

# **MONEY AND FISCAL POLICIES UNDER FLOATING AND /OR FIXED EXCHANGE RATE REGIMES**

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## **Abstract:**

Over the years, many academics have debated whether it is better to have a Floating Exchange Rate or a Fixed Exchange Rate. In this paper we will discuss both of these approaches in the context of money and fiscal policies, particularly as those policies pertain to small state systems and microstate systems, such as those which obtain in the Caribbean and the Eastern Caribbean. Our approach to the subject matter is couched in the notion that Monetary and Fiscal Policies in the Caribbean, especially in our Caribbean of small states and microstates, must of necessity be policies of an integrative nature, as we first contented in 1975, and articulated in 1985. In the end, we conclude that the Floating Exchange Rate and the Fixed Exchange Rate tend to be dependent upon the specific behavioral conditions and historical periodicity. Thus monetary and fiscal policies are guides and the exchange rate is sometimes an equilibrating force and sometimes a mechanistic arrangement.

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## INTRODUCTION

Any discussion of the issue of monetary and fiscal policies under floating and fixed exchange rate regimes must take into account the notion of the exchange rate regime in the forms of the nominal and the real rates. Furthermore, these two types of exchange rates must be located in the context of the historical nature of events. Grilli and Kaminsky (1991) argue that the Real Exchange Rate tends to be dependent on the specific behavioral/historical period as opposed to the exchange rate arrangements themselves. This is the methodological approach that we take in this paper. We begin, in Section I, with some definitional terms of monetary and fiscal policies, integrative monetary and fiscal policies, the difference between Floating and Fixed Exchange rates and we conclude by asking the questions, why do countries float their exchange rate and why do countries fix their exchange rate?

In Section II we consider, conceptually, the nominal and real exchange rates and ask, does it matter? Section III asks the question, Which is better: Floating or Fixing? We conclude that the specific historical conditions and the nature of the arrangements will make a big difference as to whether a country floats or the country fixes. The psychological ambience surrounding a floating exchange rate regime as opposed to a fixed exchange rate regime is one of perception as opposed to reality. By that we mean that there could be feed-back mechanisms in terms of how a country performs, or contagion-like symptoms in terms of how the exchange rate regime operates under a monetary and fiscal system that is hypothesized in an integrative system, as distinct from a disintegrative system. Three economic factors of

output, the price level and the rate of interest are key variables that play a major role in a country's exchange rate regime. These variables have to be monitored at all times if the substantive essence of the floating or fixed exchange rate is to benefit the country. In addition to the three economic factors of output, the price level and the exchange rate, the political leverage of a country and the historical antecedents of the country in setting up a floating or fixed exchange rate regime make a big difference in the performance of these two approaches. There is, no doubt, that a country can benefit from one or the other, but the centrality of one over the other depends on the how the regime came about in the first place. In this paper, *flexible rates and floating rates are used interchangeably.*

#### **MONETARY POLICY:**

For purposes of this paper we define Monetary Policy in the simplest of terms, namely the actions of a Central Bank designed to change or alter the equilibrium of the money market. In other words, we refer to the policies of a Central Bank effectuated in such a manner that the money supply, the interest rate and or both variables are affected. Monetary policy in its pristine sense presupposes that money is all that matters. It is concretized in the notion that such a policy of money matters is part of the self-equilibrating mechanism. If the right rules are followed, then the system would work perfectly without anyone or any body, statutory or otherwise, interfering with the system. If the system does not work properly, there may be a need for someone to intervene. While this is a theoretical possibility, the self-equilibrating mechanism does not permit this action.

## **FISCAL POLICY**

Fiscal policy is here defined as the government's plan for taxation and spending as that plan is designed to chart a course and attain aggregate demand along some given macroeconomic trajectory. It is assumed that the government or the public sector will be an active public sector, not a passive public sector that is merely the helper of last resort in a watered-down approach to Keynesianism. We have argued (Jones-Hendrickson, 1985) that the recognition of a monetary and fiscal policy was narrowly put forth for systems that could be stylized as closed economic systems. When the theoretical set was applied to economic systems that could be dubbed open economic systems, much of the substantive features of the monetary and fiscal policies were found wanting. Hence, we proffered a concept called "an integrative nature of public finance-monetary policy." (Jones-Hendrickson, 1985: 22-38). In that work we called the concept public finance (fiscal) and monetary policy because we had some implicit bias to the fiscal system in a region where the public sector was, and continues to be the main engine of economic growth and transformation. That notion about the engine of growth is now well established, but is oft times queried because opponents contend that the private sector is the real engine of growth. The reality varies from country to country and even from one island to another in a given twin-island or tri-island arrangement.

## **THE INTEGRATIVE MONETARY AND FISCAL POLICY:**

The objective of the integrative monetary and fiscal policies is economic transformation. Economic transformation is the total change of the social, economic and political systems such that the changes are beneficial to all strata of society. (Jones-Hendrickson, 1985: 36). In the

1980's when we first conceptualized this notion of the integrative nature of fiscal and monetary policy or monetary and fiscal policy, our goal was to institutionalize processes, plans and procedures to minimize inefficiencies in the system as monetary policies and fiscal policies were concerned. We argued that both set of policies were of importance in all systems and that, especially in small states and particularly microstates, such as those in the Caribbean, we did not have the luxury to engage in the futile debate of the monetarists and the fiscalists. Money mattered and the public fisc mattered. We had to use both systems. We had to integrate the summative policies of both systems because they both gave scope for development and transformation. Today, as we move into and are drawn into the era of globalization, our conceptual definitions of the integrative nature of fiscal and monetary policies take center stage. International economic issues that were always of principal import to our regional economic systems, now command an attention as if it is the only thing that matters. So, as we struggled to define our path as to which mattered, namely money or the fiscal system, today we are being ushered into a world where international economic issues are, seemingly, the only things that matter. Narrowly configured, the architecture of this new international economic system centers on an approach that suggests that the value of currency in regional and world currency markets, the large and persistent current account deficits, the adjustment problems of heavily indebted countries, are all that make the mare go in the stable where the beast of burden is the exchange rate, and where that exchange rate is the adjustment mechanism leading to one kind of economic development or another. Against this background, we now consider the Floating Exchange Rate and the Fixed Exchange Rate and seek to come to some consensus as to which is more important, and why.

## FLOATING EXCHANGE RATE REGIME

In the late nineteenth century, in part of the inter-war period, and after World War II, until 1973, exchange rates among currencies were fixed. The Bretton Woods system (named after a historic meeting at Bretton Woods, New Hampshire, USA) that was in operation from the end of World War II up to 1973, and the gold standard of the nineteenth and twentieth centuries were examples of a fixed exchange system. Nowadays, however, international economics and the system of globalization stress a system whereby currencies are transformed into one another at the international market much like goods and services are transformed at the level of an individual economy. The rates at which the transformations are effectuated are called the *Exchange Rates*. In a nutshell, the Exchange Rate states the price, in terms of one currency, at which another currency can be bought. There is an exchange rate for every pair of currencies. For instance, two dollars and seventy cents are the equivalent of one United States dollar; that is EC\$2.70 is equal to US\$1.00. We could also say that the EC\$ is nominally 37 cents in terms of its US correspondence. In the present international economic arrangements, currency rates tend to change frequently. We will not dwell too much on why the rates change, suffice to say that we can characterize the changes in two forms. When other currencies become more expensive in terms of the EC dollar, for example, (and this is just our reference point), we contend that the other currencies have *appreciated* relative to the EC dollar. *Hence a nation's currency is said to appreciate when exchange rates change such that a unit of its own currency can purchase more units of an international currency.*



On the hand, when the EC dollar purchases less of an international currency, the EC dollar is said to have depreciated relative to the other currency. *Thus, a currency is said to depreciate when the exchange rates change such that a unit of its currency purchases fewer units of an international currency.*

### **FIXED EXCHANGE RATE REGIME**

Two other features are of general concern when we consider the appreciation and depreciation of currencies. Paradoxically, these terms are devaluation and revaluation. Appreciation and depreciation of currencies are used when the exchange rates are operational in a free market, unfettered, as it were, by the shenanigans of governmental interference. However, when an officially set exchange rate is changed such that a unit of a nation's currency buys less units of an international currency, we say that there has been a *devaluation* of that currency. On the other hand, when the exchange rate is changed such that the currency can purchase more units of the international currency, we say that there has been a *revaluation*. Note, here, that it is the market intervention by a governmental authority in the "free market" that moves the terms from "appreciate" and "depreciate" to "devaluation" and "revaluation." Hence, in a schematic manner we have present Table One below which shows what happens under what system when floating or fixing of the exchange rate is in vogue. There it would be noted that float and fixed are nothing more than bi-polar cases of each other. In essence, a governmental authority is at the helm in the case of the fixed scenario, while the laws of the market, the vaunted supply and demand are in operation in the case of the floating or flexible. All of the biases, therefore, of one or the other system come into play.

**TABLE 1.0: A SCHEMATIC OF THE FLEXIBLE AND FIXED EXCHANGE RATES AND THEIR IMPACT**

	FLOAT	FIXED
APPRECIATION	+	0
DEPRECIATION	-	0
DEVALUATION	0	+
REVALUATION	0	-

Source: Our derived schematic

### WHY DO COUNTRIES FLOAT?

What is the motivation for a country to float its currency? Why do countries change their exchange rates? We examine this motivation to float, for the use of floating seems to have many contrived and real reasons as to the efficacy of floating as opposed to other actions.

In a system where currencies are permitted to float or where currencies are flexible, the underlying notion is that central bank, in a Friedmanian sense, will be lackadaisical, and hence it will not interfere in the monetary system. The central bank will assume a passive stance and let the exchange rate be determined freely in the foreign exchange markets (FORX). This notion of float is a *clean float*. The central bank's non-intervention in the FORX, means that official reserves transactions are zero. Thus, in this floating system, the balance of payments (BOP) is zero. The exchange rate will adjust to make the current and capital accounts sum to zero. Pragmatically, however, the floating or flexible exchange rate system has not always been that squeaky clean, as the theoretical argument would have us believe. In fact, *the system has been managed or has been dirty*, as

some people have called it. "Under managed floating, central banks intervene to buy and sell foreign currencies in attempts to influence exchange rates." (Dornbusch and Fischer 1990, p. 180). Under managed floating, official reserves are not equal to zero.

Prior to the collapse of the Bretton Woods system, advocates of the floating exchange regime contended that the real exchange had a tendency to be more stable, given that flexibility in nominal rates would balance out the impact of the various national inflation rates of many countries on a given country's international competitiveness. (Friedman, 1953) and Sohmen (1961) make this point and Liang (1998) reviews this notion in terms of the exchange rate. Floating was the *sine qua non* for good economic governance. Friedman's point of view was nothing more than his free market thesis as enunciated in his governmental hands-off approach to money, the exchange rate, and the rest, as he developed in his apparent distaste for any government to interfere in the money market. In fact, his rules-base approach suggested that if a rule is set, central banks, and in his case the FED in the USA, would really be redundant.

In 1973, all major exchange rates were permitted to float. When President Nixon allowed gold to appreciate to its natural market value, the efficacy of the floating exchange rate was seriously called into question. Central to the post-World War II experience of floating currencies is the issue of high volatility of the nominal and the real rate of exchange. The jury is out on the volatility issue. But the jury has come in on the particularly way the volatility of the real exchange rate has performed in periods of floating exchange. It is to be understood, however, that from as far back as 1880, up to the present, we have had all kinds of permutations of floating and fixing.

In table two below, after Hong Liang (1998), we note that floating and fixing seemed to have had some periodicity.

TABLE 2.0 EXCHANGE RATE REGIMES

1880-1913	1914-1926	1927-1931	1932-1938	1946-1971	1972-1997
<b>Fixed Exchange Regime</b>	<b>Flexible Exchange Regime</b>	<b>Fixed Exchange Regime</b>	<b>Flexible Exchange Regime</b>	<b>Fixed Exchange Regime</b>	<b>Flexible Exchange Regime</b>

Source: Liang (1998: 9).

### NOMINAL AND REAL EXCHANGE RATES: DOES IT MATTER?

There are three pieces of information that are important in this scenario of the exchange rates. First there is the bilateral nominal exchange rate. If the USA dollar to the Guyanese dollar, that is USA\$/GYD is 1/150, then the .00666 is the bilateral nominal rate. The rate is bilateral in the sense that it is merely the exchange rate of Guyanese dollar for the USA dollar, that is one currency for another. The rate in this case is *nominal* in that the rate is specified in nominal terms as so many USA dollars per Guyanese dollars or so many USA cents per Guyanese cents.

In Table 3.0 we illustrate some nominal exchange rates for some Caribbean Development Bank countries over two periods, 1998 and 2000. Here we portray the December rates and the average rates for the two years. The Eastern Caribbean, the Bahamas, Barbados, Belize and the Cayman Islands all have fixed exchange rates vis-à-vis the USA dollar. Guyana, Jamaica and Trinidad and Tobago all have floating, managed floating or dirty floating exchange rates vis-à-vis the USA dollar. For the floaters, it would have been useful, also to consider the real exchange rate versus their nominal.

**Table 3.0 APPROXIMATE CARIBBEAN EXCHANGE RATES (US\$1.00)**

<b>DOLLARS</b>	<b>DECEMBER 1998</b>	<b>AVERAGAE 1998</b>	<b>DECEMBER 2000</b>	<b>AVERAGE 2000</b>
<b>EASTERN CARIBBEAN (XCD)</b>	2.70	2.70	2.70	2.70
<b>BAHAMIAN (BSD)</b>	1.00	1.00	1.00	1.00
<b>BARBADOS (BBD)</b>	2.00	2.00	2.00	2.00
<b>BELIZE (BZD)</b>	2.00	2.00	2.00	2.00
<b>CAYMAN ISLANDS (KYD)</b>	0.83	0.83	0.83	0.83
<b>GUYANA (GYD)</b>	150.00	145.86	180.51	180.36
<b>JAMAICAN (JMD)</b>	37.15	36.18	45.10	42.43
<b>TRINIDAD AND TOBAGO (TTD)</b>	6.28	6.22	6.24	6.23

Source: Caribbean Development Bank, *Annual Reports, 1998 and 2000*

For comparative purposes, we usually want to have a measure whereby we can measure the movement of our currency relative to all other currencies in a simple index. Here *a multilateral or effective exchange rate* is used. This multilateral or effective exchange rate is fundamentally a market basket of international currencies, each weighted by its centrality of importance to the country in question, as far as international trade is concerned. For the Caribbean, many years ago the pound sterling would have had a very large weight. Today the USA, Britain, Europe and the rest of the world may be the order of weighting. We are therefore able to track performance and plan actions of development in our countries based on the weighting of the currencies. The effective exchange rate measures the average nominal exchange rate. But, in reality, countries are more concerned with the real exchange rate. In other words, countries have to take into consideration what happens to prices at home and abroad. It is particularly important to know whether our goods and services are becoming relatively

more expensive or cheaper than international goods and services. When we are in open economies, like the Caribbean, the edge of comparison of the prices at home and abroad is vital. For our agricultural products and our tourism, the real effective exchange rate, or merely the real exchange rate is of paramount importance.

*The real exchange rate (RER) measures a country's competitiveness in international trade. The RER is the ratio of prices of goods and services in the international community, measured in the home currency, relative to the prices of goods at home.*

The RER, therefore could be noted as follows:

$$\text{RER} = \frac{eP_I}{P_H} \quad (1.0)$$

$P_H$  stands for price level at home and  $P_I$  stands for the price level in the international community, respectively, and "e" is the home country price of foreign or international exchange. In the case of a Guyana rest of the world scenario,  $P_I$  will represent international prices, for prices in terms of USA\$; so the exchange will be measured as a number of Guyanese dollars per USA\$ dollars. Thus the numerator in 1.0 above reflects prices abroad measured in Guyanese dollars. With the Guyanese dollars, that is  $P_H$ , the denominator expresses the real exchange rate abroad relative to those in Guyana.

From here on, the equation becomes tricky. And this is the crux of why a country may wish to float or to remain fix.

An increase in the real exchange rate, or a real depreciation, represents the fact that international prices in terms of the home prices have risen relative to the prices of goods and services at home. Goods and services in the international community, that is abroad, have therefore

become more expensive relative to goods and services at home. *Ceteris paribus*, this implies that there will be a **tendency** to shift some of our purchasing to goods and services at home from abroad. This code shifting is characterized as an increase in the competitiveness of our goods and services; it suggests that our goods and services are now more relatively cheaper than goods and services in the international or foreign community, both for us at home and for foreigners. On the other hand, a decrease in RER, or a real appreciation, represents the fact that our goods and services have become relatively more expensive, and given the scheme of things, we have lost our competitiveness. This is often said of our tourism in the Caribbean. What is really the truth behind these movements in the RER? How does the floater or fixer operate and what are the benefits in the context of monetary and fiscal policies? The answer to this question is at the epicenter of this paper.

#### FLEXIBLE OR FIXED EXCHANGE RATE? WHICH IS BETTER?

According to the International Monetary Fund (1999, Appendix I), at the beginning of 1999, of the 185 countries on which data were available, the various exchange rate regimes were divided as follows: 84 pegged countries; 75 floating countries and 26 limited flexibility countries. Among the 84 pegged countries, 37 had no separate legal tender; 8 used a Currency Board System; 24 were pegged to another currency, and 15 were pegged to a composite market basket of currencies. Among those that were floating, 27 operated a managed float and 48 operated an independent float. What, then, can one make of this canvass of exchange rate regimes? The what goes back to our initial statement that countries do their own thing according to their historical experience, convenience and or the overarching international

periodicity. Howard J. Shatz and David G. Tarr (2000: 1) argue that there are clear advantages and disadvantages of both fixed and flexible exchange rates, and their variants, but as a practical matter "exchange rate management in many countries in the world has resulted in overvaluation of the real exchange rate, in some cases leading to gross distortions." Ghei and Kamin (1999) present detailed explanations and econometric evidence of the so-called black market premiums of countries which have fixed exchange rates. For countries in the Caribbean, the use of float of fixed has some historical genesis. The shift of trade emphasis from the UK to the USA was clearly one of the principal features why the EC dollar was pegged to the USA dollar. Those who maintain links like the Bahamas and Belize know why they have maintained their links. Those like Jamaica and Guyana floated to attempt to capture some of the underlying features of international competitiveness.

Unfortunately, in our region, where fiscal and monetary policies have bi-directional links as far as the impact of money and the public sector are concerned, tampering with the exchange rate, or assuming that the "free market" will bale you out of your problems, is a pie in the sky hope. If the currency is overvalued, so the argument goes, devaluation of the nominal exchange rate will be beneficial to the country that devalues. The paradox of this situation lies in the fact that when a country devalues, there is, as it were, a psychological cloud of the country that makes almost impossible for the country to regain its former glory. Large countries can devalue and or change their currencies and get away with the actions. On the other hand, small countries which devalue are thrust in a black hole of never-never-land. The vaunted competitiveness that is suppose to come along with the devaluation does not come along because much of the developmental thrusts



of small countries, small and microstate economies, like in the Caribbean, come from abroad. So, on the one hand the theoretical argument may hold the some level of competitiveness will develop after the exchange rate changes. But since the inputs for development are imported, much leakage takes place and the foreign exchange that we would want to conserve goes out through the window if not the door of the foreign exchange market. In small countries and microstate economies, like those in the Caribbean, it is imperative that monetary and fiscal policies be integrative and linked to exchange rate policies to get both internal and external balance in sync. Trade deficits are the biggest problems of countries in the Caribbean. Trade deficits normally reflect fiscal deficits. In many Caribbean countries, trade deficits are financed by monetary expansion. In the Eastern Caribbean, fortunately that is not the case.

In our open economy model as is glaring exemplified in the Caribbean an increase in our prices makes our goods and services less competitive with internationally-produced goods. When the prices of our goods in the Caribbean rise, given the exchange rate, our goods become more expensive for outsiders to purchase, and their goods become relatively more cheaper for us to buy in our home bases. Thus, an increase in our local prices is tantamount to an increase in the relative price of the goods and services we produce in the region. This forces a shift away from our goods to imports, a reduction of exports, and a balloon in our trade gap. We are then caught on the horns of dilemma. Here again we are trapped. We set out to benefit the local economy by manipulating the exchange rate but we end up shooting ourselves in the foot because the change was more beneficial to the international economy, given the nature of our import-export profile.

Which is better? Flexible exchange and floating exchange? The story is inconclusive. What is clear is this: the strong arguments that floating or flexible exchange rates will get rid of distortions, and fixed exchange rate will not need to be tempered some what. The underlying management of the economic fundamentals of countries play a more fundamental role than the mere manipulative role of the exchange rate. From the variations of floating and fixed as noted in the IMF Report, 1999, it is clear that rates in and of themselves do not a economic growth path. For us, however, it is clear that in countries where the public sector is strong a fixed exchange rate is just as much strength as a float exchange rate. Furthermore, to assume that the benefits of the free market type of floating or flexible exchange rate will redound in abundance to the operators of such as system, is to assume that the underlying features of the free market will operate differently in the currency market from the goods markets.

Monetary policies and fiscal policies are best operationalized when they are of the integrative nature, and whether one uses a fixed exchange rate or a floating exchange rate, the interactive or integrative nature of the money and fiscal policies must be working in concordance, not in discordance. The exchange rate is not like penicillin or viagra. It cannot take care of all diseases, and it cannot make whole what is not whole.

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