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Fix or flex? Alternative exchange rate regimes in an era of global capital mobility

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Abstract

This paper discusses the pros and cons of fixed versus flexible exchange rate regimes under perfect capital mobility from a European perspective. Special attention is given to the exchange rate policy problems of Iceland and Norway and to the linkages between their dependence on natural resources and their choice of exchange rate regime. The relevance of the advent of a common currency in Europe for the Western Hemisphere is also discussed. © 2000 Elsevier Science Inc. All rights reserved.

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1. Introduction

It is not possible, and never has been, to claim superiority for either fixed or flexible exchange rates once and for all. Sometimes fixed rates work well, sometimes flexible. This is why some nations choose to fix the exchange rates of their currencies in various ways, and

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others do not. This makes perfect sense: the choice depends on time and circumstance. This paper examines some pertinent considerations.

2. Benefits and costs

2.1. An example from Iceland

Albeit unfamiliar to most, Iceland is a case in point. From 1927 until 1960, the Icelandic economy was poorly managed, to put it mildly. As in Ireland next door, and partly, perhaps, for comparable postcolonial reasons,[1] the economic policy regime in Iceland was inward-looking and myopic, strict import protection and foreign exchange controls were the order of the day, as were export subsidies aimed mostly at the fishing industry which accounted for an overwhelming share of merchandise exports. To make matters worse, the state banks were instructed to keep the fishing industry afloat despite mounting inefficiency and recurrent heavy financial losses.

Against this background, therefore, it made good sense in the 1960s to devalue the króna a few times as was done, because the exchange rate realignment was an essential ingredient of the radical liberalization of the economy, ten years after similar liberalization was undertaken in much of the rest of Europe. The abolition in 1960–1961—virtually overnight!—of export subsidies that had absorbed almost a half of the government budget and a radical reduction in import tariffs and exchange controls were needed to accompany the concurrent devaluation to keep the balance of payments in reasonable equilibrium. The funds that were released by the abolition of export subsidies were channeled to education, health care, and social security—and also, alas, to increased farm subsides. The main point here, however, is this: without devaluation, these economic reforms, the most sweeping reforms ever undertaken in one swoop in the history of the republic, would have triggered an uncontrollable deficit in the balance of payments and turned the economy upside down. Had an attempt been made instead to achieve a comparable realignment of the real exchange rate through domestic fiscal, monetary, and incomes policies on top of the radical structural reforms without devaluation, it would almost surely have been futile.

It also made good sense in the late 1980s to try to keep the exchange rate of the króna fixed (to a basket of trade-weighted currencies), because the circumstances had changed: at that time the battle against inflation was the first priority of economic policy. Experience seems to show that it is as a rule impossible to stop high inflation without nailing down the exchange rate at least as long as it takes the inflation to subside (Dornbusch & Fischer, 1986), or that at least was the conventional wisdom before New Zealand started with inflation targeting in 1989. True, the real exchange rate of the króna increased for a while, which hurt both the export and import-competing industries, and this was not good for an economy that was, and remains, far too closed for its size,[2] but that was the price that had to be paid for successful disinflation.

There is, however, hardly any doubt that the devaluation of the currency in the 1960s helped pave the way for the inflation of the 1970s and 1980s, when inflation peaked at more than 80% in 1983. Yet, it would be unwise to blame the escalation of inflation on the