EAGER
Policy Brief
NUMBER 16 / JANUARY 1999

Fixed or Floating Exchange Rates?

Exchange rate reform is a policy measure that is frequently included in Structural Adjustment Programs. One of the aims of this reform is to increase exports by getting the value of the currency right. This is one step that must be taken to correct the market and price distortions that inhibit economic growth in African countries. In 1998, USAID, through the EAGER project, sponsored a study* to assess the economic performance of African countries according to their exchange rate regimes. The study concluded that flexible exchange rate regimes are superior to fixed exchange rate regimes.

Countries that choose to maintain a fixed exchange rate may either peg their currency to a single currency, such as the US dollar, peg to a basket of currencies, or can become a member of a monetary union. A monetary union is an agreement between several countries to adopt a common currency regime. Countries that maintain a flexible exchange rate regime can have either an independent floating exchange rate or a managed floating exchange rate. A floating exchange rate is one whose value is determined by private buyers and sellers of the currency. Under a managed float, the central bank of the home country plays a larger role in this market for the currency.

Between 1980 and 1995, nineteen African countries have shifted from pegged currencies to more flexible exchange rate regimes. Some African countries have frequently switched between different exchange rate regimes. For example, Uganda shifted its exchange rate regime eight times between 1980 and 1994. The arguments for shifting from fixed to floating exchange rate regimes have centered on three major issues. These are exchange rate stability, economic independence, and macroeconomic adjustment.

Stability of Exchange Rate

Floating exchange rate regimes can, in the absence of strong and well-managed domestic capital markets, make economies vulnerable to wild swings in exchange rate values. In Africa, where capital and currency markets are notoriously thin, floating exchange rates have tended to be unstable. Exchange rates seem to move inexplicably, with no apparent link to monetary policy or to observable disturbances. Proponents of fixed exchange rates had based part of their argument on the proposition that uncertain exchange rate fluctuations would impede international trade and investment.

Equity And Growth through Economic Research– an activity of USAID, Bureau for Africa, Office of Sustainable Development, Strategic Analysis Division

While it is not clear that the increase in exchange rate volatility has caused a net loss in foreign direct investment, it is clear that less exchange rate volatility would be better. Under flexible exchange regimes, market forces are important determinants of a country's money supply and its real exchange rate. These regimes, therefore, benefit from the presence of well-functioning internal capital markets and from international markets for the country's currency. The larger the market for a country's currency, the less effect some small set of transactions will have on the value of the currency. The stronger the domestic capital market, the easier it is to buffer (while still communicating) changes in the value of the domestic currency.

Independence versus Cooperation

A fixed exchange rate requires a high degree of coordination between the country whose currency is pegged and the country (or countries) who provide the base rate. For instance, if the base rate country inflates its currency and the pegging country does not, then the currency of the pegging country will become undervalued and vice versa. Floating exchange rate regimes, however, allow a degree of independence in monetary policy because the adjustment of exchange rate values is expected to be made in the marketplace. Advocates of fixed exchange rates believe that international cooperation is required to adjust to macroeconomic disturbances in any event, so, why not do it through managed exchange rates?

It is difficult to determine whether independence or cooperation is of greater advantage to African economies. In the CFA zone, where fourteen African countries cooperate in a currency union with a fixed exchange rate, there is evidence that the currency union has not delivered all of the expected benefits to members of the union. The exchange rate of the CFA zone was more stable than the rest of Africa over the study period. But the benefit to this stability in terms of increased investment and/or increased economic output is uncertain. One expected advantage of monetary union is improved regional trade and factor mobility across member countries. Even though the member countries posses a common language and a common currency, there is, in fact, limited regional trade within the zone. Their import share of GDP is 35 to 41 percent, while their share in regional trade is roughly 8% of the regional GNP.

Macroeconomic Adjustment

Proponents of floating exchange rate regimes identify three main macroeconomic advantages to floating exchange rates. These are: equilibrium in the balance of payments, internal as well as external equilibrium, and a reduced need for foreign exchange reserves. If the exchange rate is allowed to float, it will automatically adjust to the level that equates supply and demand for foreign exchange, thus resulting in equilibrium in the balance of payments and smaller trade imbalances. The balance of payments equilibrium will reduce the constraints on domestic policy instruments, while the smaller trade imbalance will reduce political pressure for protectionism. Finally, under the floating exchange rate regime the central bank does not need to hold foreign reserves and has to commit to nonintervention in the exchange rate market.

Advocates of fixed exchange rates argue that such regimes provide a more stable environment for the growth of world trade and international investment. On the other hand, according to neoclassical theory, a flexible exchange rate promotes economic growth by insulating the domestic economy from external disturbances. When the balance of payments is in equilibrium, a recession abroad will lead to a decline in export demand. Under the fixed exchange rate regime, this situation would yield a balance of payment deficit, resulting in a recession at home as well. However, with a market-determined exchange rate, the exchange rate level would increase to equate supply

and demand on the foreign market, thus moderating the impact of the external disturbance on exports and aggregate demand. Advocates of fixed exchange rate regimes believe that such insulation is not sufficient, since a country can be isolated from foreign demand, but not supply shocks. The advocates of fixed exchange rate regimes suggest that countries maintain the balance of payment through a reduction in government expenditure and devaluation of the domestic currency.

Empirical Analysis

Most studies of African economic performance reject the hypothesis that fixed exchange rate regimes are the best way to overcome macroeconomic disturbances and increase the level of economic growth. To date, however, long-term studies involving several African countries have ignored the economic impacts of the process of switching to new regimes. The EAGER study on exchange rate regimes endeavored to appraise the economic effects of switching exchange rate regimes. It also attempted to quantify and to identify as positive, or negative, the impacts of fixed versus floating exchange rates on total economic growth and on growth in exports.

Beginning in the 1970s African economies have experienced sluggish growth of real output, a decline in investments and savings, a drop in export performances, and a deterioration of current account balances. Most African countries were operating under fixed exchange rate regimes before 1980. By 1980, most of those currencies were overvalued at the official exchange rate. As a means to adjust the value of their currencies to improve the competitiveness of exports, many African countries have, since 1980, shifted to floating exchange rate regimes.

In order to determine whether exchange rate regimes and changes in exchange rate regimes had an impact (and what kind of impact) on economic growth, several different models of the determinants of growth were run. Comparing just the variance between countries that used fixed exchange rates and countries that floated, it is clear that countries that floated suffered much greater exchange rate movements from 1980 to 1989. However, past the initial adjustment period (i.e., 1990 to 1994), exchange rates in countries with a floating regime have become relatively more stable. In part because of the deterioration in exchange rates, the terms of trade worsened for countries with floating exchange rates. However, over the study period, export growth was positive for countries with a floating exchange rate and negative for countries with fixed exchange rate regimes.

Because so many of the countries included in the study changed their exchange rate regimes over the period examined, the model tested whether the current exchange rate was a significant determinant of growth, as well as whether the shift from fixed exchange rates to a floating regime had any impact on growth. Under the hypothesis that current rates were the determining factor, the analysis showed that only fixed exchange rates in a monetary union had a statistically significant impact on per capita growth. Unfortunately for countries using these regimes, this impact was negative. When the analysis was done using the assumption that the exchange rate regime during the initial period was the more important determinant, it was found that the impact of a managed float had a significant, positive impact on per capita income growth. Fixed exchange rates in the CFA zone were still, however, negative in their impact.

Estimating the model for the impact of exchange rate regime on the rate of growth of total output showed that single-pegged currency countries had higher rates of growth of total output from 1980 to 1984 compared with all the other groups. The single-pegged countries benefited from adequate variations in the real effective

exchange rate as well as from their domestic investment ratios. The real effective exchange rate adjustment in these countries favored the rate of growth of total output during the four-year period. For 1980 to 1994, the results show consistently significant coefficients for CFA zone countries and for countries whose money was pegged to a single external currency. These coefficients are negative for the variable tracking membership in the CFA zone and positive for the variable tracking a single currency peg. The combination of low inflation, a lower budget deficit, and low domestic credit expansion did not offset the inherent cost of overvaluation of their nominal exchange rate during that period.

Finally, the model was estimated to determine the effect of lagged values for: exports, the current account balance, the rate of growth of total GDP, and investment as a share of total GDP. An exchange rate regime variable (CHANGING) was introduced as a dummy variable capturing the effect of a shift in the exchange rate regime. In this exercise, all the controlled variables had the expected signs with consistently significant coefficients. The dummy variable identifying countries that shifted to floating exchange rate regimes during the 1980s carries a significant coefficient in the export share equation. This implies that countries that moved from fixed to floating exchange rate regimes benefited from an improvement in the rate of growth of export share to GDP as compared with all other countries that did not make the same shift.

Conclusion

The choice of exchange rate regime significantly affects growth and trade performance in African economies. The benefits to African economies—mainly monetary union members—of fixed exchange rates (low inflation, financial stability, and a smaller budget deficit) did not offset the costs of overvaluation during the external shocks from or 1980 to 1993. Floating exchange rate regimes and single-pegged currency countries showed better growth performance in terms of total output and income per capita. Strict pegging increased the impacts of external disturbances through relative price rigidity and distortionary taxes that contributed to the overvaluation of the nominal exchange rate. Countries with flexible exchange rates benefited from the adjustment of their real effective exchange rates to equilibrium levels, yielding more growth in total output and an improvement in the rate of growth of exports. Nevertheless, countries with pegged currencies outside monetary unions experienced better economic performances than did members of monetary unions.

These findings are consistent with and complete those of the earlier studies of the CFA zone and other African countries. This study shows that liberalization and improved exchange rate management aids economic development. More flexible exchange rate regimes and independence in the exchange rate policy appear to be a better course of action for economic development in Africa.

***This policy brief is based on EAGER Discussion Paper Number 18, *Determinants of Trade and Growth Performance in Africa: A Cross-Country Analysis of Fixed versus Floating Exchange Rate Regimes*, July 1998, by Anatolie Marie Amvouna [A.Amvouna@lemel.fr], Centre d'Etudes et de Recherches sur le Développment International.**

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