

**Fear of Floating**

Since the end of the Bretton Woods system of fixed exchange rates in the early 1970s, the number of countries claiming to be running a flexible exchange rate regime has steadily grown. However, many of these countries appear to actively limit fluctuations in the external value of their national monies. Guillermo Calvo and Carmen Reinhart (2002) dubbed this behavior “fear of floating” and argued that this phenomenon appears pervasive in so-called “emerging markets” (middle-income countries with some access to global financial markets). Indeed, many self-proclaimed “floaters” often accumulate vast war chests of international reserves, which would not be necessary if their currencies were truly floating (see International reserves). In other words, many countries float with “a large life-jacket.” Such behavior is puzzling not only because it does not match official pronouncements by policymakers, but also because emerging market economies are typically buffeted by larger and more frequent external shocks, which in theory necessitate more (not less) exchange rate flexibility.

**Why is floating so fearsome?**

Several interlocking factors underlie “fear of floating.” First, while many industrial countries have operated fairly flexible exchange rates quite effectively, they have well-developed and diversified financial systems that are able to minimize real sector disruptions due to transitory exchange rate variations. Most importantly, industrial countries are able to borrow overseas in their domestic currencies. Many emerging economies are unable to do so, leading to an accumulation of foreign currency debt liabilities that are primarily dollar-denominated and unhedged (i.e., “liability dollarization”). This is commonly referred to as the “original sin”

problem (see original sin). In these countries, sharp depreciations in their currencies alter the domestic currency value of their external debt and therefore the net worth of the economies, with calamitous real sector effects (see “balance sheet” approach / effects). This in turn may explain why exchange rate stability is so important to emerging economies, and why such economies have an acute “fear of floating”.

The inability to borrow overseas in one’s own currency is related to the seeming lack of hedging in a number of emerging economies (see Hedging). Even if a country has the ability to hedge, the transaction costs can be too high to make it an attractive option, especially in the short term. In view of this, it may be reasonable to expect some smaller domestic firms in emerging economies to be affected by exchange rate volatility (Bénassy-Quéré, Fontagné and Lahrière-Révil, 2001). However, many economists argue that multinational firms can protect themselves from exchange rate fluctuations by maintaining diversified production facilities in different countries and by sourcing from a number of different countries.

Second, policymakers in emerging markets suffer from a chronic lack of credibility. They often have a poor track record in monetary and fiscal policy as a result of, for example, resorting to an inflation tax too often in the past. As a result, an emerging economy might experience large and frequent shocks to exchange rate expectations or to interest rate risk premiums. A true floater would allow the spot exchange rate to absorb these shocks, while a true pegger would allow the interest rate to adjust in a way to keep the spot exchange rate stable. Governments struck by “fear of floating” allow for some flexibility in both variables, but by and large it is the interest rate that absorbs most of the shock. This might be why various empirical studies have found that emerging economies with officially floating exchange rates have domestic interest rates whose

volatility is considerably higher than that in the developed world. Policymakers in these countries might be limiting exchange rate volatility as a way to gain credibility and in order to signal to financial markets their commitment to monetary discipline.

A third reason for “fear of floating” is that small and open economies are relatively more susceptible to exchange rate pass-through effects in domestic prices (see Exchange rate pass-through). Nonetheless, evidence suggests that exchange rate pass-through has declined across all countries over the last few decades, including those in Asia (Edwards, 2006 and Ghosh and Rajan, 2006). In fact, exchange rate pass-through may be endogenous to the degree of flexibility of the exchange rate regime itself. This appears to be the experience of New Zealand which has operated one of the most flexible exchange rate regimes in the world. The low exchange rate pass-through implies that small and open economies may be less concerned about the potential inflationary consequences of exchange rate fluctuations, suggesting there is less reason to fear floating. In addition, there is also some evidence that emerging economies “learn to float” in the sense that as they adopt more flexible exchange rate regimes, they tend to adopt stronger monetary and financial frameworks (Hakura, 2005). China appears to be a good example of a country engaging in this “learning to float” behavior as the Chinese authorities gradually allow for greater volatility of the currency as they also put in place the necessary infrastructure and institutions to ensure that the foreign exchange market functions well (i.e., is liquid) and that agents are able to hedge themselves against volatility.

Fourth, countries with flexible regimes have experienced “excessive” volatility over the last few decades. It is difficult to define “excessive” with any precision, but evidence of excessive exchange rate variability comes in a number of forms. For instance, a number of

surveys of foreign exchange (“forex”) market participants clearly indicate that short-term/high-frequency exchange rate movements are caused by “speculative” or “trend-following” elements rather than by underlying macroeconomic fundamentals. Destabilizing speculation is a particular problem in developing countries with thin markets (Indonesia’s post-crisis experience since 1999 is a case in point). Of course, even if flexible exchange rates exhibited greater volatility than would be warranted by underlying fundamentals, why might such excessive volatility be of concern? Studies suggest that institutionally fixed exchange regimes (i.e., common currency, currency boards or dollarization) stimulate trade, which in turn boosts income. Proponents of the European Monetary Union (EMU) have used such an argument extensively in support of a single regional currency (see common currency and European Monetary Union).

Fifth, some economists argue that access to global financial markets for developing countries is conditioned on currency stability. A sharp depreciation in the nominal exchange rate will often trigger an abrupt pause or even reversal of capital flows into the country (the so-called “sudden stop”). Empirically, such a reversal is associated with a sharp adjustment in the current account (from deficit to surplus), an output contraction, and a collapse in credit ratings (see separate entry on Hot money and Sudden stops).

Finally, there are political reasons behind “fear of floating.” Sharp fluctuations in the nominal exchange rate combined with sticky prices translate into unstable relative prices for traded versus non-traded goods. This might cause political disruption in a country in which both the traded and non-traded sectors are large and have powerful lobbies.

## **Significance**

Given these explanations for fear of floating, it is reasonable to ask why emerging economies do not fix their currencies. One reason is that pegging the exchange rate constrains monetary independence (see separate entry on Impossible Trinity). To be sure, some research casts doubt on the extent to which floating regimes in emerging economies provide insulation from foreign interest rate shocks (see Frankel, Schmukler and Serven, 2004 and Hausman, Panizza and Stein, 2001). However, a more recent study using *de facto* exchange rates for 100 developing and industrial countries between 1973 and 2000 finds that the interest rates of the countries that operated pegged regimes followed the base country far more closely than non-pegs (Shambaugh, 2004). There may even be a degree of endogeneity in the sense that as countries “learn to float,” they gain a greater degree of monetary policy autonomy (see Hakura, 2005). All this suggests that the loss of monetary-policy autonomy can have significant costs.

In addition, small and open economies are far more susceptible to large external shocks, such as changes in foreign interest rates, terms of trade, and regional contagion effects. Received theory tells us that a greater degree of exchange rate flexibility is called for in the presence of external or domestic real shocks. By acting as a safety valve, flexible exchange regimes could provide a less costly adjustment mechanism by which relative prices can be altered in response to such shocks as opposed to fixed rate regimes. The latter relies on gradual reductions in relative costs through deflation and productivity increases vis-à-vis trade partners to restore internal balance. This can prove to be prolonged and costly, as made apparent by both Argentina and Hong Kong SAR in the late 1990s.

*See also:* Balance sheet approach / effects, Bretton Woods system, Contagion, Currency board arrangements, Discipline, Exchange rate pass-through, Exchange rate regimes, Expenditure switching, Foreign exchange intervention, Hedge, Hot money and sudden stops, Impossible Trinity, International reserves, Original Sin, Real exchange rate, Speculation, Sudden stop.

### **Further Reading**

Bénassy-Quéré, A., L. Fontagné and A. Lahrière-Révil (2001). “Exchange Rate Strategies in the Competition for Attracting FDI,” *Journal of the Japanese and International Economies*, 15, pp.178-198. This paper examines the impact of exchange rate volatility of FDI.

Calvo, G., and C. Reinhart. 2002. “Fear of Floating.” *Quarterly Journal of Economics* 117(2): 379-408.

Calvo, G., and C. Reinhart. 2005. “Fixing for your life.” In Guillermo Calvo, *Emerging Capital Markets in Turmoil: Bad Luck or Bad Policy?* Cambridge, MA: MIT Press.

The preceding two papers launched the debate on “fear of floating.”

Edwards, S. (2006). “The Relationship between Exchange Rates and Inflation Targeting Revisited,” *Working Paper No.12163*, NBER. This paper examines the impact of exchange rate pass-through in developing countries.

Frankel, J. S. Schmukler and L. Servén (2004). “Global Transmission Of Interest Rates: Monetary Independence and Currency Regime,” *Journal of International Money and Finance*, 23, pp.701-733. This paper examines the empirical validity of the impossible trinity.

- Ghosh, A. and R.S. Rajan (2006). "Exchange Rate Pass-through in Asia: What does the Literature Tell us?," mimeo, Claremont Graduate University and George Mason University. This paper examines the analytical and empirical literature on exchange rate pass-through into inflation in Asian economies.
- Hakura, D.S. (2005). "Are Emerging Market Countries Learning to Float?," *Working Paper No.WP/05/98*, IMF. This paper discusses how the underlying institutional exchange rate and monetary framework of a country changes as economies "learn to float".
- Hausmann, R., U. Panizza, and Ernesto Stein. 2001. "Why Do Countries Float the Way They Float?" *Journal of Development Economics*, 66(2): 387-414. An empirical study of "fear of floating," with a special focus on the role of exchange rate pass-through and currency mismatches.
- Levy-Yeyati, Eduardo, and Federico Sturzenegger. 2005. "Classifying Exchange Rate Regimes: Deeds vs. Words." *European Economic Review*, 49(6): 1603-35. Uses "cluster analysis" to disentangle what countries say versus what they do with regard to exchange rate management.
- McKenzie, M. (1999). "The Impact of Exchange Rate Volatility on International Trade Flows," *Journal of Economic Surveys*, 13, pp.71-103. This paper surveys the literature on the impact of exchange rate volatility on trade.
- Rajan, R.S. (2006). "Exchange Rate Policies in Asia since the 1997-98 Crisis," mimeo July 2006. This paper examines the empirical trends on exchange rate regimes in Asia since the 1997-98 crisis and the analytical rationale behind the choice of various currency regimes.

Shambaugh, J. (2004). "The Effects of Fixed Exchange Rates on Monetary Policy," *Quarterly Journal of Economics*, 119, pp.300-351. This paper revisits the empirical validity of the impossible trinity.

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