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A New Assessment of Floating Exchange Rates

by D. R. Waimann*

The switch to floating exchange rates during the 1970s has given economists the first comprehensive opportunity to assess the arguments for and against floating. Much new work has been done on various aspects of floating exchange rate behaviour. This article attempts a limited survey of the evidence concerning two important issues – whether floating exchange rates are inherently unstable and whether they harm international trade.

The new theories of exchange rate determination point to the possibility of greater exchange rate uncertainty and volatility under floating rates; that is, there are special destabilising forces which come into play which may be peculiar to floating exchange rates. Friedman's¹ seminal article entitled "The Case for Flexible Exchange Rates" denies the possibility of destabilising speculation. This assertion stems from the belief that speculators will iron out temporary movements in the exchange rate and will not hinder the permanent changes in the rate. But can speculators differentiate between temporary and permanent changes in the exchange rate? The fact that short-run movements in exchange rates have been far greater than the corresponding movements in domestic price levels, suggests that they cannot.

Neither is this phenomenon compatible with the two traditional theories of exchange rate determination – purchasing power parity theory and what Isard² describes as "the popular balance of payments view". Purchasing power parity is not a complete theory of exchange rate determination. It simply emphasises the relationship between relative prices and the exchange rate. There are severe doubts as to whether it now holds in the short run, let alone the medium and long runs. The popular balance of payments view also suffers from short-run deviations in exchange rates. The old notion that a worsening balance of payments on current account is associated with a depreciating exchange rate is accepted by most economists, but not without

qualification. The shortcomings of these two major theories led to a situation where Bilson³ says there was no generally accepted economic theory of the determination of exchange rates.

In recent years, various new theories have been brought forward which have attempted to fill this vacuum. The most important of these are the

- asset market theories and the
- speculative run theories.

These two theories virtually ignore current account positions and maintain that in the short run financial considerations which affect capital account transactions are dominant.

Asset Market Theories

Asset market theories and the popular balance of payments view do not differ to any great extent, so long as the popular view emphasises the capital account. Thus a current account deficit can be associated with a stimulative government budget and a currency depreciation, or buoyant investment expenditure and a currency appreciation.

Asset market theories treat the exchange rate like an asset price, i. e. "the relative price at which the stock of

¹ M. Friedman: The case for Flexible Exchange Rates, in: Caves and Jones (eds.): AEA Readings, 1968.

² Isard: Exchange Rate Determination: A survey of popular views and recent models, in: Princeton Studies in International Finance, No. 42, 1978.

³ Bilson: The Monetary Approach to the Exchange Rate: some empirical evidence, in: IMF Staff Papers, 1976.

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money, bonds and other financial and real effects of a country will be willingly held by domestic and foreign asset holders".⁴ Therefore, at times of rapidly changing interest rate differentials and exchange rate expectations, the exchange rate is likely to fluctuate violently in the short term.

One of the advantages of the approach is that it allows for the numerous factors that affect exchange rate expectations, e. g. monetary and fiscal policies, official intervention in the exchange market, political uncertainties etc. to, at the same time, determine the exchange rate. Asset holders will continually adjust their portfolios according to the changing circumstances.

Overshooting Mechanisms

Within this framework various mechanisms have been identified which could cause the short-run exchange rate to overdepreciate.

□ Dornbusch⁵, amongst others, has formulated a dynamic model in which an initial overshooting of the exchange rate can take place because of differential speeds of adjustment between prices and exchange rates. Exchange rates overreact when asset markets adjust faster than goods markets. Starting from a monetary expansion, Dornbusch believes that interest rates will fall, together with a simultaneous fall in the exchange rate to a level where the public anticipate an exchange rate appreciation. This fall will be below the short-run purchasing power parity level because real output does not react to a monetary expansion immediately. The result will be that spot rates will depreciate further than forward rates and the expected future increase in real output will cause the forward premium to increase. Therefore spot rates should fluctuate more violently than forward rates.

However, Isard⁶ observes that since the advent of floating, this last phenomenon has simply not happened. The differentials between spot and three-month forward rates have not varied significantly. Even so there may still be some truth in Dornbusch's argument if longer term forward rates show greater stability.

□ Artus and Crockett⁷ identify a risk aversion mechanism which could overdepreciate a currency. A devaluing country with a balance of payments deficit will

increase the quantity of that country's currency held by traders. The traders will be unwilling to commit themselves to too large a holding of a depreciating currency and would prefer to keep a safe spread of currencies in their portfolio balances.

□ Friedman⁸ himself admitted that when a substantial change in external circumstances occurs followed by a period of relative calm, some overshooting or undershooting may take place before equilibrium may be reached. But he claimed this would only arise if there were intervention by the monetary authorities, otherwise there would seem to be no reason to expect the timing of adjustment to be systematically biased in one direction. However, this may be a "hydra-headed" situation. Official intervention in the market to overcome destabilising mechanisms of one sort may only have encouraged overshooting mechanisms from alternative sources. Mussa⁹ tends to agree with this hypothesis. He is of the opinion that government intervention makes it more difficult for speculators to estimate the long-run equilibrium rate and so they have tended to act in a destabilising manner. The ability of speculators to act in a stabilising manner may also have been hampered by imperfections in the international capital markets. Therefore MacKinnon¹⁰ argues that the removal of exchange controls on the number of dealers and the size of the positions they can legally take, would lead to greater exchange rate stability.

Speculative Run Theories

The three overshooting mechanisms may not be a sufficient explanation of the exchange rate volatility of recent years. Certainly there is no reason why they should not have been present during the float of, for instance, the 1920s, when prices were more unstable than exchange rates. During the 1970's the reverse has been true. Even so, together with other factors (e. g. variations in interest rate differentials which according to Artus¹¹ have in certain cases led to large fluctuations in the exchange rate), they can provide the sparks which can set in motion various speculative run theories. These theories were of relevance even under fixed

⁴ Artus and Crockett: Floating Exchange Rates—some policy issues, in: Finance and Development, Dec. 1977.

⁵ Dornbusch: Expectations in Exchange Rate Dynamics, in: Journal of Political Economy, Dec. 1976.

⁶ Isard, op. cit.

⁷ Artus and Crockett: Floating Exchange Rates and the Need for Surveillance, in: Princeton Studies in International Finance, 1978.

⁸ Friedman, op. cit.

⁹ Mussa: The Exchange Rate, Balance of Payments, and Monetary and Fiscal Policy under a Regime of Controlled Floating, in: Scandinavian Journal of Economics, 1976.

¹⁰ MacKinnon: Floating Exchange Rates 1973-4 – The Emperor's New Clothes, in: Brunner and Meltzer (eds.): Institutional Arrangements and the Inflation Problem, 1976.

¹¹ Artus: Exchange Rate Stability and Managed Floating. The Experience of West Germany, IMF Staff Papers, 1976.

exchange rates but under the present circumstances they have gained in importance. This is due to three major developments which have caused today's circumstances to be so different from any previous period in which floating rates have been in operation:

- the growing "internationalisation of banking" and most importantly, the meteoric rise of the Euro-Currency Markets;
- the growth of international trade and incomes worldwide plus the fact there has been a redistribution of world income to a group of traders with lower marginal propensities to consume, i. e. OPEC;
- the growing size of multinationals is especially important. In fact, intra-industry trade, i. e. trade taking place within a corporation across national boundaries, now constitutes one third of all international trade.

These developments have brought about an increase in the supply of speculative funds and, not surprisingly, a simultaneous increase in speculative activity in both the foreign exchange and commodity markets. Because of the similarity between these two markets, it may be helpful to draw an analogy between them. This analogy draws attention to the potentially highly unstable nature of speculative activity in foreign exchange markets. The two markets are not perfectly alike since the value of paper money will depreciate with inflation whereas commodities, being part of the goods market, will not on the whole be affected by rising inflation.

Professional Speculators

The motives for holding currency can be explained in Keynesian terms. A currency is held on the one hand by domestic traders and monetary authorities and on the other by professional speculators as well as banking institutions and traders with surplus balances over and above their needs for transactions and precautionary purposes, i. e. for speculative motives. In contrast to the domestic traders and monetary authorities, these latter agents have an elastic demand for any currency. The framework gives an indication as to why Friedman's¹² claim that "It is unlikely that a body of professional speculators profit at the expense of a changing body of amateurs, who regularly lose larger sums", is

¹² Friedman, *op. cit.*

¹³ Similarly in commodity markets, speculators may be seen to be profiting at the expense of commodity producers and consumers.

¹⁴ Nurkse: *International Currency Experience*, 1944.

¹⁵ This is especially true now because of the relative ineffectiveness of devaluations. Nowadays speculators may consider a slight depreciation of the exchange rate to be more a sign of the underlying uncompetitiveness of the country's economy rather than a sign that the country's exports will be more competitive in future.

erroneous. The speculating agents are the ones able and willing to manipulate their funds from one currency to another, and they will on average profit at the expense of other currency holders.¹³

This framework also gives one a greater understanding as to how speculative run theories can come about. One of the most important of these theories has its origins in Nurkse's¹⁴ study of inter-war exchange rate behaviour which revealed that speculators frequently have extrapolative expectations. The initial increase in the money supply or fall in interest rates may lead, with the help of the three alternative overshooting mechanisms, to irrational behaviour as speculators jump on the bandwagon. Fluctuations occur due to expectations of future changes rather than current purchasing power. Speculators will only buy the currency once it has stopped depreciating¹⁵ or sell it once the appreciation appears to be petering out. And they will do this since they have the facilities to switch their funds from one currency to another at a moment's notice and may act on the slightest change in exchange rate prices.

Self-fulfilling Speculation

Extrapolative expectations or "bandwagon effects" can be partly explained by the concept of self-fulfilling speculation. The similarity between foreign exchange dealings and commodities should be borne in mind here.

It is believed that speculators do not consult each other as a group but do act collectively in the sense that they understand by intuition and experience how other speculators will react to certain random moves or monetary developments.¹⁶ Hence at any given time speculator expectations concerning any given currency will be by and large similar. (If a currency is stable this means that speculators are not dealing to any great extent in the market.) It will be in the interest of the speculators to overdepreciate or overappreciate the currencies. Because speculators think alike, if they believe an exchange rate is moving in a certain direction – it will be by their actions. For instance they will overdepreciate a currency by very simply switching in large numbers into alternative currencies. The incentive for their action is the large capital gain they receive once

¹⁶ K. Arrow, in: *American Economic Review*, 1914, p. 253, realises that each agent in the market may have a subconscious understanding of other agents in the same market. He observes that "one recurrent theme of economic analysis has been the remarkable degree of coherence among the vast number of individual and seemingly separate decisions about the buying and selling of commodities". More support comes from Allen and Enoch: *Some Recent Evidence on Short-run Exchange Rate Behaviour*, Manchester School, 1978, who claim that the less government intervention there is, the more likely speculators will spend "their time watching each other. This sort of behaviour is likely to be destabilising."

they buy back the currency later. They profit at the expense of the monetary authorities when the latter are committed to ironing out excessive fluctuations.

The speculators can gain twice over since the currencies they switched into temporarily will appreciate in relative terms. It is often the case that commodity and currency speculators rely on dealers or advisors. So just as dealers or brokers advise their clients to buy and sell stocks or commodities, so at any moment in time a currency dealer may tell his clients to switch out of or move into any currency. The presence of these dealers will reinforce the "collective" attitudes of currency speculators, which enables bandwagon mechanisms and self-fulfilling speculation to come about. Unfortunately there can be no empirical proof that self-fulfilling speculation exists. Anecdotal evidence of sociological behaviour can only be, at the most, intuitively appealing.

Arguments against Speculative Run Theories

Observers of foreign exchange market dealers note that international banks and multinationals never take open positions in currencies and always cover their dealings in the forward exchange markets. Therefore the fact that there has been an increase in the supply of speculative funds does not necessarily mean that there has been an increase in speculative activity. But this argument is incorrect since the international banks and multinationals must have some idle funds – they cannot be totally illiquid. The increase in speculative funds has led to an increase in the foreign exchange dealings covered in the foreign exchange markets *as well as* an increase in liquid assets.

Holders of foreign exchange have been paying more attention to how they should best utilise these assets. Long gone is the industrialist's saying that "we are not in the foreign exchange business". Because fluctuations of exchange rates have been so frequent and so large, potential losses from holding a weak currency are substantial. Before 1971, most firms had no definite policy on exchange rate uncertainty. Many showed no interest in profiting from exchange rate speculation because of a general policy of avoiding risk whenever possible. There was also little evidence of exporters delaying conversion into sterling for foreign exchange receipts. Now more traders indulge in this leads and lags activity.

Also, since the early 1970s more private individuals and companies have realised that they need to become more aware of international monetary developments. The whole process has become cumulative as more

speculation has led, in turn, to more and more speculation. A threshold has been passed where many companies cannot ignore exchange rate fluctuations because of the potentially damaging effects on profits. It is now worthwhile for many more holders of foreign exchange to employ investment analysts and advisors to manage portfolio balances. The general impression one receives from the investment analysts of multinationals is that their understanding of foreign exchange dealings is not very scientific, and hence their instincts may bear some similarity to the risk aversion and bandwagon effects mentioned above.

Batchelor¹⁷ has argued that because purchasing power parity holds in the medium run, for extrapolative expectations to take place speculators would have to have a high degree of irrationality. This objection is a relatively easy one to overcome. Leaving aside previously mentioned doubts about whether purchasing power parity holds in the medium run, one can see from recent developments, encapsulated in the new theories of exchange rate determination, that speculators are willing to act purely on short-run fluctuations in the exchange rate. As MacKinnon says, "large exchange rate swings since 1973 make it difficult to argue that the market has been dominated by positions taken in pursuit of long-run profits".¹⁸

International Trade

Historically, floats have not been associated with a decrease in trade, but there are some new ideas which may give one second thoughts concerning the growth of international trade in the future.

One of the main driving forces behind the new desire for greater exchange rate fixity between the European currencies has come from industry, which is complaining of excessive business competition arising from exchange rate instability. As world markets have been contracting, exchange rate charges have led to firms at first hesitating and then cutting their mark-ups. Firms have been subjected to messy signals for pricing policies, i. e. sales are not growing buoyantly for all firms. The atmosphere of greater uncertainty has prompted a collective cut of mark-up over costs. This has in turn led to undesirable behaviour by various countries and the Germans especially, attempting to depreciate their currencies so that their industries are not pushed into reducing their mark-ups. The Germans appear to attach some importance to this theory but any statistics showing a general reduction in profits is not yet

¹⁷ Batchelor: Must Floating Exchange Rates be Unstable?, in: Annual Monetary Review, Oct. 1979.

¹⁸ MacKinnon, op. cit.

forthcoming. There is also the suspicion that European industry is using the floating exchange rates as a scapegoat for declining world markets.

More frequent fluctuations in exchange rates may make the conventional tariff barriers less effective and may therefore encourage countries to impose greater non-tariff barriers, for example quotas, which would ensure that protection remained adequate. Yet apparently there has been no tendency for countries to switch from tariffs to the less desirable non-tariff business during the past ten years. (It is a problem here that the level of non-tariff barriers is very difficult to ascertain.) Another objection to this theory is that a float should, if anything, reduce the amount of trade protection necessary since greater flexibility enables greater control over the balance of payments.

Trade with Developing Countries

Any discussion of the drawbacks of floating exchange rates would not be complete without a brief reference to the problems of developing countries. During the IMF discussions in 1972, the underdeveloped countries attached the highest priority to the attainment of greater fixity in the exchange rate believing that this would lead to greater stability of their balance of payments and should therefore encourage increased trade between developed and developing nations. The greater uncertainties associated with floating rates and the lack of forward market facilities for poor country currencies has been overcome by the pegging of their currencies to the rate of their main trading partner (which is invariably a major developed country with sufficient access to forward exchange markets).

Yet recently there has been a general tendency to switch from pegging against a single currency to pegging against a basket. This suggests that there are other problems with floating rates.

□ Developing countries have traditionally held their reserves mostly in the form of some major currency. The volatility of the value of their reserves may force developing countries to diversify into other currencies and has therefore led to problems of portfolio management.

□ Fluctuations in the exchange rates have increased the risk of external debt appreciations.

□ There is the fear that floating rates lead to greater fluctuations in commodity prices thus jeopardising the export revenues needed for economic development.

However, these problems should not be exaggerated. Developing countries have been steadily increasing their trade during the past ten years and there is no unambiguous proof that volatility of export earnings has adversely affected economic development. Even if the latter could be proven demand and supply factors are likely to be far more important causes of developing countries' export earnings instability. An additional point raised by Cline¹⁹ appears to fallacious. He claims that developing countries should prefer floating exchange rates because of risk aversion factors – small frequent changes are better than large infrequent ones. This may be in one sense true, but as mentioned previously, risk aversion factors may also be the cause of excessive fluctuations of flexible rates.

Lastly there is an important point in favour of the float if it discourages the manipulation of exchange rates so that under-valuation cannot occur. The industries of the strong economies such as the Federal Republic of Germany and Japan will then be encouraged to invest abroad since the under-valuation of the D-Mark or Yen no longer protects them. Indeed the investment from these countries in developing countries has remained relatively high during the past ten years. The balance of payments of the developing countries has not improved substantially because the beginning of the cycle of foreign investment requires capital exports from the developed country. This factor may have encouraged developing countries to be over-critical of floating rates.

Possible Reforms

Disillusionment with the floating system is widespread but at present there is no consensus among academics as to what the next step should be. Mundell and Laffer²⁰, for instance, on the basis of their staunch belief in the "law of one price", advocate a return to fixed rates. However their loyalty to this law may be misplaced. At the other extreme there are economists such as MacKinnon or Dornbusch, who believe that if the forward markets worked more perfectly, by removing exchange and capital controls, then speculation would only be of a stabilising nature and a free float would be best. Unfortunately, the probability of any countries carrying out these measures is low. Thus the scope of reform lies within the strict confines of various rules pertaining to managed floating. In fact we are at a stage where most countries accept the present system though in some cases grudgingly. Nowadays the urge for reform is not as great as it was in previous times.

¹⁹ Cline: *International Monetary Reform and the Developing Countries*, 1976.

²⁰ Mundell and Laffer, in: *The Survey on International Banking*, in: *The Economist*, March 28, 1980.

But two problems still remain. Firstly, the increased intervention in the markets to achieve greater stability has led to greater opportunities for exchange rate manipulation, which will have detrimental effects on the world economy. (This used to be one of the advantages of a float.) And secondly, destabilising speculative flows still lurk in the background. The large fluctuations in the commodity markets and especially metals indicate that the desire to speculate is still very much in evidence.

Two Alternative Proposals

Some action has already been taken to combat these problems. Increasingly economists are coming out in favour of greater intervention by the monetary authorities. At the moment the most popular method of smoothing out exchange rate fluctuations is the leaning-against-the-wind rule. Cooper²¹ proposes fixing limits on the use of foreign reserves so that countries are only allowed to intervene in the markets up to a point. Restrictions such as these overcome worries about exchange rate manipulation but fail on the second count, i. e. they give no guidance to foreign exchange dealers as to what the future exchange rate is likely to be. Williamson²² believes that destabilising speculation will only be discouraged if rates are set to which a country can "fix its flag" and set its policies by.

Therefore Ethier and Bloomfield²³ claim that restrictions such as Cooper's will only exacerbate exchange rate fluctuations. They prefer a targets approach which encourages countries to adhere to certain exchange rate "norms" or targets. Ethier and Bloomfield's Reference Rate Proposal (RRP) requires countries to keep their currencies within certain bounds and the rates will be periodically revised according to internationally agreed procedures. They stress that the RRP cannot be compared to an adjustable peg system since there is no obligation to intervene in the exchange market.

This proposal is quite attractive apart from one problem – the target set may initially appear to be indefensible. After years of floating it will be difficult to determine where the equilibrium rates should be. Yet if

the countries participating show strong commitment to the proposal and are prepared to readjust the rates frequently in its formative period, then the RRP might have a good chance of working.

IMF economists are forever proposing a system of international surveillance of exchange rates. A targets approach such as the RRP would allow them to have their way. However, Halm²⁴ is concerned that the IMF will attach more importance to stability rather than flexibility, as expressed in the 1976 Jamaica Agreement. Therefore he fears for the longevity of any IMF administered system.

Heller's²⁵ work suggests a different approach. He has shown that differing flexibility-stability trade-offs may be appropriate for different countries. His studies attempt to determine what country characteristics suit each exchange rate regime. For instance, a float appears to be the best policy for the United Kingdom because it is a large, open economy, with a wide variety of exports and imports. It also has free and large capital markets and a tendency to have an inflation rate which is dissimilar to the world average rate. In contrast, the EMS countries seem to draw strength from the fact that their markets are closely related, and have opted for greater fixity of their exchange rates.

Hence a heterogeneous system may be unavoidable. It would consist of various floating countries such as the UK or USA (adhering to a targets approach) plus various groups of countries such as the EMS bloc forming optimum currency areas. If there is some degree of international cooperation, there is no reason why the two sub-systems should conflict.

²¹ Referred to in: Ethier and Bloomfield: The Reference Rate Proposal and Recent Evidence, in: Banca Nazionale del Lavoro, 1978.

²² Referred to by Emerson, in: Major (ed.): Britain's Trade and Exchange Rate Policy, 1979.

²³ Op. cit.

²⁴ Halm: Jamaica and the Par Value System, in: Princeton Studies in International Finance, No. 120, March 1977.

²⁵ Heller: Choosing an Exchange Rate System, in: Finance and Development, 1977.

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