

Let It Ride

By Kenneth Rogoff

When taming volatile currencies, policymakers are trying to rein in forces they can't control—much less understand.

When European Central Bank (ECB) President Jean-Claude Trichet described the soaring exchange rate of the euro as “brutal” last November, he captured the gut feelings of many European exporters, not to mention Americans and Asians who are fond of European goods. The recent wild gyrations of the euro and other currencies have once again led to demands for a more stable system of international exchange rates. Business magazines are filled with articles asking whether today's central bankers ought to take a more active role in stabilizing exchange rates, or perhaps contemplate a move toward a global currency. But, for all its flaws, the current system—in which monetary policy does a pretty good job at stabilizing inflation and a horrid job at stabilizing exchange rates—may be the best anyone can expect.

Other things being equal, almost everyone likes stable exchange rates: Tourists, international corporations, and consumers who are fond of imported goods. Unfortunately, everything else is rarely equal. In a world of highly mobile and integrated capital markets, governments face a trade-off: They certainly can use monetary policy to fix the exchange rate, but only at the cost of ignoring everything else, including domestic growth and inflation. Under a fixed exchange rate, any attempt to set interest rates significantly higher or lower than the anchor currency sees capital wildly fleeing in or out of the country. Currency volatility is the price we pay for having independent monetary policies. It may sound grand to coordinate monetary policy to fix exchange rates, but the costs can prove severe in practice. One only need look at Europe, where recession-bound Germany has been choking under an ECB interest rate policy that produces low inflation in Europe, but near deflation in Germany.

There are two key reasons for sticking to a hands-off policy. First, history has shown that policymakers are much better at mismanaging exchange rates than stabilizing them, in large measure because currency swings are often maddeningly hard to explain or even understand. When the euro was near its low in early 2002 (at \$0.85), financial reporters and columnists argued that investors lacked faith in Europe. When it soared to \$1.36 at the end of 2004, many of these same commentators began worrying that the high-priced euro was making investors, well, lose faith in Europe. Similar confusion reigns for other major exchange rates, such as the U.S. dollar-Japanese yen rate and the U.S. dollar-British pound rate. (Only so-called commodity currencies, such as the South African rand and the Canadian, Australian, and New Zealand dollars show a bit of rhyme or reason to their swings, because they are linked to the prices of those nations' key commodity exports.)

Little wonder that when it comes to volatile currencies, many policymakers find themselves trying to regulate forces they can barely comprehend, much less control. That is one reason why attempts to fix rates often end in a huge speculative attack, such as the one that brought down the British pound in 1992 and cost the Bank of England at least \$7 billion.

Second, although there may be costs to volatile exchange rates, demonstrating that they really matter is next to impossible. Back in 1990, when European Commission economists were struggling to find a rationale for the euro, they pointed out that multiple currencies created various accounting burdens for companies doing business throughout Europe. Such arguments rang true at the time, but not today, when modern business software allows firms to view their books in different currencies with the click of a mouse.

Another common argument holds that exchange rate volatility dampens trade, but most recent estimates suggest that however large that effect seems in theory, it is small in practice. For example, when the euro moves versus the U.S. dollar, neither the price of American automobiles in Europe nor that of European cars in the United States seems to move much in response. In fact, the cost is usually borne by those firms doing the importing and exporting; ordinary consumers only shoulder the burden if exchange rate changes endure for a long time, in which case, they presumably reflect fundamental economic problems.

If the costs of flexible exchange rates are hard to detect, the risks of trying to stabilize currencies are all too obvious. China, for example, has shown that it can stabilize (indeed, fix) the yuan-U.S. dollar rate, but only through a draconian system of capital controls that severely punishes ordinary citizens seeking to invest their money in something other than the country's bankrupt banking system. Although some left-leaning economists seem to think heavy-handed financial controls are wonderful, the truth is that they just don't work well for more-developed economies that need sophisticated and competitive financial markets to channel savings toward productive investments. Unfortunately, if China were to suspend its capital controls without allowing its exchange rate to float, it would almost surely suffer a massive speculative attack à la Mexico in 1994 or Asia in 1997 and 1998.

Of course, at some point, exchange rate movements can become so wild as to lose all touch with underlying economic fundamentals. In these extreme circumstances, policymakers must think about temporarily subordinating domestic objectives in favor of international stability. But we are not there yet. In general, policymakers should focus on adopting sound policies for growth at home, and leave exchange rates to the market. Over the last 10 years, most countries have made enormous progress in achieving more stable and predictable monetary policy, thanks in no small part to independent central banks that have learned that controlling the exchange rate is less important than controlling inflation. Exchange rate stability looks good on paper, but it is not worth the price.

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