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“Floating” or “ Fixed”? Credibility makes the difference | Exchange Rates

Di Biagio Bossone

Exchange Rates | *“I used to think that if there was reincarnation, I wanted to come back as the president or the pope…But now I would like to come back as the bond market. You can intimidate everybody.” James Carville*[1]

Is it true that floating **exchange rates** protect the economy from the consequences of “sudden stops” in capital flows,[2] and grant policymakers greater flexibility in both managing demand and sustaining public debt?

Antonio Fatas has raised this issue already a while ago, arguing that where countries run large persistent current account deficits, sudden stops of capital could be contractionary even under floating rates (Fatas, 2013). In fact, scholars’ views on the “insulation value” of different exchange rate arrangements vary widely, from those holding that the adjustment following sudden stops is contractionary under fixed rates and expansionary under floating (Krugman, 2013a, b), to those observing that economies facing common shocks have in fact not performed much differently under different exchange rate regimes (Rose, 2014). Others recognize that a country issuing its own currency may inflate its debt, though only to the extent that inflation is not priced in (Rogoff, 2013), and others yet notice that outright default is far from rare even on domestically denominated public debt of countries where the authorities control the ‘printing press’ (Corsetti and Dedola, 2013). According to a more nuanced view, in a confidence crisis the central bank may credibly commit to keeping the short-term safe nominal interest rate at zero (swapping out cash and pulling in bonds at will), unless and until the country falls into extremely dysfunctional circumstances (e.g., hyperinflation) where people would move out of *both* domestic bonds and cash and into foreign securities (DeLong, 2013). Recent research in the field has produced no conclusive evidence (Obstfeld and Taylor, 2017).

Is there a way to reconcile these views?

Financial integration and policy credibility

I have recently submitted that the effectiveness of the exchange rate as an adjustment mechanism in a given country depends critically on three key variables (Bossone, 2018). These include the country’s

- degree of financial integration into the global markets
- size of its public debt (irrespective of currency denomination), and
- level of policy credibility.

To see this, take a fully financially integrated country, suffering from weak policy credibility (based on its past policy track record), and assume that its policymakers adopt a floating exchange rate regime and commit to expanding public liabilities (debt and/or money) as much

as necessary to stabilize output and employment at full capacity. With persistent expansion of the public liabilities, the policymakers would soon be faced with a dilemma:

- they may either be forced to set the interest rates on debt liabilities high enough to prevent the exchange rate from falling at levels that would make the liabilities unsustainable, or
- or they may decide to monetize the debt as needed to keep interest rates low and to guarantee debt service.

Under the first option, the country would have to abandon its policy objective of stabilizing output and employment, and the resulting endogeneity of the interest rate would, de facto, amount to bringing back through the window the fixed exchange policy that was thrown out the door. Under the second option, the country would fail to achieve the objective anyway. In ex-ante (equilibrium) terms, and from the standpoint of the liabilities' holders, the two options are equivalent since the expected losses from the risk of debt default (as compensated ex ante by higher interest rate premia) would equal the expected losses from currency depreciation (a form of default of its own).

Indeed, if the liabilities consist of public debt denominated in a foreign currency, investors face the risk of the country defaulting on its debt obligations at some future date and thus protect their investments by requiring an appropriate premium on the debt interest rate. On the other hand, if debt is denominated in the domestic currency, investors are protected against the risk of default (since the issuer can always monetize the debt), yet they are exposed to the risk of future currency depreciation and the real value loss of their asset due to the authorities' commitment to unbounded debt monetization – stocks matter, not only flows. Thus, all else equal, both options carry the same probability of triggering a contractionary sudden stop, and the flexibility of floating exchange rates would play no role in influencing the economy's real variables.[3]

Financial integration

A crucial assumption underpinning this conclusion is the country's full integration into the global financial markets, which removes systematic differences between the intertemporal behavior of resident and nonresident agents and between their valuations of the country's liabilities. Under such conditions, when faced with the prospects of the country issuing "excess" liabilities,[4] residents and nonresidents alike would replace at the relevant margin *both* domestic debt and money holdings with foreign assets deemed to be safer stores of value. It should be emphasized that the concept of excess liabilities here refers to a sustained issuance of public liabilities by a poorly credible economy, not to the financing of short-run budgetary policies to address transitory output gaps.[5]

This effect of financial integration would be further reinforced if i) the incidence of institutional investment over total domestic savings were high and ii) the distribution of domestic wealth were largely unequal, since both features would reduce "home bias" factors in investment strategies. In particular, as exchange rates often diverge considerably and persistently from purchasing power parities, institutional investors and the owners of large wealth are typically

more sensitive than small savers to the need to protect their assets not just from domestic inflation but also from losses due to exchange rate dynamics. Such investors optimize their portfolios by taking a more global view of asset risks and returns than small savers and much more easily than small savers can (re)direct their investments across global markets. Since such investors would operate at the relevant margin, they would set the benchmarks for others to determine their own allocations choices.[6]

It is often objected that resident and non-resident agents use different inflation rates to gauge their portfolio choices, with resident agents being primarily interested in protecting their wealth from the erosion due to domestic price increases and therefore being less responsive to exchange rate dynamics. In fact, to the extent that no frictions separate domestic and foreign markets, and that relevant portfolios of resident and nonresident agents are global, asset values are driven by the expected dynamics of international asset prices.[7] In such circumstances, domestic inflation rates are determined by the exchange rate dynamics (not the contrary), and exchange rate pass-through effect would grow with the openness of the economy, the flexibility of its prices, and the weakness of its policy credibility (Takhtamanova, 2008).

In a poorly-credible and highly-indebted economy higher inflation could materialize even at positive levels of the output gap as a reflection of the growth of public liabilities and their impact on the currency's exchange rate. In fact, with full financial integration, high incidence of institutional savings, and large concentration of wealth, the issuance of excess liabilities (as defined above) would first prompt a larger demand for domestic assets (e.g., real estate) and would then increasingly cause capital outflows.

Based on the above assumptions, thus, the policy space available to a country grows narrower with its stock of liabilities – in whichever currency these are denominated – and is limited by the country's level of policy credibility. The lower the credibility, the more would a floating regime be equivalent to a fixed regime and bear limited "insulation value" or no insulation value at all.

'Modigliani-Miller' applied to open macroeconomies

This equivalence resembles the neutrality property of the **Modigliani-Miller** (1958) theorem for corporate finance, whereby, under condition of perfect competition, the value of a firm's capital is unaffected by the type of securities used to finance capital acquisition. Equivalently, if traded in an open (global) competitive market, a public liability must carry an identical value independently of its type and the exchange rate regime under which it is traded.

Obviously, we do not live in world of perfectly competitive markets and any departure from the 'Modigliani-Miller' paradigm (or any relaxation of its assumptions) softens the equivalence above. Yet, with all imperfections, not all investors can be fooled all the times and – once again, assuming full financial integration – a country could (and should) not ground its debt financing strategy on the expectation that domestic investors would be more willing than foreigners (or forced) to accept losses on their public debt holdings or that investors value the public debt differently depending on its currency of denomination.

The equivalence above does not imply that all countries are subject to the same intertemporal

resource constraint. This is exactly where a country's policy credibility comes into play. Credibility would be factored by investors into their own expectations and determine the "elasticity" of the country's intertemporal resource constraint and, hence, the latitude of its policy space under floating rates. This elasticity would ultimately be a function of the markets' evaluation of the sustainability of the country's liabilities and its reflection on their price.

A country issuing a reserve currency or a country with high policy credibility would enjoy much greater policy space under floating rates than any other countries, since the elasticity of their intertemporal budget constraint, as determined by the markets, would be much higher than the others'.

Exchange rate equilibrium: fundamentals vs. speculation

The foregoing arguments suggest also that the fundamental equilibrium exchange rate (FEER) of a country under floating is endogenous to the market reactions to the country's policy stance, since the determinants of the FEER incorporate the valuation that markets attribute to the country's domestic and foreign liabilities.[8] In fact, this would hold even in the case of a country whose public debt were entirely held by residents and expressed in the domestic currency, since the FEER would need to reach the level where the economy generates the resources needed to finance the fiscal budget and service the debt (also through the contribution of the external sector).

Thus, where a country's financial stock of liabilities is of significant size, market expectations do not only determine the deviations of the actual exchange rate from its PPP as transitory divergences from equilibrium due to speculative phenomena. They would determine the PPP itself.

Take again the same fully financially-integrated and poorly-credible country running a large stock of public debt. Under the equivalence above, and all else being equal, the country's equilibrium general price level would be lower than under a smaller stock of debt. Public debt and policy credibility would thus affect the country's PPP by a factor that increases directly with the level of debt and inversely with the level of credibility.

The implications of the above discussion can be summarized as follows:

- If affected by lack of policy credibility, an economy does not stand much to gain from floating rates in terms of both being more insulated from shocks and enjoying greater independence in the use of its policy levers.
- Although, in principle, floating rate regimes grant policymakers greater flexibility than fixed regimes, flexibility varies inversely with the country's policy credibility in the perception of the financial markets.
- The larger is a country's total public liability position, the more binding (less elastic) is the intertemporal resource constraint imposed by the markets on its policy choices.
- In the case of financially integrated economies suffering from lack of policy credibility, their vulnerability to sudden stops is high irrespective of the currency of denomination of its liabilities.

In conclusion, for highly-indebted and poorly-credible economies, the exchange rate is a ‘veil’ in that markets detect their underlying risks regardless of the extant exchange rate regime and the currency of denomination of its public liabilities. Floating rates would not insulate such economies from exogenous shocks, nor would they grant greater independence to their policymakers, any more that fixed rates would.

Policy implications

Do the above conclusions imply that a weak economy should move to a fixed exchange rate regime, substitute its currency (by dollarizing), or join a monetary union? And what about a weak economy that is already a member of a monetary union and has lost space for effective fiscal policy: should it stay in at whatever price? Would it have other options available beside exiting the union?

Let’s first clarify that, for the purpose of this discussion, the term “weak” here refers to a fully financially integrated economy as defined above that is highly indebted, suffers from poor policy credibility, and undergoes a period or prolonged recession or stagnation.

As then regards the first question, the fact that floating rates do not benefit a weak economy does not imply that the economy should then move to a fixed exchange rate regime, especially an irreversible one or one that is presumed to be so. Taking such a step in the expectation that the economy would "import" discipline and credibility from the regime’s core country and using the new regime as an "external constraint" would not work, unless the country decided not just to import discipline and credibility but to replicate the whole economic and institutional structure of the core country. Otherwise, the risk for it would be too high of ending up in un unsustainable regime.

Rather than moving to an irreversibly fixed exchange rate regime, the country would be better off in the long term by going down the path of economic mismanagement and paying the consequences of it, until the situation forces an endogenous change in leadership and policy. As that happens, the country eventually recovers the benefits of exchange rate flexibility, and policy sovereignty more broadly, although to preserve them it should pay attention not to consign itself to financial market dependence through an inordinate expansion of its liabilities. In other words, while a floating regime would not bring immediate benefits to the weak country, it would at least leave the door open to a possible future “reversal of fortune”, with the fortune ultimately being in the hands of the country. On the contrary, the external constraint could prove deadly in the sense of condemning the country to permanent decline and secular stagnation.

Said differently, a country has to find its own way to sound policies and credible policy institutions, and not rely on external constraints: if it's capable of doing the former, it doesn't need the latter; if not, the latter do not help.

As regards the second question, concerning the options available to a weak economy that is already part of a fixed exchange rate arrangement and has exhausted its fiscal space, clearly, the situation would look like that of a “deadly trap,” with very serious negative consequences potentially deriving from either the “stay” or “exit” decision. Here, the options are essentially

two:

- A very costly and risky “exit” and an extremely long and difficult road to restoring credibility under recovered national policy sovereignty (especially considering that exiting a fixed exchange rate arrangement is not the same as not having being part of it), or
- A “stay” decision, supported by the adoption of “unconventional” fiscal policies (UFP) aimed to revitalize the economy without violating the rules of the exchange rate arrangement.[9] This is the easiest and least costly option, and yet its implementation requires strong political leadership and economic policy stewardship, including to be able to persuade exchange rate partner countries and the financial markets that such policies’ are revenue neutral and legally legitimate.

Summary and conclusion

If I had to capture in one line the discussion above on floating versus fixed exchange rates, and in particular on their relative comparative advantage, I would say that

“An open and fully financially integrated economy with large public debt and poor policy credibility (in the eyes of the markets) would not stand to gain much in terms of shock insulation and policy autonomy from either i) issuing liabilities in its own (rather than a foreign) currency or ii) adopting a flexible (rather than a fixed) exchange rate regime.”

As a corollary, I would add that, all else equal, the benefits from options i) and/or ii) increase with the degree of policy credibility of the country under consideration.

It is to be noted that the above statement rests on the full integration of the economy under consideration into the global financial markets and the reduction of the home bias factors affecting agents’ intertemporal resource allocations due to the high incidence of institutional investors over domestic savings and the large concentration of domestic wealth. All these factors cause relevant shares of domestic savings to be managed as global portfolios, driven by the expected dynamics of international asset prices.

Said differently, what has been discussed above assumes the central role of the global financial markets and their power to determine the effectiveness of national macro policies. It is their choices that defines the space for active and effective policies based on their judgement of the countries that adopt them. Whether such judgment is wright or wrong is not the issue, here; what matters is that it decides the elasticity (or the stringency) of the government’s intertemporal budget constraints.

The above considerations, however, should not lead to conclude that a weak economy (as defined above) should be indifferent between the two types of exchange rate arrangement – especially if the fixed arrangement is supposed to be “irreversible” – and even less so to prefer the latter.

While a strong economy would greatly benefit from the policy flexibility and insulation power that

floating rates make in principle possible, and should therefore have no reason to join a fixed arrangement (unless to protect its competitiveness from its own currency appreciation), the risks and costs of a fixed arrangement for a weak country should strongly discourage its policymakers from adopting it.

Finally, a weak country that is already part of a fixed exchange rate arrangement, has exhausted its fiscal space, and is trapped in a recession or stagnation, should seriously consider resorting to some form of “unconventional” fiscal policy with a view to revamping its economy.

I am indebted to Antonio Fatas for his inspiring views on the issue of this article, and I would like to thank Larry Summers for his (always) thought-provoking comments and Charles Wyplosz for his helpful insights at an earlier stage of my own reflection on this topic. I am also grateful to Marco Cattaneo and Warren Mosler, whose debating force has prompted me to be as rigorous as I could possibly be in thinking about the issue of this article. Obviously, the responsibility for the opinions expressed in the article and any eventual errors are mine only.

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[1] Lead strategist of the successful 1992 presidential campaign of then-Arkansas governor Bill Clinton.

[2] “Sudden stops” are when capital inflows dry up abruptly (Eichengreen and Gupta, 2016). Introduced by Calvo (1998), the concept is defined as a sudden slowdown in private capital inflows into emerging market economies, and a corresponding sharp reversal from large current account deficits into smaller deficits or small surpluses, typically followed by a severe drop in private spending, credit to the private sector, and output, and by real exchange rate depreciation. The term “sudden stop” originate by a banker’s adage that “it is not speed that kills, it is the sudden stop”.

[3] Getting there might in fact be gradual, but the stop could be sudden.

[4] The concept of “excess” liabilities may emerge in circumstances such as when public liabilities exceed the value of nominal aggregate output and the former grows at least at the same rate of the latter, causing the difference between the two variables to grow indefinitely, beyond the point at which the holders of the liabilities might no longer be willing to absorb them and start diversifying their portfolio into alternative assets, including those denominated in foreign currencies. Notice that this would happen as a result of portfolio rebalancing effects, not necessarily higher inflation expectations. The latter could in fact be the consequence, not the causing factor, of such portfolio effects, as will be discussed below. This is suggestive of a “portfolio” theory of inflation, which would be especially relevant for small open and fully financially integrated economies and will be the subject of a forthcoming work.

[5] Of course, residents would still demand the domestic currency for transaction and tax payment purposes, but such demand might not be enough to prevent the currency from depreciating if people move large share of wealth out of it and into foreign currency denominated assets.

[6] In other words, it is not necessary that *all* investors are global for the above allocation choices to hold; it is sufficient for relevant global investors to be seen as acting at the margin (Bartholdy and Kate (2004): they determine financial market prices.

[7] When valuing assets across international markets, global investors simply compare the expected dynamics of the nominal exchange rates of the relevant currencies.

[8] For a definition and discussion of the FEER, see Williamson (1994).

[9] Bossone (2019) evaluates three types of UFP: pre-announced distortionary taxes (Correia et al, 2013), fiscal devaluations (Farhi et al, 2014), and fiscal money (Bossone and Cattaneo, 2018). The first type of UFP is not highly beneficial in a situation where the economy needs a strong and persistent demand stimulus, while the impact of the second type is not strong

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enough to reactivate output production and employment in the non-export sector of the economy. Only a fiscal money program could be calibrated to induce a demand shock that is commensurate to the economy's output gap. Such conclusion is further reinforced taking into consideration recent evidence on the income multipliers (Realfonzo and Viscione, 2019).

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