The Question of a Fixed Exchange Rate for Jamaica
An Answer from Theory and Practice
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EXECUTIVE SUMMARY

Whenever the Jamaican dollar comes under pressure, there typically results a public debate as to whether the country should change its currency regime to some form of fixed exchange-rate or dollarisation. The recent experience of depreciation vis-à-vis the US dollar has been no exception. To inform this discussion, the Caribbean Policy Research Institute (CaPRI) elected to do a short study of the options facing the country in this respect. We found that the important choice is not whether the country installs a fixed or floating exchange regime, but whether the fiscal and monetary undergirding is balanced and stable. In the absence of such a sound undergirding, repeated devaluations appear inescapable.

THE REGIMES

Let us start with the two basic alternatives. In flexible, or “floating”, exchange rate regimes, the exchange rate is determined at every point in time by the demand for and supply of foreign currency. Notwithstanding occasional intervention, there is no obligation by a central bank to ever enter the foreign exchange market in such a regime. Changes in the level of foreign reserves of the central bank are purely a matter of choice.

Under a fixed exchange rate regime, the exchange rate is determined by the central bank’s willingness and ability to trade at the announced rate. An exchange rate can only be fixed with that willingness - the role of the central bank in a fixed exchange rate regime. Any inequality between the private demand for and supply of foreign exchange ends up being bought or supplied by the central bank. Fixing the rate necessitates that the central bank gives up choosing the amount of international reserves it holds. Further, every foreign exchange transaction conducted by the central bank is simultaneously a domestic currency transaction. Domestic currency is, after all, what the bank is purchasing the foreign currency with, and selling it for. Monetary policy, therefore, comes to be conducted at the foreign exchange window of the central bank as the backside of the foreign exchange transaction.

STRENGTHS AND WEAKNESSES

Depreciations and appreciations of the exchange rate are a useful “shock absorber” for an economy and are therefore especially useful for an economy that is vulnerable to external economic events and natural disasters. In the absence of exchange rate movements, the economy is subjected to deep cyclical contractions to adjust to the shocks.

A flexible regime which allows the exchange rate to respond to imbalances, however, can provide too much latitude for the central bank to increase the
money supply too frequently and create inflation. A fixed rate provides an “anchor” for monetary policy and therefore inflation.

While both types of regimes have their strengths and weaknesses, they both become undermined by fiscal indiscipline and monetary laxity. Fiscal deficits push up the cost of capital by raising interest-rates and create unproductive inflows of foreign exchange to finance the deficit - whether the government borrows domestically or internationally. This causes import-substitutes as well as exports to become more expensive and therefore uncompetitive. This, in turn, depresses the level of production. This occurs irrespective of the exchange rate regime.

If the central bank is not disciplined in its monetary policy, and does not restrict its issue of base money to that which flows out of the foreign exchange window, the extra liquidity will inflate the economy. This will eventually show up as [unbacked] increased demand for foreign exchange. Since the demand is unbacked, the central bank will eventually exhaust its reserves and then can no longer maintain its peg.

Without fiscal discipline and monetary prudence, then, economies develop macroeconomic imbalances that put pressure on the exchange rate, irrespective of exchange rate regime. Where there is a flexible regime, the imbalances manifest as frequent exchange rate movements. Under a fixed regime, however, the imbalances build up for a longer time, often creating disruptive periods of speculation and capital flight betting on a devaluation. Those periods are accompanied by production downturns that are damaging in their own right and also inhibit economic growth.

**COUNTRY EXPERIENCES**

Barbados has successfully maintained its peg by disciplined monetary management, guided by the exchange rate imperative and with drastic fiscal corrections whenever called for. Argentina, which had the benefit of more rigid institutionalization, was spectacularly unsuccessful in sustaining its rate because persistent fiscal deficits gradually undermined the competitiveness of its businesses.

Beyond Barbados, there are few examples in the last half century of sustained fixed exchange rate regimes. Instead the plethora of fixed regimes that obtained only 30 years ago have mostly given way to flexible regimes throughout the developing world. These countries seem to lack the institutional strength, fiscal control, and monetary discipline required in the face of their numerous structural weaknesses and vulnerabilities.
...AND THEREFORE

The conclusion is that, while for a selected few a fixed exchange rate regime acts as an anchor for monetary policy and creates stability in external economic relations, success in such a regime calls for a strength of fiscal management that has so far eluded Jamaican administrations. The evidence of good fiscal management would be a fiscal deficit far lower than obtains at present. Until such time, a fixed exchange rate would create a more unstable environment than now exists.
One of the most challenging areas of economic policy concerns the choice of an exchange rate regime. At the opposite ends of that issue are the alternatives of fixed and flexible exchange rates. Theory is agnostic, but experience suggests that the difference between fixed and flexible regimes is not one of stability or instability. Rather, it is a choice of whether you prefer your instability in small, frequent doses, as you get with a flexible regime, or in infrequent, large, discreet jumps, as tends to happen with fixed or “pegged” rates. The reason is that macroeconomic instability requires exchange rate realignments. As a policy-maker, then, your only options are whether the realignments follow the market immediately and relatively smoothly or lag the market and jump dramatically. To avoid that unsavory choice, fiscal and monetary policy must ensure stability so no realignments are ever necessary. This brief will explain why.

**EXCHANGE REGIMES EXPLAINED**

**A FLEXIBLE EXCHANGE RATE**

Under flexible or “floating” exchange rate regimes, the exchange rate is determined at every point in time by the demand for and supply of foreign currency. Since the steady demand for foreign exchange derives from imports and investment outflows while the supply of hard currency is sourced largely from exports and foreign direct investment, movements in the currency value are automatic responses to the changes in those foreign currency flows. **Long-term stability** in the context of a flexible exchange rate therefore requires that the economy is not building up imbalances in those flows over time.

Even if the economy does not have a long term imbalance in net outflows, in any month, inflows or outflows can change significantly and temporarily due to episodic events. Examples of such events are government borrowing or debt repayments, foreign direct investments, and changes in domestic interest rates. These transitory influences on the foreign exchange market can be smoothed away by countervailing action by the central bank, known as “sterilization.” When central banks, as Jamaica’s has done recently, engage in that kind of smoothing, the regime is referred to as a “managed” or “dirty” float.

Despite attempts to manage the float, there is no obligation by a central bank to ever enter the foreign exchange market in a flexible regime. The foreign reserves of the central bank become a pure policy choice in that the bank would buy only if it wishes to accumulate reserves and will sell when it wishes to deplete them. The central bank can end up with any level of net international reserves that it desires as long as it is prepared to put up with the consequences for the market-determined exchange rate.
A Fixed Exchange Rate

Under a fixed exchange rate regime, the exchange rate is determined by the central bank’s willingness and ability to trade at the announced rate. An exchange rate cannot be fixed without that willingness. That is the role of the central bank in a fixed exchange rate regime. As long as the central bank is willing to make a market at a particular rate, sellers will not be willing to take less from anyone else and buyers will have no reason to pay more. So the entire market will trade at the central bank’s rate.

In this case, any inequality between the private demand for and supply of foreign exchange ends up being bought or supplied by the central bank. Fixing the rate, therefore, necessarily implies that the central bank gives up control of the amount international reserves it holds.

Further, every foreign exchange transaction conducted by the central bank is simultaneously a domestic currency transaction. Domestic currency is, after all, what the bank is purchasing the foreign currency with, and selling it for. Monetary policy, therefore, comes to be conducted at the foreign exchange window of the central bank as the backside of the foreign exchange transaction.

This is the critical point to understand about a fixed exchange rate regime. As long as the only source of monetary policy is foreign exchange transactions, the regime is stable. But for that to be the case, the monetary authority must eschew the usual options for managing liquidity, such as open market purchases and sales of government treasury bills and the bank’s own certificates. This regime, if it is to be sustainable, also eliminates the possibility that the central bank can provide funding for a fiscal shortfall, because that, too, would be an act of money creation that would undermine the fixed exchange regime.

Because it is the central bank’s willingness and ability to trade at the fixed rate that actually accomplishes the fixing, the central bank must have and maintain a stock of foreign reserves adequate to meet the market’s excess demand and to provide the confidence that the peg is defensible. If the central bank does not have sufficient foreign currency reserves at its disposal, then the peg will be vulnerable to a currency attack in which individuals hurry to dump the local currency before reserves run out and devaluation is forced. Unfortunately, currency attacks are often self-fulfilling, in that they deplete reserves faster and make the devaluation necessary.

The long term sustainability of the fixed exchange rate regime therefore requires that monetary policy be conducted only at the foreign exchange window of the central bank. Otherwise, what may have been adequate reserves initially will quickly be inadequate for the expanded money stock.
WHICH IS BETTER?

On strictly theoretical grounds, the choice of exchange rate regime is a matter of identifying the appropriate conditions where each would apply. Each type of regime solves different problems and brings its own challenges.

THE PROBLEM WITH FIXED

Central banks, with their plethora of instruments for influencing the level of liquidity and thereby the general price level, evolved for good reasons, many of those reasons being exemplified by the current global financial crisis.

Occasionally, an economy faces a “negative shock” – an event which requires a contraction in production or consumption. Such shocks have many sources: a hurricane reduces productive capacity or a rise in oil prices raises the cost of production. All such shocks require that the residents of the country reduce their aggregate consumption level. The critical issue is, how is this accomplished?

Consumption will fall if incomes fall – real income, that is. Real income will fall if unemployment becomes so prevalent that workers are forced to accept a lower money wage as a preferred alternative to no job at all. People generally don’t accept a lower money wage unless they are persuaded that the only alternative is unemployment.

Alternatively, real income can fall if everyone keeps their current money wage (and their jobs), but the exchange rate and therefore the prices of all goods and services rises by a commensurate amount. This solution reduces purchasing power without requiring a reduction in the actual money wage.

In the event of negative shock, a central bank can purposefully allow inflation and a commensurate depreciation in order to effect the reduction in the capacity to consume. Everyone’s income and consumption falls without too much productive dislocation.

In the presence of fixed exchange rate regime, however, the central bank does not have that option. It cannot allow a depreciation as a quick means to rebalance consumption with production -- or for any other reason, for that matter. So in the presence of, say, an oil price increase, higher payments for electricity and petrol require dramatic reductions in the consumption of everything else. Such a reduction will force layoffs and create open unemployment until enough people are forced to work for a lower money wage. Experience suggests that that takes a long time.

There is one way out of this box of shocks. Suppose the economy that you are pegged to is suffering a similar shock simultaneously. Then, its own central bank will be making the appropriate response -providing extra liquidity as in the event of a financial crisis like the one being experienced now. That extra
credit will naturally show up as extra foreign exchange inflows on the shores of the economy. When purchased by the local central bank, it will translate some of the liquidity boost to the local economy. In the happy circumstance, of the two economies moving in cyclical tandem, the loss of monetary autonomy that comes from a fixed exchange rate is not harmful. However if, on the other hand, the two countries are not experiencing the same shock simultaneously, a fixed exchange rate can become problematic. If the central bank of the economy to which the currency is pegged is fighting inflation by withdrawing money from the economy, and the home country is trying to raise its growth rate, the tight monetary policy might actually choke off growth in the developing country.

The conclusion to draw is that the ability to inflate the economy can sometimes save the country from deep dislocation and a long contraction after a negative shock. Pegging will be harmful unless the economy to which you are pegged suffers simultaneous swings.

**THE PROBLEM WITH FLEXIBLE**

While having the ability and the authority to create inflation can occasionally be useful, as indicated in the above example, the ability is used far more often than is warranted. The experience of many countries, especially those in the developing world, is that central banks end up creating inflation. Indeed, this has been Jamaica’s own experience. Since 1974, the inflation rate has been in double digits for all but a handful of years.

With discretion over when to increase the money supply, central bankers too often choose to inflate because they misunderstand the state of the economy. Far more often, they are obligated to do so because the government of the day needs money to bridge a fiscal gap. Without a fixed rule governing when to expand liquidity, providing an “anchor”, discretionary monetary expansions are promulgated too often, with inflationary consequences.

A fixed exchange rate can provide such an anchor. If the central bank is bound to maintain the currency peg, it ought not to increase liquidity under any other circumstances. If it does not create liquidity in any other way, the economy cannot have high inflation and need never depreciate.

**WHO SHOULD FIX**

The answer to the question, “which is better” therefore turns on the particularities of the economy’s conditions and needs. From the above discussion we can derive a check list of conditions that suggest where a fixed exchange regime would be appropriate.

1. The country exists in a stable economic and natural environment and is not subject to frequent negative shocks. Alternatively, the country’s shocks are
coterminalous with those of the country to which it is pegged. With Jamaica’s economy vulnerable to the fickleness of tourism and the susceptibility to hurricanes, such stability and co-cyclicality with the United States would not seem to be the case.

2. If the country is large with only a small percentage of its activity related to trade, then most of its shocks will be internally generated and less likely to be co-cyclic with its major trading partner. A fixed exchange rate is therefore more likely to succeed in a small, open economy.

3. A large percentage of trade is undertaken with the trading partner to whose currency it plans to peg.

4. There is high mobility of labour amongst sectors and flexibility of wages. This ensures that the economy will recover quickly to setbacks either to specific sectors or to the whole economy.

5. If there is a history of inflation, then the disciplined application of a fixed exchange rate could provide an anchor for monetary policy, tying the country’s inflation to that of the country to which it is pegged.

6. The central bank has access to an adequate level of foreign currency reserves to satisfy all of the potential demand for foreign exchange.

7. The fiscal accounts are close to balanced, or at least, the deficits are below the rate of economic growth so that its debt to GDP ratio is not rising.

8. The country has a strong, well-supervised, and regulated financial system.

**THE FUNDAMENTALS OF INSTABILITY**

The choice of regime, though, does not determine whether an economy is unstable. Rather, it determines how that instability is manifest. Both fixed and flexible exchange rate regimes resolve macroeconomic imbalances in different ways.

**THE PROBLEM OF FISCAL DEFICITS**

Fiscal deficits have to be either monetized (financed by money creation) or securitized (financed by borrowing). Under a fixed exchange rate regime, monetization would violate the rules for maintaining the currency peg. The excess liquidity would create excess demand for foreign exchange that the central bank would not have sufficient reserves to meet. The authorities would eventually be forced to re-align claims and reserves by adjusting the fixed rate -- that is, devaluing. Under a flexible regime, monetization and the ensuing inflation would immediately depreciate the currency.
If instead of money creation to finance the deficit, debt is accumulated, the borrowing would generate an inflow of foreign exchange. If the government borrows abroad, that represents a straightforward inflow of foreign exchange. But even if it borrows locally, the resultant rise in interest rates will incentivize an inflow of foreign capital nonetheless. What happens next depends on the country’s exchange regime. What happens ultimately does not.

If the country has a flexible exchange rate regime, the extra inflow of foreign exchange appreciates the currency. That over-valuation tends to make local import substitutes as well as exports more expensive abroad, and thereby uncompetitive. This therefore depresses the level of production. This is the scenario, incidentally, that has played out in Jamaica.

But if the economy is governed by a fixed exchange rate regime, then the monetary authorities cannot allow the capital inflow to appreciate the currency, so the inflow is sterilized – the foreign exchange is bought by the government at the pegged rate. So instead of excess foreign exchange floating around, the economy will have excess local currency. This, however, is inflationary, which once again makes local import substitutes as well as exports uncompetitive.

Sustained fiscal deficits weaken the economy, regardless of whether they are monetized or borrowed, and regardless of the exchange regime in place. That weakness, we will see below, can itself challenge the stability of a fixed regime.

**THE PROBLEM OF MONETARY LAXITY**

The primary mission of a central bank is to maintain the value of the currency, whether measured against goods and services (inflation) or other currencies (depreciation). But a central bank faces many temptations, and sometimes obligations, to shift its focus from its central goal.

A government that is unable to avoid fiscal deficits can borrow in the present, but ultimately will be required to run a fiscal surplus if it is to repay.

Otherwise, the government is forced to turn to its central bank in order to finance the ongoing deficit with money creation and to inflate away the value of its outstanding domestic currency debt. As the central bank complies, it will create inflation, which in turn will undermine the status quo ante in the exchange rate.

In the presence of an event that raises costs (such as an oil price increase) or reduces capacity (such as a hurricane), the central bank will be tempted to increase its money supply in order to avoid the dislocating contraction that nominal wage reduction implies.

However doing so is incongruent with the central mandate. This has been the norm throughout Jamaica’s post-independence economic history and
throughout Latin America’s as well – that central banks become guilty of liquidity leakage, ultimately undermining the value of the currency.

If there is a flexible exchange rate, the trend inflation is accommodated by a secular depreciation of the exchange rate. If, however, there is a fixed exchange rate, the rate becomes untenable and the authorities are forced into a “one-time” devaluation.

So if a country is prone to large and persistent fiscal deficits and monetary indiscipline, then there is another dimension to its choice of exchange regime. If it prefers its depreciations relatively smooth and frequent as Jamaica’s have been, then it should choose a flexible regime. With a fixed regime, the pressures for a re-alignment can build for a long time, which provides a long period of exchange rate constancy, but usually end with a dramatic and disruptive devaluation preceded by months of contraction, uncertainty and speculation. It’s a choice of pay now or pay later; but eventually, the cost of living beyond its means will come back to haunt a country.

COUNTRY EXPERIENCES

Whereas theoretical guidance suggests that structural conditions and history are key factors in the choice, experience is more definitive. In this section, we look at the good (Barbados), the bad (Argentina), and the ugly (Jamaica) of fixed exchange rates experiences. Then we draw upon worldwide experiences with fixed exchange rates to assess the prospects for a fixed exchange rate in Jamaica. We start at home.

JAMAICA: A VARIETY OF EXCHANGE REGIMES

Jamaica has experimented with a variety of regimes during its economic history. Prior to independence, the country operated with a currency board – an extreme form of fixed exchange rates in which the monetary authority, the currency board, cannot legally issue domestic currency for any reason to any party other than in a foreign exchange transaction. Since this begins at inception, the currency is fully backed by foreign reserves, and the exchange rate need never change. In this light, a fixed exchange rate regime is an attempt to achieve a similar outcome with similar means, but through the discipline of the central bank in its use of monetary instruments rather than by banning.

The Bank of Jamaica Act (1962) deposed the currency board and ushered in the era of central banking, with a fixed exchange rate. With the introduction of exchange controls in 1974, the Bank of Jamaica ceased to guarantee transactions at the official rate and so, despite the government’s intentions, an
era of flexible exchange rates began. During this period, the central bank largely accommodated the foreign exchange transactions of that small number of persons who had a license granted by the trade board for a limited range of uses.

In the absence of the central bank’s unhindered participation in the market, a flexible regime must obtain. So in the 1970s and early 1980s, the vast majority of foreign exchange transactions occurred at a market-determined rate - the “black” market rate. Whatever its location on the grayscale, though, it was THE market for foreign exchange. Unfortunately, because of the legal prohibitions, it was an inefficient market, and that inefficiency manifested itself as a high spread between the buying and selling rate.

With the repealing of the Exchange Control Act in 1992, the legal prohibitions were lifted and a far more efficient flexible exchange regime emerged with considerably lower spreads. That regime, accompanied by targeted and disciplined interventions by the Bank of Jamaica, continues to the present.

**Barbados: A Peg Well Done**

The Barbadian dollar is pegged to the U.S. dollar at a rate of BDS$2 to US$1. This peg has been successfully maintained for more than thirty years. External transactions on the current account are free of restrictions and the Central Bank of Barbados conducts all current transactions without hindrance at its established rate. There is a registration process for capital account transactions, but inward investment amounts and earnings may be repatriated in full once the inflows have been registered.

The first challenge to the regime came in the economic wake of the 1980 world oil crisis. The higher cost of energy led to a contraction in output and a cost-push inflation rate in excess of 10%, along with rapidly depleting foreign exchange reserves. The government’s response was a deficit-reduction programme consisting of new taxes and a cut in government expenditure. The stringent programme allowed Barbados to negotiate a Standby Agreement with the IMF, providing the reserves needed to ride out the excess demand for foreign exchange, which eventually subsided with the fiscal correction.

The next episode that challenged the regime occurred in 1991 when the fiscal deficit ballooned to seven percent of GDP as fiscal discipline slipped in the latter part of the previous decade. This necessitated a rising foreign debt and the fiscal obligation to service it. The intensifying problem became a crisis when credit to emerging markets became scarce in 1991 and Barbados was unable to roll over maturing loans. The foreign currency reserves had to be depleted substantially to only a few weeks worth of imports, an amount insufficient to defend concerted capital flight.
Once again, the government met the challenge with a fiscal rebalancing that, this time, was as draconian as the dire circumstances required. The principal adjustment was a reduction in recurrent expenditure by the government on the basis of a cut in public sector salaries. That measure was accompanied by the privatization of some government-owned entities and a tax restructuring. The fiscal deficit fell to 1.6 percent.

By sticking to the peg and having government disciplined enough to make fiscal corrections when necessary, the Central Bank of Barbados has been able to dedicate monetary policy to maintaining the peg, anchoring inflation to that of the economy to which it is pegged. Barbados has experienced an average inflation of only 2.5% since 1992. On the other hand, the country has experienced greater volatility in output and employment and the need for occasionally painful, and politically costly, fiscal corrections.

ARGENTINA: AN INSTRUCTIVE FAILURE

Argentina established a currency board in 1991. Its Convertibility Law stripped the central bank of any authority to issue local currency except for foreign exchange transactions, with one important exception. The law guaranteed the convertibility of the Argentine currency at the fixed rate of one Peso to one U.S. dollar.

Argentina had not fit the profile of a candidate for such a regime in one key respect – it had had a long and debilitating history of high inflation, including an episode of hyper-inflation. Argentines had little faith in the ability of the government to maintain the value of the currency and as a result informal dollarization was widespread.

The regime delivered on its biggest promise in bringing inflation dramatically down to low single digits for the first time in modern Argentine history. In the presence of that stability, Argentina experienced impressive economic growth in the mid 1990s.

In every other respect, however, Argentina was a poor candidate for such a regime. It pegged to the currency of the United States, a country with which it conducts a relatively small amount of trade compared to the exchange of goods and services with its near neighbours, Brazil, Uruguay, and Chile. Moreover, the amount of domestic economic activity in Argentina is not small compared to the amount of international trade, which allows many opportunities for internally generated booms and busts to push the economy out of alignment with its fixed rate.

Another weakness was that the Convertibility Law initially required that only two-thirds of the central bank assets be invested in foreign currency reserves. The remainder could be held in the form of Argentine government bonds. In doing so, the arrangement violated the core principle of a currency
board, allowing for the possibility of pursuing some degree of discretionary monetary policy, but more importantly, opening the door for capital flight since the entire monetary base was not backed by foreign reserves.

Argentina also had powerful labour unions. Large firms could not easily shed labour as other costs rose, which created rigidity in the labour market.

Finally, the Argentine government structure is constitutionally prone to fiscal deficits. Provinces in Argentina had a degree of autonomy over expenditure which then created debt obligations that the central government had to absorb. The inability of the national government to rein in powerful and spendthrift provincial administrations produced continuous overall fiscal deficits and rising public debt.

In the late 1990s, when the U.S. dollar began to appreciate, Argentina experienced an automatic revaluation relative to the neighbouring countries – the very countries with which it conducted most of its trade. Then in 2000, Brazil devalued its Real, further exacerbating the cost disparity with Argentina. The Argentine Convertibility Law and its specified peg to the U.S. dollar prevented a matching devaluation. The two events made the Argentine currency massively overvalued with respect to its major trading partner, Brazil, an overvaluation that may have been as high as 40%.\(^1\)

Under the assault of the overvalued currency and the high debt burden, and in the context of not having the option of slashing purchasing power across the board with a swift devaluation, economic logic dictated that the cut in income and consumption had to occur by idling productive resources. GDP declined by over 20% in the three years after 2001 and domestic prices began to fall. But not fast enough. These pressures created rising social unrest.

The collapsing economy, rising debt, falling confidence, and burgeoning unrest all came to head in 2001 to 2002 when the country went through no less than \textbf{four administrations in 18 months}. Eventually, there had to be a devaluation, so the currency board was abandoned, the exchange rate quadrupled, and a flexible exchange rate regime was instituted.

While Argentina was an ill fit with the United States as a monetary partner and failed to implement the text book currency board, the regime achieved its main aim of inflation control and was effective for a time. But the ultimate undoing of the regime was the combination of sustained fiscal deficits and an economy insufficiently flexible to effect the required contraction and income reduction.

\footnote{Rajan (2002)}
THE BROAD EXPERIENCE

The experiences of Barbados and Argentina were selected to highlight the two extreme outcomes, but very few countries have been able to sustain a fixed exchange regime, much less the actual value of the peg. Whereas the vast majority of developing countries, almost 90 percent, had fixed exchange rate regimes in the mid 1970s, twenty years later that proportion was down to less than half. For example, the countries of the CFA Franc zone in sub-Saharan Africa have managed a relatively stable peg over a sustained period, but there was a substantial devaluation in 1994. Why is the Argentine experience so much more common than the Bajan?

Pegged rates are short-lived because, when most administrations are faced with the choice between political suicide and expediency, the relatively easy path is chosen. The expediency of a “one-time” devaluation of the “fixed” rate seems and is relatively painless. But the factors that lead to the imbalances that produced the need for the devaluation continue uncorrected, so before long there is need for another devaluation. Before long, the staccato disruptiveness of repeated devaluations is recognized and the regime is abandoned.

Another factor that contributes to the difficulty of adhering to the established rate in a fixed-rate regime is the frequency and severity of contagious shocks in the era of globalized flows of goods and finance. Since 1980, there have been several oil shocks, interest rate swings, commodity price booms and busts, and financial crises of various types and magnitude.

Finally, most developing countries, and especially those in the Caribbean, continue to experience difficulty in maintaining fiscal discipline. The Caribbean contains almost half of the 30 most indebted countries in the world, and all but Jamaica have become so because of continuous deficits in the recurrent fiscal account.

The experience of the world over the last thirty years would, therefore, seem to suggest that Barbados is more an exception than a model. Whether the particular institutional arrangements that make for the Barbados fixed exchange rate regime are exportable is unclear, but also unlikely.


3 Sahay (2004)
CONCLUSION

The success of a foreign exchange rate regime is ultimately measured by its ability to support a country’s economic goals -- usually stability and economic growth. Once a government decides on its priorities, it must take into consideration the limitations imposed by the structural characteristics of that particular country. The primary advantage of employing a flexible exchange rate regime is that it allows for the use of monetary policy, which ends up as exchange rate movements, in smoothing out the fluctuations in the price level, output and unemployment whenever there are shocks to the economy. However, it exposes the activities of consumers, producers and the government to currency risk and lends itself to higher levels of inflation than a fixed regime.

A fixed exchange rate regime is designed to eliminate currency risk and to anchor inflation at a low rate. It ought to preclude the use of monetary policy as a stabilizing tool and as a source of deficit financing. At the very least, the economy will therefore experience greater volatility of output and unemployment than it would under a flexible regime. But in practice, most attempts at a fixed regime fail even to eliminate currency risk and anchor inflation, prone as they have been shown to be to periodic devaluations and ultimately regime abandonment.

Regardless of the exchange rate regime being employed, and the implicit priorities associated with it, fiscal and monetary discipline are still of paramount importance. While a fixed exchange rate provides an opportunity for fiscal discipline and an obligation of monetary stringency, neither regime can inherently instill that discipline. And in the absence of relatively low fiscal deficits or none, a fixed regime will compound a misaligned exchange rate and periodic speculative crises on top of the fiscal cost of deficits. So before any government can contemplate a switch to a fixed exchange rate regime, it must first start by balancing its fiscal budget, followed by the establishment of a framework for fiscal management in the future.

In a flexible exchange rate regime, exchange rate movements reflect real economic activity as influenced by the fundamentals of the economy, such as fiscal imbalances and external shocks. In a fixed exchange regime, however, it is economic activity that must adjust to the exchange rate. In either case, it is the macroeconomic fundamentals and institutional structures that determine stability and in turn prosperity.

There is no substitute for fiscal balance, conservative monetary policy, and resilient institutions in ensuring a favourable exchange rate. It is on these that policy-makers must focus their attention.
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