



From Fixed to Float: Fear No More

The nuts and bolts of how countries can move to floating exchange rates

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ALTHOUGH a majority of the world's countries maintain pegged exchange rate regimes, a growing number of economies—such as Brazil, Chile, Israel, and Poland—have adopted flexible regimes over the past decade. This trend will likely continue because deepening cross-border linkages have increased the exposure of countries with pegged regimes to volatile capital flows. And flexible regimes usually offer better protection against external shocks and greater monetary policy independence.

Even so, many countries are reluctant to float their exchange rates for fear of excessive volatility—a major concern for countries whose balance sheets are exposed to exchange rate risk and where exchange rate pass-through to inflation is higher—and of a diminished ability to control inflationary expectations. They also worry about achieving an orderly exit from a peg, as it requires advance preparation, good timing, and a strong policy framework. Indeed, the reality is that a majority of exits to flexible regimes have been driven by crises (see Chart 1).

What steps can countries take to minimize the risks associated with moving from a fixed to a flexible exchange rate, and how quickly should they move? Should they exit from a peg before or after liberalizing their capital account? This article summarizes key operational and policy issues for countries that have decided to adopt a market-determined exchange rate. Our goal is to provide hands-on guidance to help alleviate the “fear of floating” of countries managing the transition. Not surprisingly, sound macroeconomic and structural policies are vital preconditions for countries moving toward exchange rate flexibility, just as they are for maintaining a credible peg. But we emphasize that institutions and markets also matter.

Foreign exchange market

First, *it is essential for countries to develop a deep and liquid foreign exchange market for price—exchange rate—discovery and determination.* Foreign exchange markets of most developing and emerging market economies are shallow and inefficient, partly because they rely extensively on foreign exchange reg-

ulations. Exchange rate rigidity also hinders the development of the foreign exchange market because market participants have less incentive to form views on exchange rate trends, take positions, or manage risks. Moreover, a central bank operating a fixed regime is usually active in the market by necessity, which constrains interbank activity.

What steps can countries take to improve the depth and efficiency of their foreign exchange markets? Allowing some exchange rate flexibility is the single most important step. Fluctuations in the exchange rate, even if small, quickly create incentives for market participants to gather information, form views, price foreign exchange, and manage exchange rate risks (see Chart 2). It is essential that the first step toward flexibility—regardless of the pace of exit—be large enough to produce a sense of two-way risk in the exchange rate. Two-way risk induces market participants to take both short and long positions. Other steps countries can take to deepen the market include

- *reducing the central bank's market-making role*—including its quotation of buying and selling rates—which undercuts other market makers. Instead, the central bank can foster the market by minimizing its trades with banks and by being a price taker. For example, in Turkey, the central bank gradually withdrew from the market after the lira floated in early 2001, forcing market participants to trade among themselves.

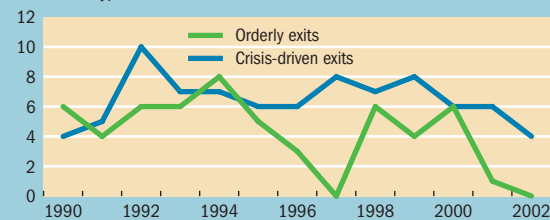
- *increasing market information* on the sources and uses of foreign exchange and on balance of payments trends so that market participants can develop credible views on the exchange rate and future monetary policy and price foreign exchange efficiently.

Chart 1

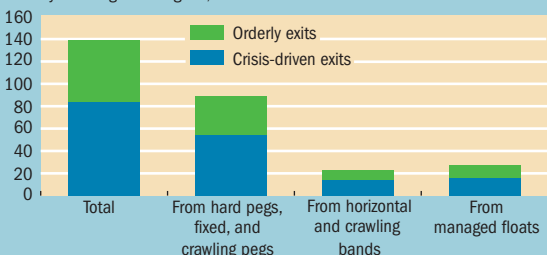
Orderly versus disorderly exits

Most exits to flexible exchange rate regimes have been crisis-driven rather than orderly.

Number and type of exits



Exits by exchange rate regime, 1990–2002



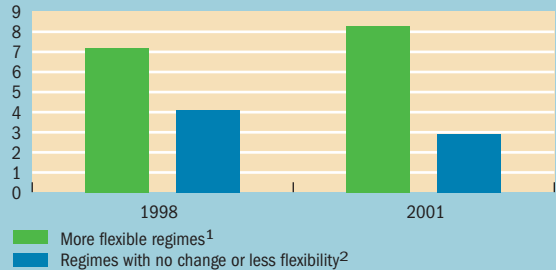
Source: IMF.

Chart 2

How flexibility helps

While foreign exchange market turnover has declined in countries with less flexible (or unchanged) regimes, it has grown in emerging markets with greater exchange rate flexibility.

(percent of current and capital account flows)



Sources: Bank for International Settlements; and IMF.

¹Brazil, Chile, Czech Republic, Philippines, Poland, Russia, South Africa, and Thailand.

²Hungary, India, Malaysia, and Mexico.

- *phasing out regulations that stifle market activity*, such as the requirement to surrender foreign exchange receipts to the central bank, taxes and surcharges on foreign exchange transactions, and restrictions on interbank trading. Other measures to take are unifying foreign exchange markets and relaxing current and selected capital account restrictions.

- *unifying and simplifying foreign exchange legislation* and avoiding ad hoc and frequent changes. Well-defined, simple, and easily understood foreign exchange laws and regulations can improve market transparency and reduce transaction costs.

- *facilitating the development of risk-hedging instruments* by lifting controls on forward market activity once financial institutions achieve adequate risk management capacity.

Official intervention

Second, *countries need to develop policies to guide the objectives, timing, and amounts of foreign exchange intervention*. In fixed regimes, the timing and amount of intervention are largely beyond central banks' control. In a flexible regime, intervention is discretionary, and central banks still intervene to correct misalignment, calm disorderly markets, accumulate reserves, and supply foreign exchange. But country experiences suggest why interventions may need to be selective and parsimonious.

- *Exchange rate misalignments are difficult to detect and measure*, given the variety of methodologies for estimating the equilibrium exchange rate.

- *Short-term exchange rate volatility may not always warrant intervention*. Exchange rate volatility may result from changes in economic fundamentals or the arrival of new information and reflect the market process of price discovery. Moreover, despite the widespread view that exchange rate volatility can have real economic costs, empirical studies have failed to detect them.

- *Official intervention may not always be effective* in influencing the exchange rate or reducing volatility, as seen in Chile, Mexico, and Turkey. In fact, intervention often increases exchange rate volatility.

- *Intervention is more effective when it is relatively infrequent* because it maximizes the element of surprise and builds market confidence in the official commitment to exchange rate flexibility.

Transparent intervention policies also help. Many countries, among them the Philippines and Turkey, affirmed their commitment to a market-determined exchange rate and stressed that intervention would not target the exchange rate. Moreover, a public commitment to the objectives of intervention enables market scrutiny of, and accountability for, the central bank's foreign exchange operations. Good examples of transparency are the published intervention policies of Australia and Sweden clearly stating the reasons for intervention.

Changes in anchor and monetary policy

Third, **countries need to establish a new nominal anchor and redesign the monetary policy framework to accommodate it** when they exit from a fixed exchange rate. These two tasks require substantial capacity and credibility building. Planning for the transition is vital for an orderly exit. The difficulty of developing an alternative nominal anchor—which serves to anchor inflationary expectations—has caused many countries to relinquish the exchange rate's anchor role (and therefore fixity) only gradually. Several countries have used a (gradually widening) crawling band as an intermediate regime for transitioning to another nominal anchor, potentially over a long period (as in Chile, Hungary, Israel, and Poland).

Countries that have managed orderly exits from pegs have thus generally adopted inflation targeting as an alternative nominal anchor over long time horizons. The lengthy transition periods have reflected, in part, the time required to fulfill the necessary institutional requirements and macroeconomic conditions. But regardless of whether preconditions for full-fledged inflation targeting are met, many of its elements are critical to building a reliable monetary policy framework. In particular, the monetary policy regime should give uncontested priority to price stability over competing objectives, provide operational independence to the central bank, establish transparency and accountability for the conduct of monetary policy, demonstrate adequate capacity to forecast inflation, and take policy actions consistent with maintaining price stability. Moreover, monetary policy has more credibility when it is anchored in an intermediate targeting rule based on inflation forecasts and in a formal process of monetary policy-making (such as regularly held monetary policy committee meetings followed by the issuance of press releases, rather than ad hoc decision-making and communication processes).

Managing exchange rate risk

Fourth, **countries need to contain exchange rate risks in all sectors of the economy**. Building the capacity of market participants to manage these risks and of the supervisory

authorities to regulate and monitor them takes time and should be nurtured while the exchange rate is still pegged.

The Mexican financial crisis in 1994 revealed how a government's poor management of foreign currency liquidity can trigger a currency crisis. Similarly, the East Asian crisis showed how unhedged foreign exchange borrowing by the corporate sector can translate into massive losses for creditor banks and a surge in demand for foreign currency. Even when banks match foreign currency liabilities and assets, the use of short-term external funds to finance long-term foreign currency loans to unhedged borrowers creates sizable credit and liquidity risks for banks.

A comprehensive analysis and management of exchange rate risks in all sectors of the economy is a key step for countries planning an orderly exit from a peg. Evaluating exchange rate risk exposures, in turn, involves detailed balance sheet analysis—focusing not only on currency compositions of balance sheet items, but also on the maturity, liquidity, and credit quality of foreign currency assets and liabilities.

Exchange rate risk is also present in pegged regimes, but regulating and managing the risk is more pressing in flexible regimes, where exchange rates fluctuate daily. The management of exchange rate risk by financial institutions involves establishing information systems to monitor the sources of risk, designing accounting-based formulas and forward-looking analytical techniques to measure risk, and developing internal risk policies and procedures.

Timing of capital account liberalization

Turning to the critical policy issues, countries must weigh whether they should liberalize their capital account before or after moving to greater exchange rate flexibility. The experiences of emerging markets over the past decade highlight the risks associated with opening the capital account before adopting a flexible exchange rate. Many countries were forced off pegs after sudden reversals of capital flows under open capital accounts (Mexico at the end of 1994, Thailand in July 1997, and Brazil in early 1999). Others, facing heavy inflows and upward pressure on pegged rates, had to allow exchange rate flexibility to avoid overheating the economy (Chile and Poland during the 1990s). Thus, even under favorable economic conditions, opening the capital account before introducing exchange rate flexibility can destabilize domestic liquidity conditions, create macroeconomic imbalances, and precipitate speculative attacks.

Even when exchange rate flexibility comes before the capital account is opened, however, the direction and composition of capital account liberalization has macroeconomic implications. For instance, countries opening the capital account to inflows run the risk of creating excess liquidity and credit growth. More generally, a substantial asymmetry in the openness of the capital account can introduce an upward (or downward) bias in the value of the exchange rate relative to its long-term equilibrium value. (For example, because China is more open to capital inflows than to outflows, some observers have speculated that the current upward pressures on the renminbi may not continue if capital outflows are allowed.) Thus,

the shift toward exchange rate flexibility should be supported by a gradual removal of existing asymmetries in capital mobility to facilitate an orderly correction of any potential exchange rate misalignment.

Fast or slow exit?

Countries must also decide how quickly they should adopt exchange rate flexibility. Gradualism entails taking measured steps toward a free float—for example, by shifting from a fixed peg against a *single* currency to a fixed or crawling peg against a *basket* and, further, to an exchange rate band with incremental increases in the bandwidth. By contrast, a rapid approach involves fewer intermediate steps, if any.

The degree of institutional and market development is a key determinant of the appropriate pace. In the absence of supporting institutions and markets, a *gradual* exit strategy may be more appropriate as it reduces the risk of excessive exchange rate volatility and its potentially adverse effects on market credibility, inflationary expectations, and balance sheets. It also allows the foreign exchange market to deepen through the mutually reinforcing relationship between exchange rate flexibility and foreign exchange activity

A rapid exit strategy offers important advantages, provided that the institutional underpinnings for operating a floating exchange rate are in place. A rapid approach—if undertaken from a position of macroeconomic strength and with a prudent monetary policy in place—can signal the commitment to exchange rate flexibility more credibly than a gradual approach. It also provides greater discretion on foreign exchange intervention: the lack of commitment to a predetermined exchange rate path or bandwidth allows the central bank to limit its interventions and conserve its foreign exchange reserves.

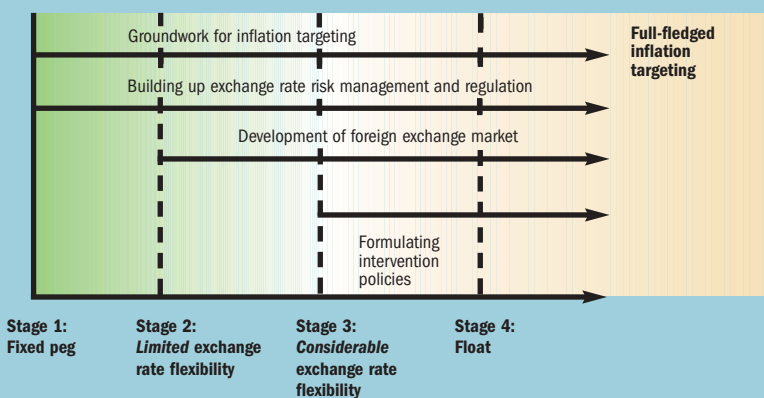
Whatever the exit strategy, each step forward should aim to create two-way risk in exchange rate movements. For example, when a band is used, it should be wide enough to ensure that the exchange rate moves in both directions around the central parity. It is also critical to adjust the exchange rate level to ensure that the flexibility offered by the bandwidth is not quickly exhausted by a potential misalignment. A move to a narrow band under persistent upward pressures can cause the exchange rate to hit the band's upper limit, forcing the monetary authorities to either defend the band or widen it further. Frequent adjustments in bandwidth, in turn, can impair market credibility and lead to speculative pressures to test the band limits. These issues become more pressing with greater capital account openness.

Early preparation can bolster an exit strategy's chances for success—gradual or rapid. Many of the operational steps require substantial time to develop, and countries should lay the groundwork before exiting a peg (see Chart 3). They can,

Chart 3

Orderly exit

Taking a step-by-step approach in preparing for an exchange rate float makes success more likely.



Source: Authors.

for example, undertake several aspects of the operational prerequisites: secure central bank independence, improve inflation-forecasting capacity and monetary policy transparency, develop information systems on foreign exchange risk, and increase information on balance of payments developments. The second stage may involve some exchange rate flexibility to stimulate foreign exchange market activity while allowing other operational areas to develop. Intervention policies can be addressed once greater exchange rate flexibility is embraced. ■

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