Towards a stable system of exchange rates by Atish Ghosh

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NIPFP

March, 2008

Based on 3 strands of literature

- Macroeconomic stabilisation (Mundell-Fleming)
- Economic integration (Europe)
- High inflation experiences (Latin America)

Framework for the model

- 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 suprise inflation.

Exchange rate pass-through

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?

Choice of exchange rate regime

- 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.