Flexible rates may instil greater fiscal restraint

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Should developing countries have a flexible exchange rate, which responds freely to market pressures? This was the question that *Business Line* posed to Mr Ramkishen S. Rajan, Associate Professor in International Economics at the School of Public Policy, George Mason University (http://mason.gmu.edu) in Virginia, US, during a recent interaction.

"A priori, there are a number of reasons that underlie a preference for a greater degree of exchange rate flexibility," he says, and lists at least five reasons. "First, the more flexible the exchange rate regime, the keener the incentives for agents to undertake appropriate foreign exchange (forex) risk management techniques in response to the higher element of exchange rate risk, while simultaneously reducing the extent of moral hazard which could lead to 'excessive' unhedged external borrowing (referred to as a 'fixed exchange rate bubble')," opines Mr Rajan. "The introduction of these transaction costs and exchange rate risks may also help moderate the extent of capital inflows, consequently dampening the intensity of boom and bust cycles (this is essentially a moral hazard argument)."

The second reason, in support of flexibility in exchange rate is that small and open economies are far more susceptible to large external shocks, such as changes in foreign interest rates, terms of trade, regional contagion effects and the like. "Received theory tells us that a greater degree of exchange rate flexibility is called for in the presence of external or domestic real shocks." This is how: "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, points out Mr Rajan. "However, this can prove to be prolonged and costly, as made apparent by both Argentina and Hong Kong SAR in the late 1990s."

Third, many Asian economies have diversified trade structures, being dependent on the US, Japan and intra-Asian trade, reminds Mr Rajan. "Theory suggests that such economies are good candidates to maintain more flexible regimes. Thus, in the case of East Asia, institutionalisation of the pre-crisis dollar pegs (via a Currency Board Arrangement or dollarisation) would not have helped domestic economic performance in 1996-97 (just prior to the crisis) to the extent that the problem was, at least partly, one of loss of competitiveness due to fluctuations in the US dollar and yen cross-rate."

Fourth reason that the professor offers is that pegging the exchange rate also constrains monetary independence, which in turn, could handicap the central bank in responding to domestic financial and macroeconomic imbalances.

And lastly, the effects of unsound macro-policies become evident immediately under flexible rates through currency and price-level movements (i.e. depreciation-inflation spiral). "In view of this, flexible rates may, under certain conditions, instil greater fiscal restraint (relative to a fixed regime) as the costs of macroeconomic policy transgressions have to be paid upfront," notes Mr Rajan.

He hastens to remind that for small and open economies in Asia and elsewhere, fluctuations in the exchange rate can and do have significant and direct impacts on the domestic economy (inflation, exports, growth). "Consequently, many Asian inflation targeting central banks do take into account exchange rate movements in their monetary policy frameworks," concludes Mr Rajan.