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Correspondence

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Fixed Exchange Rates

In their article, "The Mirage of Fixed Exchange Rates," in the Fall 1995 issue, Maurice Obstfeld and Kenneth Rogoff argue persuasively that, except in limited and rather special circumstances, fixed exchange rates have become inviable due to the development of capital mobility. Since I have been saying much the same thing myself for a long time (Williamson, 1965), I do not wish to challenge this central contention. However, they go on to argue that the same difficulties rule out intermediate regimes, notably target zones, also known as crawling bands, and now fixed rates lite.

It would be odd if this were true. A fixed exchange rate requires that monetary policy be directed to its defense, as they rightly argue, while a floating exchange rate allows monetary policy to be directed to domestic objectives. In most parts of economics, it would be assumed that an intermediate policy regime, where monetary policy is guided by a tradeoff between domestic stabilization and the maintenance of an appropriate exchange rate (as in Svensson, 1994), would not only be feasible but might well be optimal. At least one version of a target zone regime can be characterized in exactly this way: direct monetary policy to domestic objectives except when the exchange rate becomes seriously misaligned, at which point give priority to the exchange rate objective. Why is exchange rate economics so different as to require ruling out any such interior solution? Why cannot target zones in fact "provide a good practical balance between the seeming chaos of flexible rates and the straitjacket of fixed rates," in the words of Obstfeld and Rogoff (p. 91)?

They argue that a wide band can only postpone the day of reckoning when the exchange rate comes under attack: "When the zone's boundaries are reached, maintaining them in the face of speculative pressure presents all the problems of a fixed exchange rate" (p. 91). They cite the experiences of speculative attacks on the ERM parities of Britain, Spain and Portugal, and the 1994 Mexican crisis. But the relevant analytical question is not how wide the bands were, but whether the equilibrium exchange rate lay outside the band; wide bands give the *opportunity* of making reasonably sure that the equilibrium rate lies within the band, but they cannot prevent governments from trying to defend ranges that do not meet that criterion, which those of Britain and Mexico (at least) certainly did not.

Obstfeld and Rogoff fail to acknowledge that it matters whether or not the equilibrium exchange rate lies within the band. The equilibrium exchange rate is where nonspeculative private demand and supply are equal. Consider a situation where the equilibrium rate is lower than the band, and speculators stage an attack on the weak edge of the band by selling the currency. In this case, it is easy to see how

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the speculators can make money even without the central bank entering the market. The nonspeculative private sector will be needing to buy foreign exchange to finance its continuing balance of payments deficit, and the speculators can count on eventually buying their domestic currency back from thesetraders at a lower price, and recognizing a profit. But if the equilibrium rate lies within the band, and speculators stage an attack on the weak end of the band, the situation is different. Now, the balance of payments is already close to balance, or even in surplus, so the speculators will have no agent with whom they can rely on being able to realize their profits, unless the central bank were silly enough to step in and validate the speculative attack by selling the domestic currency at a lower price than it had previously bought it. This is analytically exactly the same point made by Milton Friedman (1953) in his attack on the possibility of speculation against a floating rate being destabilizing.

If one accepts that a wide band that contains the equilibrium rate will avoid speculative attack, then the question is whether the parity can be adjusted so as to ensure that the band always contains the equilibrium rate. This raises questions about how accurately it is possible to estimate equilibrium exchange rates, which cannot be discussed here, but interested readers might begin with Williamson (1994) for attempts to estimate fundamental equilibrium exchange rates.

Of course, Obstfeld and Rogoff are right to say that such a target zone does not use the zone to provide a nominal anchor, but rather to avoid the medium-term misalignments to which floating rates have proved so prone. But does this imply that a target zone will be "little more than a placebo, differing in principle from a freely floating rate only to the extent that it affects market psychology," as Obstfeld and Rogoff (p. 92) argue? That might be true if floating exchange rates were really determined in the way that economic theory postulates, but we know from Meese and Rogoff (1983) that this is not so, and a random walk outperforms any of the standard models of exchange rate determination except for rather long time horizons. A target zone is intended to introduce an actor into the market that worries about the long term, thus providing an incentive for the market to develop regressive expectations toward a rate that reflects the fundamentals, thus helping the market behave in a way that fits the models. The aim is exactly that of influencing market psychology, but it is quite wrong to suggest that this means a target zone would be no more than a placebo.

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