

Exchange Rates: Fixed, Pegged, or Flex? Should We Care?

IT HAS BEEN ALMOST three years since the devaluation of the Mexican peso in December 1994. At that time, the doomsayers predicted the end of the world for Mexico. And how is Mexico's economy doing these days? Alive and well, thank you. In fact, it's booming—just like the economy of Argentina, another country doomsayers had predicted would have collapsed by now. As noted in an earlier issue of *Southwest Economy* (November/December 1996), Argentina was the Latin American country that suffered the greatest contagion effect from the Mexican crisis.

The doomsayers were followed by the usual “Monday morning quarterbacks,” to quote the expression that Dallas Fed President Robert D. McTeer, Jr. uses to describe the amazing amount of ex post facto wisdom elicited by the Mexican devaluation of the peso. After the crisis, self-appointed experts made all kinds of recommendations about the exchange rate policies that would take both countries out of the woods forever. Not surprisingly, proponents of flexible exchange rates argued that Mexico would have never gotten into the crisis in the first place if it had had a flexible exchange rate instead of the pegged one implemented five years prior to the crisis. By the same token, they argued that Argentina would have suffered a milder form of “tequila effect”—or escaped it altogether—if it had had a flexible exchange rate instead of the rigid currency-board mechanism adopted in 1991. According to these views, flexible exchange rates were the only way out of the slump for Mexico and Argentina. Thus, they blessed Mexico's decision to move to a flexible exchange rate regime and predicted that Argentina, which decided to keep its currency-board system, was doomed to failure.

This prediction, however, did not materialize, as is apparent in Chart 1. The chart plots quarterly rates of GDP growth for Mexico and Argentina right after the devaluation of the Mexican peso in December 1994. Keeping in mind that the effects of the devaluation reached Argentina about one quarter later than Mexico, we compare Mexico's GDP growth in any given quarter after the devaluation with Argentina's GDP growth in the *subsequent* quarter. Alignment of growth rates in this way reveals a striking similarity in the recession–recovery pattern of both countries. In the analysis that follows, we take the view that the recent economic experiences of Argentina and Mexico are very close to the controlled laboratory experiments that economists crave, and envy in other sciences.

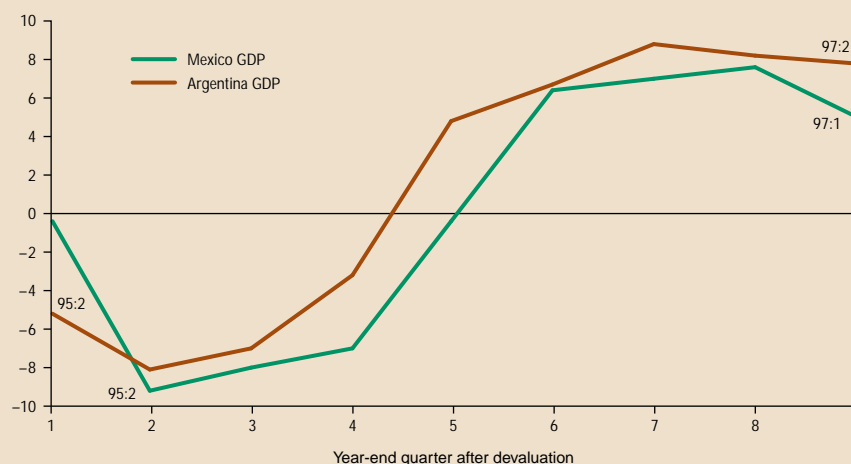
The two countries are alike in many dimensions, but responded with almost opposite policies to basically the same speculative attack against their curren-

cies. Mexico devalued; Argentina did not. Mexico bailed out its financial system; Argentina did not (in fact, it let 25 percent of its banks go belly up). Mexico engaged in “sterilization” policies during the crisis; that is, it tried to keep the money supply from falling as the capital outflows tended to dry up liquidity. Argentina, instead, let the money supply contract an astonishing 20 percent in three months, the same percentage by which the money supply contracted during the Great Depression in the United States over three *years*. Yet, despite the almost opposite monetary policies pursued by the two countries, they faced the same fate: a similar recession followed the speculative attack against their currencies (*Chart 1*).

The differences in economic policies and the commonality of outcomes do not stop there, however. As mentioned above, Mexico stopped following a pegged exchange rate after the crisis and instead adopted a flexible exchange rate.

Chart 1
Recession–Recovery Patterns in Argentina and Mexico after Peso Devaluation

Percent growth over same quarter of previous year



NOTE: First observation for Argentina corresponds to second quarter of 1995, for Mexico to the first quarter of 1995.



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Beyond the Border

Argentina, by contrast, continued implementing a fixed exchange rate policy in its most extreme form: a currency-board system. Yet, despite these different policies, the chart shows that both countries have recovered at about the same brisk pace. And there are no signs that the recovery will fizzle out any time soon in either country; in fact, markets seem to be bullish about both of them.

What can we conclude from all this? Perhaps that there is very little that exchange rate regimes (whether flexible, fixed, or pegged) can do to prevent economic crises and recessions, and, conversely, that there is little exchange rate management can do to boost economic activity. In fact, while our "controlled experiment" interpretation of the data in Chart 1 is admittedly rather casual, it is not without some support from well-established economic theory. A number of respected scholars, including Helpman (1981) and Auernheimer (1987), have argued that the choice of exchange rate regime is not all that important for the growth performance of the economy. According to these theories, what matters most is "real" factors, not "nominal" ones. Low inflation, fiscal policies such as liberalization of trade and financial intermediation, and free-market reforms are much more important determinants of growth and economic fluctuations than is the particular monetary instrument used by the central bank to achieve (or destroy) price stability.

To see this from the perspective of a policymaker confused as to what to do, consider once more the view that Argentina would have escaped the recession if it had provided more liquidity to banks in the course of the speculative attack. Mexico did exactly that, yet its recession was as intense as Argentina's. Likewise, consider the advice, heard equally often, that Mexico's road to recovery would be smoother and faster if it were to adopt a currency-board system like Argentina's. Mexico, with its flexible exchange rate, is growing at about the same pace as Argentina with

its fixed exchange rate. Meanwhile, doomsayers in the flexible exchange rate camp believed that Argentina could not possibly recover from the recession unless it adopted a flexible exchange rate regime. Yet, Argentina is growing almost as fast, if not faster, than flexible exchange rate Mexico. In each case, the dynamics of output, as predicted by theory, seems to have been invariant to the choice of exchange rate regime.

On these grounds, the recent experiences of Argentina and Mexico (and of Southeast Asian countries, for readers familiar with the crisis triggered by the devaluation of the Thai baht beginning July 2 of this year) suggest to policymakers that speculative attacks, with or without devaluations, will come and go and that exchange rate management may do little about them. Policymakers might be better off, therefore, concentrating their energies in controlling "real" factors rather than in experimenting with different varieties of monetary voodoo. Doing the right things about real factors—sound fiscal policies, low inflation, free-market reforms, free trade, free and strong financial systems—will, in the end, be the only effective way to put speculators in retreat. That is what Chile did many years ago, and it paid off. This is what Mexico and Argentina started to do not long ago and have kept doing despite the recent crisis. There is no reason to think that their efforts will not pay off as handsomely as the same approach did in Chile.

—Carlos E. J. M. Zarazaga

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