Towards a stable system of exchange rates
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Based on 3 strands of literature

- Macroeconomic stabilisation (Mundell-Fleming)
- Economic integration (Europe)
- High inflation experiences (Latin America)
Objective of monetary policy is low inflation
Theoretical foundations: Barro Gordon model
Central bank has incentive to do surprise inflation
But its commitment is not credible
Pegging to a low inflation country is a credible pre-commitment device.
Now the central bank has a positive incentive to renege, to do a surprise devaluation.
Setting for the choice of currency regime

- High inflation history in countries such as those of Latin America
- Small country with little role for independent monetary policy since shocks were synchronised with that of large country
- Current account deficits
- Pressure on the currency to depreciate
- Limited reserves that could get depleted and lead to speculative attacks (Krugman)
- The cost of abandoning the peg is high inflation. Assumption of high exchange rate pass-through.
Today’s setting is quite the opposite

- The focus of debate on pegged exchange rates is Asia, and countries like China and India.
- The setting for the choice of exchange rate regime is very different. Pegging leading to a huge build up of reserves. Stability threatened by imbalances such as East Asia’s current account surpluses.
- China and other Asian economies are not pegging to the dollar to keep inflation low, but due to the perception that pegging nominal rates will keep exports competitive.
- They are facing pressures on their currencies to appreciate, not depreciate.
- The cost of abandoning the peg is not high inflation, but perceived loss of exports.
Assumptions of the model

- If the economy is open, capital flows into a country when interest rates are higher than abroad.
- *But we see large capital flows for investment (both FDI and portfolio) even when interest rates are low. eg. China.*
- Shares of unionised labour and weights on output and inflation are similar.
- *But when small open economies peg to the US dollar this is far from reality*
- Central banks need to solve the credibility problem. Pegging provides an answer.
- *The Asian peggers are pegging to maintain export shares*
Costs of pegging in Asia

- Build up of reserves. Reserves are costly.
- Sterilised intervention is costly - fiscal cost, loss of monetary policy autonomy.
- Possibility of reverse speculative attack as pegging can lead to one way bets on the currency.
- No breaking point as in the case of losing all reserves while defending a currency.
- Cost of exiting the peg is not inflation, but perceived loss of exports.
Theoretical framework needs to catch up with current questions

- Economy faces large net capital flows.
- Capital flows are putting pressure on the exchange rate to appreciate.
- The cost of exiting the peg perceived to be loss of export competitiveness.
- Pegging is not an instrument for pre-commitment. The central bank does not have an incentive to do surprise inflation.
Recent empirical research shows that there is a relationship between exchange rate pass-through and inflation. The pass-through is low in low inflation countries, when inflationary expectations are anchored. So if we are in a high inflation economy a small depreciation will have high impact on prices. This reduces the likely benefits of a soft peg. The model should take this into account.
Issues in modelling

- The issue of pre-commitment arises from a large share of unionised labour and inflexible wages. If this is not the concern, how should the choice between a peg and a float be made?
- Can the model be modified to address large capital flows even when interest rates are the same as in the anchor country?
- Can the welfare loss function be set up to witness a reduction in welfare if exports fall?
- Can the costs of pegging be modified from being surprise depreciation (and inflation) to appreciation?
- Can the model take into account the cost of sterilised intervention?
The model is based on the literature prevalent at a time when the questions of the age were different.

It does not offer interesting answers to the peggers of today. Asian countries are facing increasing costs of pegging.

Models can bring analytical foundations to the key question of today: When is it optimal to exit the peg?
Thank you.