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Understanding Latin American Currency Pegs to the Dollar

"Currency pegging can lead to a stable monetary policy, and it can allow the business community to identify deviations from stable policy."

Latin American countries have been making major changes in their economic policies in recent years, but one reform of particular importance to U.S. monetary policy has been scarcely noticed in the United States. Argentina, Chile, Bolivia and Mexico have begun to peg their currencies to the U.S. dollar. (*See the box titled "A Glossary of Exchange Rate Regimes."*)

When a country pegs its currency to the dollar, that country's government sets a limit on the price of its currency relative to the dollar. If the amount of that country's currency required to buy a dollar rises above the limit, the government uses its reserve of dollars to buy its own currency in an effort to bid the exchange rate back to the limit.

For example, Argentina has established an exchange rate peg with a limit of one peso per dollar. If the amount of pesos required to buy a dollar rises above one, the Argentine government purchases pesos with U.S. dollars to bring Argentina's exchange rate within the limit.

By fixing their exchange rates to the dollar instead of allowing them to fluctuate freely, Latin American countries are effectively importing U.S. monetary policy. Thus, these new Latin American currency ties increase the importance of U.S. monetary stability because the effects of instability will be amplified in other parts of the world.

A simple explanation of why countries peg their currencies to the dollar is to facilitate investment and trade and to hold down inflation. This article explains how exchange rate pegging works, why exchange rate pegs amount to importing U.S. monetary policy and what motivates countries to import U.S. monetary policy instead of pursuing their own.

How Exchange Rate Pegging Works

If a foreign country pegs its exchange rate to the dollar, the consequences of failing to follow U.S. monetary policy can be severe. Suppose a country that pegs its exchange rate to the dollar launches a highly expansionary monetary policy, but the United States does not. The inflation rate in the pegging country will probably be higher than in the United States because inflation, by definition, is too much money chasing too few goods.

When a country's exchange rate is pegged to the dollar, the price of dollars in the other country's currency is supposed to remain fixed, *"Latin American countries want price stability because it facilitates trade and stimulates investment by improving firms' abilities to predict selling prices and the costs of doing business."*

no matter what. As the prices of goods produced in the foreign country rise faster than prices of U.S. products, U.S. buyers will purchase fewer of the foreign country's products. For the same reason, the foreign country's buyers will import more products from the United States and will purchase fewer products from home.

As demand in the foreign country falls off, unemployment rises there. Ultimately, unemployment rises because the combination of exchange rate pegging and a high rate of monetary expansion make the country's products increasingly expensive relative to products from the United States, where inflation is lower. (*The box titled "Prices and Inflation in Countries with Flexible Exchange Rates" describes the effects of inflation and rising prices in countries without currency pegs to the dollar.*)

In sum, an exchange rate peg to the dollar amounts to importing U.S. monetary policy because a foreign country with a currency peg can suffer highly punitive consequences by failing to match its monetary policy to that of the United States. Furthermore, this country will eventually lose all of its dollar reserves and will ultimately have to abandon its attempts to peg to the dollar. That is, it will no longer be able to defend its fixed exchange rate by purchasing its currency with dollars.

Why Countries Import Monetary Policy

With such severe consequences, why would anyone want a pegged currency? For Latin American countries, the answer is that they want to establish stable, anti-inflationary monetary policies, and to make

A Glossary of Exchange Rate Regimes

Exchange rates can be determined by several methods. At one extreme is a *pegged*, or *fixed*, *exchange rate* policy, in which the central bank fixes the price of its currency at a constant value and exchanges a foreign currency, such as the U.S. dollar, for the local currency at the constant value. The central bank becomes the main supplier of foreign exchange to the market. The central bank's ability to support its own currency's exchange value depends on the size of central bank dollar holdings.

At the other extreme is a *floating*, or *market-based*, *exchange rate* policy, in which exchange rates are determined completely in the market, with little or no intervention by the central bank. If the market for foreign exchange is not well-developed, small movements in the demand for and supply of dollars causes large exchange rate movements.

Any exchange rate that is not fixed through a currency peg is considered a *flexible exchange rate*. Numerous arrangements fall between the extremes of fixed and market-based exchange rates. The most common type in Latin America is a *crawling peg*. In a crawling peg regime, the central bank increases the price of the dollar over time to maintain the competitiveness of domestic goods in international markets. In this sense, crawling pegs resemble market-based exchange rate regimes. On the other hand, the central bank buys and sells dollars at an announced exchange rate and continues to be the main source of foreign exchange, making the crawling peg more like the fixed rate regime.

them credible to potential investors and other observers.

Credibility is an important issue because a government's stated policy is not always a credible policy. Latin American countries have often shifted far from stated policies of monetary stability; new policies that emphasize stability are often met with fears that they will not last.

Latin American countries want price stability because it facilitates trade and stimulates investment by improving firms' abilities to predict selling prices and the costs of doing business. A stable monetary policy, like that of the United States, goes a long way toward establishing price stability.

During the early 1980s, many Latin American countries moved away from stable monetary policies. These moves caused Latin America a good deal of difficulty and aggravated pre-existing problems that stemmed from events in the 1970s.

In the 1970s, many Latin American countries had borrowed money to develop new industries or to expand existing ones. Historically, most Latin American countries have been large exporters of raw materials, and during the 1970s, raw materials prices were high. These countries expected that continued high prices would allow them to pay off their loans.

When interest rates rose and raw materials prices fell sharply in the early 1980s, Latin American countries began to have difficulty making their debt payments. The declines in raw materials prices led to falling incomes and serious government revenue problems for many Latin American countries.

To expand exports and contract imports, these countries began to devalue their currencies against the dollar. To address their revenue problems, these countries would then print money at very expansionary rates. As the resulting inflation put new pressures on their exchange rates, these countries would again devalue. Protracted cycles of devaluation, inflation and more devaluation began to appear in some countries—and their business communities soon began to expect such cycles and to suspect government claims that the cycles would stop.

The cycles of devaluation and inflation only aggravated economic uncertainty that had already emerged. For Latin America, the 1980s came to be called *the Lost Decade*. Both income and investment shrank. Technology in developed countries continued to advance rapidly, however, and the drop-off in Latin American investment resulted in increasing technological backwardness in the region.

Meanwhile, the depression of raw materials prices persisted, and many Latin American leaders realized that they would have to concentrate more on manufactured exports and less on the export of raw materials. To facilitate low-cost manufacturing production by allowing imported inputs, to hold down inflation and also to placate rising protectionist pressures in the large U.S. market, Latin American countries began to lower their trade barriers. These countries also began to privatize their publicly owned industries and to pursue stable fiscal and monetary policies.

These measures alone might have achieved what Latin American governments wanted, if these governments had not had histories of reneging on new policies. But these histories created a credibility problem. If no one believes a reform will persist, even the most well-designed and well-intentioned policy can fail.

Latin American governments can only regain full credibility by main-

Prices and Inflation in Countries with Flexible Exchange Rates

Countries that do not peg the value of their currency to the dollar are pursuing a flexible exchange rate policy and, thus, are not importing U.S. monetary policy. If a country with a flexible exchange rate pursues a monetary policy that is more expansionary than the United States', exchange rate adjustments will eventually push domestic and foreign demand for traded goods back to their pre-inflation relationships. With pegged exchange rates, this adjustment does not occur.

How does this adjustment process take place with flexible exchange rates? Just as in the case of pegged exchange rates, rising prices in the foreign country discourage demand for this country's products. Because foreign buyers want to purchase fewer of the country's goods, their demand for the country's currency also declines. The increased prices in the foreign country will mean that both its citizens and U.S. buyers will choose to purchase more U.S. products and, therefore, demand more U.S. dollars.

Because of the reduced demand for the foreign country's currency and of the increased demand for U.S. currency, the price of U.S. currency in terms of the foreign currency will rise. For the same reason, the price of the foreign currency in terms of U.S. currency decreases. That is, everyone must now exchange more of the foreign currency to buy a dollar.

Consequently, flexible exchange rates counteract the effects of higher inflation in the foreign country. As prices rise in the foreign country, the value of its currency in terms of dollars falls. There is no longer any extra incentive to purchase U.S. goods over home-country goods.

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taining stable monetary and financial policies over a protracted period. But there are ways of accelerating credibility.

One way for a government to enhance credibility is to let the business community see easily and quickly if the government is cheating. Currency pegging is one such signal. Currency pegging can lead to a stable monetary policy, and it can allow the business community to identify deviations from stable policy.

Currency pegging can hasten credibility because of the consequences of pursuing a highly expansionary monetary policy when a government is trying to maintain a fixed exchange rate. If a country with a peg to the dollar begins to print enough money to make inflation a good deal higher at home than in the United States, people will want less of that country's currency and more dollars as that country prices its products out of the market. If that happens and the government wants to maintain its fixed exchange rate, the government must spend its foreign currency reserves to buy back its own currency. That is the only way the government could keep its currency's exchange rate at the old levels. If the government did not spend these reserves in this way, the international price of its currency would fall, which means that the exchange rate would no longer be fixed.

But as the government intervenes in the foreign currency markets, it runs down its foreign currency reserves. The loss of such reserves would be easily noticeable, and the business community might suspect that this meant the country had been expanding its domestic currency stock imprudently. Investors who were bringing money into the country would pull out in fear of a devaluation and further inflation. Those who were planning to invest might change their minds.

If the country ran out of reserves, it would have to devalue. The devaluation would aggravate inflation by sharply increasing the price of imports. And a new round of inflation, bad in and of itself, would trigger yet another round of economic decline. In sum, a country with a fixed exchange rate has an added incentive to limit inflation, and the private sector knows it.

Why Latin America May Not Always Want to Import U.S. Monetary Policy

Latin American economies differ a good deal from ours. Economic shocks that affect the United States in one way may affect some Latin American countries in quite another way. As a result, the optimal path of monetary growth for the United States or Argentina or Chile or Mexico will not always be the same, even if all these nations are working in earnest to preserve economic stability.

Ultimately, when the business community takes for granted a Latin American government's commitment to hold down inflation, that country might safely uncouple its currency from the dollar. With a credible, demonstrated commitment to keep inflation low, a government can pursue a stable monetary policy on its own and allow its exchange rate to adjust to external market forces. This independence would allow the rate to accommodate price movements that are not tied to excessive internal monetary expansion. After all, not every price movement is solely a result of monetary expansion.

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