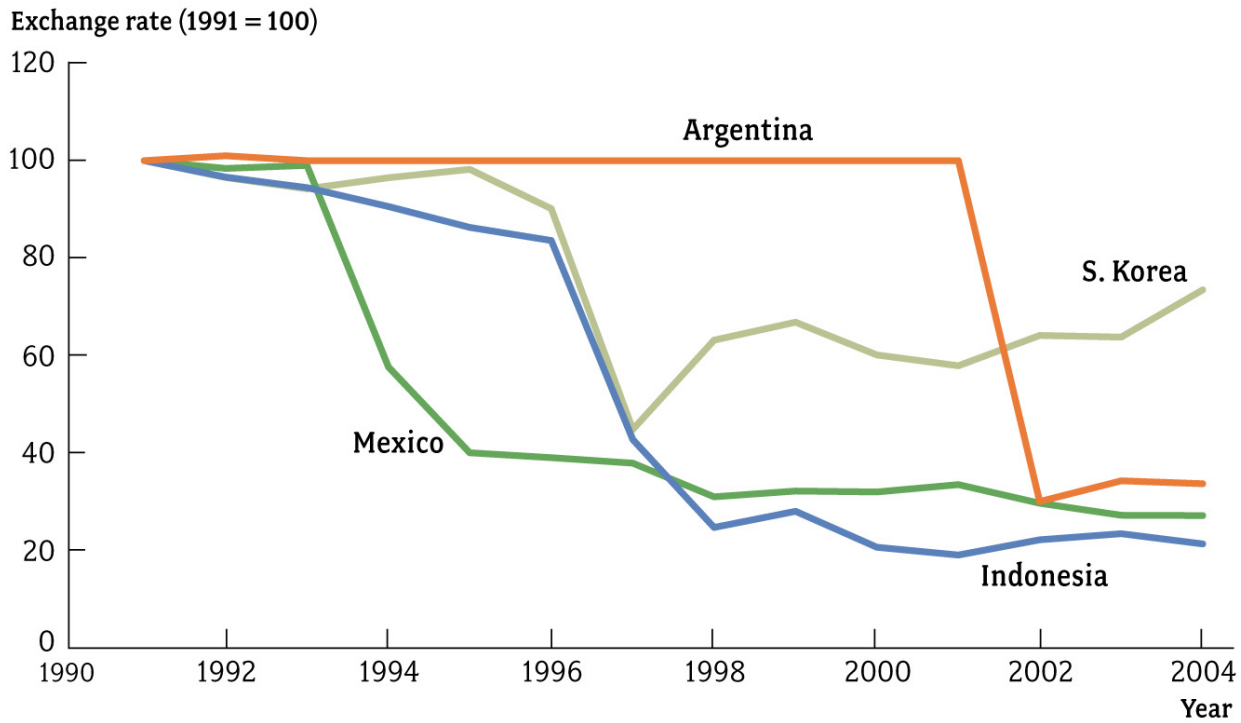


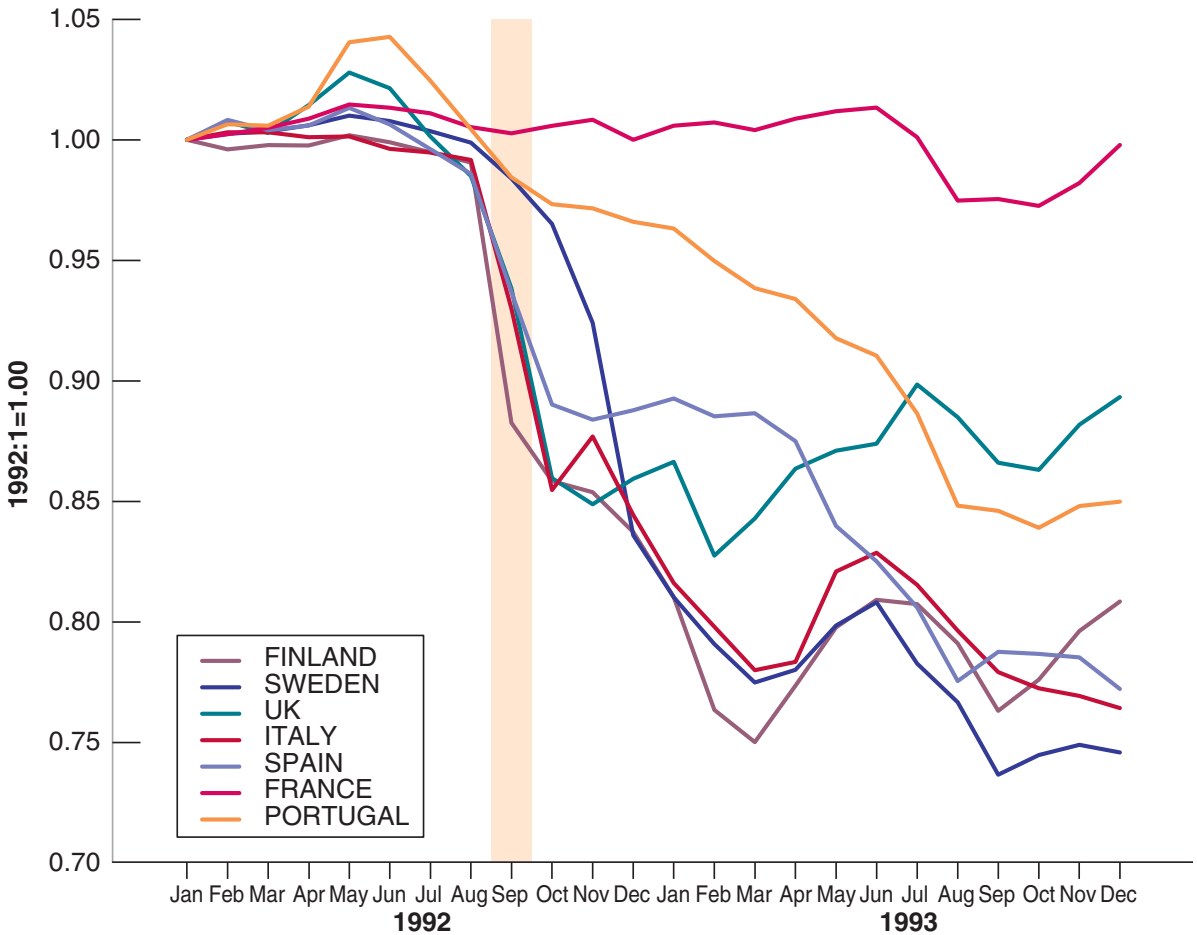
FIGURE 15.7 Depreciations During Several Currency Crises, 1991–2004

Macroeconomics, Charles I. Jones

A typical story:

- high inflation causes real appreciation
- inflation finances fiscal deficits

Crisis Examples



Speculative attacks even hit the Euro zone.

Currency Crises

Why are speculative attacks so common?

If the peg is credible $(E^e = E)$, UIP implies $i = i^*$.

But what happens if investors fear a devaluation?

The Logic of Speculative Attacks

UIP:

$$i_t = i_t^* + x_t \tag{1}$$

$$x_t = \frac{E_{t+1}^e - E_t}{E_t} \tag{2}$$

x: expected FX appreciation appreciation.

Floating: x_t can be positive or negative.

- Selling a currency has upside risk and downside risk.

Peg: the CB ensures that the currency does not appreciate

- x_t can never be negative.
- Selling a currency only has upside risk.

Currency Crises

Even small chances of devaluation have big effects.

Example:

- 25% chance of 20% devaluation over the next month
- $x_t = 0.75 \times 0 + 0.25 \times -0.2 = -0.05$
- investors demand an interest premium of 5% **per month** to compensate for this risk

Policy Options

1. Raise i by 60%
   major recession as borrowing shuts down
2. Raise i by less than 60%
   - capital outflows
   - CB must sell FX to stabilize currency
   - CB eventually runs out of reserves
3. Devalue the currency

Lessons

1. Fixed exchange rates are fragile
   - 1.1 they can only be sustained as long as investors remain utterly convinced that a peg will hold
   - 1.2 betting against a peg is insured by the government
2. Fixed exchange rates can collapse without reason
   If many investors believe the peg will fail, it will fail.

Currency Unions

One solution: get rid of the exchange rate entirely

- Main example: Euro
- Speculative attacks are no longer possible.

Costs:

- hard to reverse (Brexit)
- EU monetary policy may not suit all countries

Reading

- Blanchard / Johnson, Macroeconomics, 6th ed., ch. 21

Additional reading:

- Jones, Macroeconomics, ch. 15.