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Exchange Rates, Capital Flows, etc.

The International Monetary Fund is supposed to be the repository of economic wisdom and we in the developing world have, for long, been expected to listen to its sage advice. Recently even the Group of Twenty has started to look to the IMF for, in effect, becoming a think tank for global policy issues. The question is whether such trust is well merited or whether the IMF's views are more a reflection of empirical, rather than principles-based, analysis.

On the subject of exchange rates, consider an article titled "Choosing an Exchange Rate Regime" (Finance and Development, December 2009) by Atish Ghosh and Jonathan Ostry, which summarises the evolution of IMF's thinking on the subject over the last decade. It starts with the fact that "*the 1990s …. saw a spate of capital account crises in emerging market countries, with sharp reversals of capital inflows leading to collapsing currencies and underscoring the fragility of …. fixed exchange rate regimes".*

In the sweeping condemnation of fixed exchange rates, it glosses over some points.

⇒ That fixed exchange rates had worked extremely well for 25 years;

⇒ That the system collapsed when capital flows started dominating the foreign exchange market; and

⇒ That the basic cause underlying the 1990s crises was not fixed exchange rates per se, but pegging them at an unrealistic level, disregarding the effect on competitiveness of the domestic economy and its reflection in the current account balance.

As a result of the 1990s experience, the article argues that by 1999 "*the received wisdom was that simple pegs were too prone to crisis and that countries should adopt either "hard" pegs – such as monetary unions or currency boards – or, at the other end of the spectrum, free floats in which the market determines a currency's value without* *government intervention"*: the so-called "corner" solutions. However, the received wisdom of bipolar prescription had to be discarded in short order with the *"collapse in 2002 of Argentina's hard peg".* The 2003 review therefore "*concluded that emerging market countries – and developing countries as they became more financially integrated – should adopt freely floating exchange rates*". It also found that "*emerging economies captured little inflation benefit from pegging".*

The latest 2009 review "*based on a data set of IMF member countries over the period 1980 – 2006, is the most comprehensive study of exchange rate regimes"* and comes to yet another conclusion: *"Growth performance is best under intermediate exchange rate regimes – those that maintain relatively rigid exchange rates but do not formally peg to a single anchor currency"*. It is truly amazing that IMF researchers and, following therefrom, policy advice have swung so much in a decade: remember that the IMF's original purpose was the administration of exchange rates; it should therefore have enough expertise on the subject; and the exchange rate is the single most important price for an economy in a globalised world. To add to the confusion, the article goes on to claim that "*Pegged exchange rate regimes are associated with better growth performance than floating regimes – but only if they are able to avoid real exchange rate overvaluation and loss of competitiveness*".

One wonders whether the last point lets the cat out of the ideological bag: *"real exchange rate overvaluation and loss of competitiveness".* By implication, the statement concedes that there is such a thing as a reasonable exchange rate which can be estimated with acceptable accuracy. But market fundamentalism denies this: the correct price is what a market determines it to be, and the real economy has to adjust to its violent and often illogical (on fundamentals) fluctuations. This has been the Chicago School theology for a long time and the IMF has been under its ideological sway for the last few decades. Therefore, it talks of bipolar prescriptions, of intermediate regimes, of umpteen other concepts instead of stating the simple truth: developing countries should choose an exchange rate regime which ensures that the tradeables sector is reasonably competitive in the global economy. One measure of this is a properly constructed real effective exchange rate index. Another is a current account surplus or deficit not exceeding say 2 of GDP: a larger deficit foregoes potential growth and employment, may not be sustainable, and can lead to a crisis; on the other hand, a larger surplus reduces affordable consumption when increasing consumption is the goal of economic policy, and can be inflationary.

In my view, for this purpose, the current account number should exclude remittances which, though classified as current receipts, are more in the nature of capital flows. The financeability of the deficit, through capital inflows or remittances, should not unduly influence the exchange rate policy. A corollary is that capital flows may need to be controlled in the interests of a reasonable exchange rate. On the last point, a recent IMF Staff Position Note, *Capital Inflows: The Role of Controls,* by Jonathan Ostry and others, grudgingly concedes that "*controls that limit debt inflows (and debt flows recorded as financial FDI) might usefully supplement prudential regulations aimed at curtailing domestic credit booms and unhedged foreign-exchange-denominated lending*". But more on this paper in a later article.

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