F International Economics

Flexible Exchange Rates for a Stable World Economy. By Joseph E. Gagnon. With Marc Hinterschweiger. Washington, D.C.: Peterson Institute for International Economics, 2011. Pp. xvi, 265. $26.95, paper. ISBN 978–0–88132–627–7. *JEL 2012–0086*

The question of fixed versus flexible exchange rates is one of the most enduring topics in international economics. In *Flexible Exchange Rates for a Stable World Economy*, Joseph Gagnon makes the case for flexible exchange rates using empirical research, model simulations, and country studies. In addition to making compelling arguments in favor of flexible exchange rates, Gagnon provides an extremely clear introduction to many topics in exchange rate economics. I would recommend the book to anyone (including, and maybe especially, graduate students), who wants either a clear discussion of the choice between fixed and flexible exchange rates and/or a clearly written introduction to exchange rate economics.

The book starts with the obligatory straw man, recent calls by (then) French President Nicolas Sarkozy and Nobel Prize-winning economist Robert Mundell for a return to fixed exchange rates, and proceeds to knock it down in every way imaginable. The choice between fixed and flexible exchange rates is presented in the framework of the macroeconomic policy trilemma, the impossibility of having monetary policy independence—the ability to set the short-term interest rate, exchange rate policy independence—the ability to set the exchange rate, and free and open capital markets. The latter is taken for granted, reducing the trilemma to a choice between fixed (exchange rate policy independence) and flexible (monetary policy independence) exchange rates.

Three chapters pose the following questions: "Are Floating Exchange Rates Too Volatile?," "Do Volatile Exchange Rates Reduce Economic Output?," and "Do Volatile Exchange Rates Destabilize Inflation and Output?" While Gagnon argues that floating exchange rates are excessively volatile, he presents convincing evidence that this volatility neither reduces long-run output nor destabilizes inflation and output. These chapters contain well-written short surveys on a number of topics in international economics, including purchasing power parity, uncovered interest rate parity, volatile exchange rates and international trade, and price elasticities in international trade, as well as five historical examples where large and sudden exchange rate changes were not associated with volatility in inflation and unemployment.

The core of the book is contained in the subsequent chapter, "Monetary Policy with Fixed and Floating Exchange Rates." Using a textbook model, a modern economic model based on a dynamic stochastic general equilibrium model used by the Federal Reserve Board, empirical research on monetary policy stabilization, and case studies of monetary policy and exchange rate fluctuations, Gagnon demonstrates that inflation and output are more stable with floating exchange rates than with fixed exchange rates, provided that the central bank conducts appropriate monetary policy.

While Gagnon makes a compelling case for flexible exchange rates, there is a sense that he is preaching to the converted. Adherence to the Taylor (1993) principle, where the central bank raises the real interest rate when inflation exceeds its target and/or output exceeds potential output, clearly contributed to the Great Moderation in inflation and output since the mid-1980s. Conducting monetary policy according to the Taylor principle requires a flexible exchange rate, and why would the Federal Reserve or the European Central Bank even consider giving up the improvements in monetary policy over the past two decades in order to keep the exchange rate fixed. For middle-income developing countries, the exchange rate crises of the 1980s and 1990s clearly demonstrated the large costs of attempting to keep exchange rates fixed.

One issue regarding the analysis is the presumption that free and open capital markets are always desirable, a presumption that has come under increasing scrutiny following the U.S. financial crisis of 2008 and the ongoing crises in the Euro Area. If limiting capital mobility is precluded, the lesson of the demise of the Bretton Woods System in the late 1960s and the European Monetary System in the early 1990s, as well as the currency crises of the 1980s and 1990s, is clearly that flexible exchange rates are preferred to fixed exchange rates, which are subject to speculative attacks. If limits to capital mobility are considered, then the picture is not so clear, especially for middle-income developing countries. The experience of China, which has limited exchange rate movements through capital controls, is barely mentioned in the book.

As of the date when this review was written, it is not clear whether the Euro Area will evolve into a stronger fiscal union, break up, or somehow survive more or less unchanged. In retrospect, should the countries that now comprise the Euro Area have abandoned their national currencies in favor of the Euro? Would Greece have done better with a floating exchange rate with Germany? If yes, would the same answer apply to Italy? If still yes, what about France? While Gagnon makes an exception to his arguments in favor of floating exchange rates for countries that seek deep political and economic integration with their neighbors, the analysis in the book does not seem well-suited to answer these questions.

The final chapter in the book is on policy conclusions. After summarizing the arguments in favor of flexible over fixed exchange rates, Gagnon spends most of the chapter advocating a system of reference rates, which are wide target zones with intervention allowed only outside the band. These conclusions seem to be unrelated to the rest of the analysis, as the term "reference rates" does not even appear until the last chapter. The introduction of reference rates, however, provides a link between the beginning and end of the book. In the Mundell (2011) lecture that motivates the analysis, he does not advocate a return to fixed exchange rates. Instead, he advocates a Euro/Dollar rate with about an 8 percent band in each direction, although it could gradually be narrowed. While Gagnon does not specify the width of his reference rates, there may be more in common between his and Mundell's views than would be apparent at first glance.

References

Mundell, Robert. 2011. "International Monetary Reform 2011." Presentation at the China G-20 Seminar, Nanjing, China, March 31. robertmundell.net/ebooks/free-downloads/.

Taylor, John B. 1993. "Discretion versus Policy Rules in Practice." *Carnegie–Rochester Conference Series on Public Policy* 39: 195–214.

David H. Papell
University of Houston

G Financial Economics

Guardians of Finance: Making Regulators Work for Us. By James R. Barth, Gerard Caprio Jr., and Ross Levine. Cambridge and London: MIT Press, 2012. Pp. xiii, 280. $27.95. ISBN 978–0–262–01739–8. *JEL 2012–0411*

In this provocative and stimulating volume, Professors Barth, Caprio, and Levine, three recognized experts on financial regulation, deliver a broad indictment of financial regulators and their role in facilitating the global financial crisis.[1]

The authors' premise is that the crisis was induced by a "colossal failure of financial regulation" (3) in which "Regulators enacted and maintained policies that encouraged excessive risk-taking even as they learned that their decisions increased the fragility of the system" (18). They trace the failure to a lack of accountability in the governance of the regulatory authorities in this country and around the advanced world. For the United States, they propose establishment of a sentinel mechanism made up of truly independent experts with the power to command information and issue annual reports to foster informed debate about regulatory decisions.

Barth, Caprio, and Levine start by acknowledging that financial regulation is challenging and difficult if the dynamism of financial innovation is to be preserved. They describe the political economy of financial supervision and regulation and associated incentives. Their central indictment of the U.S. precrisis regulatory regime is based on six examples: (1) the Federal Reserve's decision to allow banks to reduce their regulatory capital requirements through the use of credit default swaps; (2) the campaign by the Federal Reserve, Treasury, and Securities and Exchange Commission (SEC) to resist tighter regulations on over-the-counter (OTC) derivatives; (3) the SEC's nonimplementation of comprehensive supervision; (4) distorted policies toward credit rating agencies; (5) the Federal Deposit Insurance

[1] In the interests of full disclosure, Professors Caprio and Levine were once my colleagues in the Division of International Finance at the Board of Governors of the Federal Reserve System, and I teach periodically at the Center for Development Economics at Williams College, which Caprio now directs.