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Real effects of collapsing exchange rate regimes: an application to Mexico

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Abstract

This paper examines the impact of collapsing fixed, permanently fixed, and flexible exchange rate regimes on real output. Much of the recent discussion of the causes of exchange rate regime collapses has focused on capital flows and export demands. In an environment in which such external shocks predominate, a flexible exchange rate is shown theoretically to produce lower output variability for a range of parameter values. A counterfactual exercise is performed using Mexican data. We find that had Mexico been on a flexible rate for the past two decades, the variance of real output would have been reduced by half.

Keywords: Collapsing exchange rate regimes; Output variability; Capital flows; Exports; Mexico

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1. Introduction

The recent rash of currency crises and fixed exchange rate collapses in Latin America and East Asia provides ample evidence that in a world of liberalised financial flows, small transactions costs and large pools of mobile capital, the

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typical fixed or pegged exchange rate regime is extremely difficult to sustain.[1] These crises have had significant real costs in terms of lost output and employment because of tighter monetary and fiscal policies and because of widespread financial distress due to the halt in capital inflows and higher debt payments.[2] Our primary purpose in this paper is to investigate the impact of collapsing fixed exchange rate regimes on the variability of output.

In addition, we examine the crucial policy decision facing emerging-market countries which are vulnerable to such crises: namely choosing an alternative exchange rate regime to avoid such disruptions in the future.[3] Currency boards or common currencies are often put forward as appropriate alternative regimes (for example, Argentina and the European Union). We, however, demonstrate theoretically and empirically that these countries should instead look to the opposite end of the exchange rate spectrum and adopt a flexible exchange rate because it would provide greater macroeconomic stability in the face of capital flow and export demand shocks, especially if the fixed exchange rate regime has a nonzero probability of collapse.[4]

To illustrate this argument, consider Mexico's recent experience. Over the last twenty-five years, it has had a series of controlled—fixed, crawling peg, dual and target zone—exchange rate regimes, all of which ended in crises and collapses.[5] Each of the major crises over this period—August 1976, February and March 1982, July to November 1985, November 1987 and December 1994—was followed by a significant decline in economic growth (see Fig. 6). Although the factors responsible for these collapses have been described in detail elsewhere, it is important to note that external shocks to goods and asset markets in the form of oil price changes, capital flow shifts or interest rate changes played key roles.[6] In particular, the typical boom and bust cycle in Mexico over this period began with a favorable external shock: for example, an increase in oil exports (following a discovery or an oil price increase), a fall in world interest rates or a liberalization

[1] Obstfeld and Rogoff (1995) argue persuasively that although a fixed exchange rate regime is technically feasible for most countries, it is not politically viable because it may require the subversion of other important macroeconomic goals, chiefly stable employment and output growth.

[2] For example, output in Mexico fell by 6.2 percent in 1995 after averaging 3.5 percent growth in the previous four years. Osakwe and Schembri (1998) provide an overview of recent crises and their output effects.

[3] Laidler (1999) argues that the appropriate comparison is not among alternative exchange rate regimes per se, but among alternative monetary orders. We agree with Laidler and Obstfeld and Rogoff (1995) that a flexible exchange rate regime should be accompanied by a low inflation target for it to be a superior alternative to a fixed exchange rate.

[4] Other authors have also emphasized the advantages of a flexible exchange rate regime. For example, Meigs (1997) argues that if Mexico had adopted a flexible exchange rate regime, there would have been no peso crisis in 1994–1995.

[5] For an overview of Mexico's recent controlled exchange rate regimes and their collapses, see Otker and Pazarbasioglu (1996).

[6] For example, see Cardoso and Levy (1987), Dornbusch (1988), Aspe (1993), Dornbusch and Werner (1994), Calvo and Mendoza (1996), Gavin (1996), Edwards (1997) and Werner (1998).