

On floating exchange rates, currency depreciation and effective demand: a comment ^{*}

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The paper "On floating exchange rates, currency depreciation, and effective demand" by Julio López and Ignacio Perottini (LP 2006 from now on) is rather simple and straightforward, but also middle of the road; mindful of the complexities of our world, which does not allow unequivocal explanations or solutions, the authors state (p. 235):

"It should be noted that when we contend that currency depreciation may be detrimental to effective demand, we are not advancing a general inference valid in all times and conditions. Obviously, the final outcomes depends on the structural parameters and circumstances of any economy".

I agree with their main point, i.e. that flexible exchange rates do not provide an automatic adjustment towards full employment equilibrium. What I would like to argue is that flexible exchange rates, nevertheless, may be more advantageous than fixed exchange rates, and that management of the exchange rate for internal policy objectives, while useful in some circumstances, should not be a rule in a world where financial events frequently affect real variables.

In the '70s the shift to flexible exchange rate was predicated on three major points, that is restoring: *i*) autonomy to monetary policy, no longer compelled to peg the exchange rate; *ii*) symmetry between countries, as there is no need any longer of a reserve currency with dif-

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ferential obligations; *iii*) automatic stabilisation, as the movement of the exchange rate offsets the impact of a shock on production and employment.

All three advantages of flexible exchange rates need to be qualified. First, no central bank can pursue a monetary policy without taking into account the stance prevailing in other major countries, particularly if capital is free to move. Second, the financing of the external deficit of the country issuing the reserve currency is no longer the unavoidable result of an international monetary system based on fixed exchange rates, but foreign exchange reserves can be voluntarily amassed to defend an undervalued exchange rate; China is a case in point. On the stabilising role of flexible exchange rates, the third point, LP (2006, p. 224) concentrate their criticism and note:

“[...] if a fall in money wages, and the consequent real depreciation of the currency, were indeed capable of bringing about an expansion of both employment and output, capitalist economies would be endowed with a very powerful built-in full employment mechanism”.

Instead, they rightly argue that currency flexibility and currency depreciation do have a bearing on output and employment, particularly in the case of developing countries, but not in accordance with what the orthodox theory assumes.

They call on Keynes's authority to underline that: *a*) what matters is not the nominal but the real exchange rate, which may be very sticky if wages are indexed to prices; *b*) Marshall-Lerner conditions may not be satisfied; *c*) when export prices fall the terms of trade deteriorate, thus provoking a decline in income.

Theoretical underpinnings are found also in Kalecki's model which, in the short run and with capitalists' expenditure given, predicts that the effect of depreciation on profits depends on the elasticity of imports and exports with respect to the real exchange rate. Moreover, the relative share of wages in output is likely to fall with currency depreciation, thus affecting negatively the social classes with higher propensity to consume, and hence aggregate demand.

LP (2006) point out additional problems that reduce the adverse-shock absorbing capacity of flexible exchange rates. Price elasticities of exports and imports depend on the elasticity of both supply and demand. Owing to bottlenecks in supply capacities and/or complemen-

tary resources (e.g., credit) response to exchange depreciation may be inadequate, and may in turn affect demand. In the short run, private investment may be negatively affected if the price of the exchange rises, through lowered expectations as well as the change brought about in the financial structure of the firm.

Financial markets are the villain of the story. Financial shocks are well known as a major cause leading to the collapse of fixed exchange rate regimes. But what about flexible ones in insulating a country's effective demand and employment against a financial disturbance arising in liberalised current and financial accounts?

An exchange rate environment dominated by the asset market impairs the effectiveness of exchange flexibility as a shock absorber owing to volatility in asset prices and interest rates. Moreover, it imparts uncertainty to the economy, and favours redistribution of income to the detriment of wage earners. A sudden increase in international interest rates may bring about a sharp deterioration of the balance of payments and trigger an outflow of capital, which would in turn elicit a restrictive monetary policy. Finally, liability dollarisation and structural currency mismatch between assets and liabilities feed the 'fear-of-floating', as well as the sentiment and behaviour of 'floating-with-a-large-life-jacket'.

Is Kalecki's theoretical model satisfactory? In my humble view, it is not for two reasons.

First, it might have been interpretative of the real world in the '40s, the '50 and also the '60 when private-capital movements were non-existent or very limited. But in a globalised world in which all developed countries and many of the emerging economies believe in freedom of capital movements and accept the corollary of rapid shifting of portfolio investments, what is its intrinsic capacity to grasp today's determinants of international economic behaviour?

Second, it is a rather un-Keynesian way of reasoning. A major achievement of Keynes was his formulation of the interest rate not only as a monetary phenomenon, but as a link between the real sector and the monetary sector. As a consequence, events in the monetary and financial sectors influence real variables. Therefore, capital movements cannot be dealt with as a kind of disturbance that affects the nominal exchange rate and hence the real one. A model would be needed that makes capital movements endogenous. Can the Kalecki model be up-

graded to accommodate financial variables and their interaction with real ones? Even if possible at all, it would not be an easy task.

In most models of open economies, real external shocks (e.g., terms of trade and real interest shocks) will affect real exchange rate, which can adjust, if the nominal exchange rate is fixed, through and only through changes in domestic nominal prices and wages. Back in 1951 James Meade maintained that the adjustment would be difficult in countries with a fixed exchange rate and inflexible money wages, but easier in a regime of "variable exchange rate" – to use his words – , provided real wages are not inflexible owing to indexation or other mechanisms (*ibidem*, pp. 201-02). Fifty years later, Eichengreen and Hausmann (1999) have argued that due to "balance sheet effects" originating from large foreign-denominated liabilities, a flexible exchange rate regime will make for larger negative effects stemming from terms-of-trade shocks.

Therefore, the issue becomes an empirical one. LP (2006) make ample reference to Kamin and Klau (1997) and their quotation include the following:

"Finally, the results [...] suggest that, compared with developing countries, devaluations in industrialised countries are about as contractionary in the short run and more contractionary in the long run. Nevertheless the results presented in this [that is, Kamin and Klau] paper do not provide support for the view that contractionary devaluations is limited to the developing countries, while expansionary devaluation prevails in the industrialised countries" (*ibidem*, pp. 11-12).

Edwards and Levy Yeyati (2003) set themselves the task of analysing empirically the effect of terms-of-trade shocks on economic performance under alternative exchange rate regimes. They investigated whether: *i*) terms-of-trade disturbances have a smaller effect on growth in countries with a flexible exchange rate regime than in countries with a more rigid one; *ii*) negative and positive terms-of-trade shocks have asymmetric effects on growth; *iii*) the magnitude of these asymmetries depends on the exchange rate regime.

The paper is based on a data set that refers to the exchange rate regime *de facto* prevailing in each country at any particular moment in time, and covers annual observations for 183 countries over the period 1974-2000. As data availability varies across countries and periods, all

tests were run on consistent sub-samples of observations corresponding to 96 and 100 countries. Although no empirical results should be accepted or refuted without a thorough discussion of the methodology and an assessment of the robustness of estimates, for the sake of brevity, let us consider them acceptable.

Edwards and Levy Yeyati summarise their findings as follows: *a*) terms-of-trade shocks get amplified in countries that have more rigid exchange rate regimes; *b*) the response to terms-of-trade shocks is asymmetric; *c*) the effect on output is larger for negative than for positive shocks, owing to price inflexibility which leads to larger quantity adjustment; *d*) the output response in both directions is larger the more rigid the exchange rate; *e*) under flexible regimes the asymmetry is not present; *f*) after controlling for other factors, countries with more flexible exchange rate regimes grow faster than countries with a fixed exchange rate; *g*) therefore, the choice of exchange rate regime has important implications in terms of output volatility.

No definitive settlement of theoretical controversies can be reached through empirical research, as shows the feud between post-Keynesians and neo-quantitativists regarding the instability of the demand for money, particularly if economic conditions change significantly over time. In today's globalised environment financial flows and assets have become so huge that financial stability has become for policy makers no less important than economic performance (growth, supply and demand, employment). A shock affecting the former can make debts and credits uncollectible, firms bankrupt, intermediaries first illiquid and then insolvent, households poor and unable to save for retirement, thus affecting the prospects of growth for many years. Japan is a case in point in the '90s and in part of this decade, not to say anything about Argentina.

A high degree of capital mobility opens fixed exchange-rate regimes to speculative attacks, while flexible exchange-rate regimes are likely to be dominated by asset market rather than trade balance considerations. Therefore, an explicit reference to which exchange rate regime is preferable in the new, more complex international economic system is in order. LP (2006, p. 239) state that:

"[...] with regards to policy inferences, our discussion does not lead to the conclusion that fixed exchange rates are to be preferred to flexible exchange rates. Nor is conducive to the monetarist hypothesis

that the exchange rate cannot be used as a policy instrument. We do acknowledge that the excessively long use of some form of fixed exchange rate regime has led several countries to experience macroeconomic distortions and twin crises”.

On the basis of the last ten years' experience, Calvo and Mishkin (2003, p. 100) maintain that:

“One often-told lesson of the east Asian experience is that nations must make a bipolar choice: either choose a framework for credibly guaranteeing a fixed exchange rate, known as a hard peg, or else accept a freely floating exchange rate. Yet neither of these extreme exchange rate regimes has an unblemished record, either”.

As the standard theory of choice between exchange rate regimes shows weaknesses particularly when applied to emerging market economies, Calvo and Mishkin point to a number of institutional traits that might predispose a country to favour either fixed or floating rates. It is the strength of and respect for institutions that can make one regime more suitable to a country than another. Conversely, the choice of the exchange rate regime may favour the development of certain desirable institutional traits. Therefore, the key to macroeconomic success in emerging market countries is not the exchange regime, but the health of fundamental economic institutions (fiscal, financial and monetary). One can reformulate all this in terms of institutional reputation, which stems from the consistent behaviour not so much of one policy maker during a short period, but from a succession of relevant position holders in the medium-long run.

Writing against an extreme form of hard peg, i.e. dollarisation, that brings about low-inflation benefits and adverse growth effects, Palley (2003) advocates that the mentality of passivity should come to an end, suggests that policy makers should opt for the middle ground in the form of managed exchange rates, as well as market-compatible forms of capital control to encourage stable flows, invokes the shifting of the obligation to intervene from the central bank of the depreciating currency to that of the appreciating currency... Such a shift, that would bring about moral hazard, goes certainly beyond the symmetrical obligation to intervene in a framework of exchange rate cooperation like for instance the ERM within the EMS. Recalling the debate and the experience regarding intervention modalities and limits in the pre-euro era, one cannot but say: *Plus ça change, plus c'est la même chose...*

Turning once again to LP (2006), they too believe that the exchange rate can and should be used to help redress the balance of payments. Let us remember however that not only the institutional and cultural environment is of the essence to ensure sound management, but that we have one rate of exchange to cater to both current and financial accounts. Economic policy is more often than not confronted with the dearth of appropriate and independent instruments.

In my view, intervention in the foreign exchange market on the part of the central bank should be infrequent and used as a signal to stem a tide downward or upward, which requires cooperation and support by other central banks. As to market-friendly measures affecting capital movements, recourse to them should be even more cautious. Anyway, a management by (rare) exception of the exchange rate is certainly possible.

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