Anchoring the Exchange Rate

Pedro Palma

In December 1995, *Business Review* staff member, Ana-Maria Smith, traveled to Caracas, Venezuela to conduct the following interview with Señor Pedro Palma, a prominent Latin American economist and Managing Director at Booz, Allen & Hamilton (Andean region). The following conversation focuses on using the exchange rate system as an anchor for economic policy. Specifically, the fixed exchange rate is used as a means to reduce inflation, encourage a disciplined fiscal policy and thus provide a more predictable climate for foreign investors. According to Palma, if the exchange rate isn't properly executed, instability will result. Therefore, the following conversation aims to elucidate the importance of a properly instituted exchange rate.

Business Review: *Señor Palma. The exchange rate issue has long riddled the Latin American region. Over the last several years, fixing the exchange rate has become increasingly popular in order to combat the runaway inflation. What countries have experimented with it?*

Palma: Generally, the policy of fixing the exchange rate is part of a stabilization or anti-inflationary policy. This policy has been used in many Latin American countries with very high inflation levels. For example, Argentina had inflation in the thousands when [Domingo] Cavallo (Finance Minister) established the exchange rate. Mexico had an inflation rate of over a 100%. Brazil, when it applied the "Plan Real" two years ago, also had four-digit inflation. Chile used this policy in the 1970's with an inflation rate of over 300%. The fixed exchange rate is an extremely important variable in stopping inflation.

Business Review: *It is important to understand that the exchange rate must be properly implemented, though, right?*

Palma: Yes. If the exchange rate policy is carried out only as an anti-inflationary measure and the government does not establish in parallel other important measures (e.g. monetary restriction, fiscal restriction, rationing commercial policies and reasonable labor cost structures), then the economy will be in a critical situation. The exchange rate policy must be a part of an all-encompassing economic policy package.

Business Review: *If the government fails to institute other economic measures in concert with the fixed exchange rate, then what is most likely to result?*

Palma: With a fixed exchange mechanism that does not impose restrictions on the amount that can be exchanged, then everybody knows that they can import products from abroad since the prices will only be affected by the international inflation rates. If the internal inflation rate continues to rise, then domestic products cannot compete with these imports. The situation is made worse if there is a reduction in tariffs. Thus, the country becomes flooded with imported products.

Business Review: *Brazil, renowned for its massive inflation over the years, has drastically curtailed its inflation rate. But at what economic cost has it been able to achieve this?*

Palma: In economies that have high inflation, like Brazil, who use this policy for stabilization, they are

able in a very short period of time to go from an inflation rate of over 3000% to a very low inflation rate of approximately 27%. This would imply an extraordinary success of the economic policies. They have managed to stop inflation radically. But the catch is that the inflation rate has not gone down to international levels of 3%, say in the case of the United States and Europe. After one year of this stabilization, you must allow a depreciation of the currency of about 25%. If not, problems of currency overvaluation begin to appear. This happens because even though the inflation rate declines significantly, it does not go down to international levels.

Business Review: *This currency differential then leads to a trade imbalance, correct?*

Palma: Absolutely. Since the prices of domestic products rise faster than those of imports, then it becomes attractive to take a quantity of local currency and change it into dollars. With these dollars, you can buy more than what you can buy domestically. Thus, the trend is to import more and more.

Business Review: *Evidently, we now have solved one economic problem while creating another. What's to follow?*

Palma: We need to have fiscal and monetary discipline to avoid recessionary pressures. We then must create a series of stimuli to foreign investment. Then private investment becomes very attractive.

Business Review: *At first glance, private investment in the region sounds very promising. But is it necessarily a means to a better end?*

Palma: In the beginning, private investment generates capital needs such as machinery and equipment. Moreover, the inexpensiveness of foreign products compared to domestic products leads to an excess of imports. This produces problems of imbalances in the current account.[1] balance of payments. At the beginning of the process, this is not a cause for concern because there is a steady inflow of capital.

Business Review: *The opening and modernization of the economy has certain linkage effects. In particular, what are these linkage effects and how do they impact the overall economic environment?*

Palma: The opening and modernization of the economy generates very good prospects for the economy. If we couple this with investment capital, then we get an inflow of speculative capital that is looking for short-term opportunities. This comes as a result of the modernized economy. This will create a surplus in the capital account[2] that will cover the deficit in the current account. While this lasts, all is well. But if the inflationary difference persists (i.e. 25% in the first year, 15% in the second year, 10% in the third year and 3% in the fourth year), it is not until the fourth year that we start to reach the international inflation rate. Therefore, in the first three years we have accumulated an over appreciation of our currency in real terms. This continues to stimulate imports and consequently the deficit of the current account. When this deficit starts to reach the point of 7-9% of the Gross Domestic Product, it becomes unsustainable. And, as a result, a devaluation is around the corner.

Business Review: *In fear of this, what must we do to insure that our currency doesn't spiral out of control?*

Palma: Of course, we will want to protect ourselves against this devaluation. When there is general consensus that a devaluation will occur not only does foreign investment cease to enter (particularly short-term

[1] Current Account - This is the broadest measure of a country's international trade in goods and services. Its primary component is the balance of trade, which is the difference between merchandise exports and imports.

[2] Capital Account - This is the difference between exports and imports of goods and services. A current account deficit occurs when imports exceed exports.

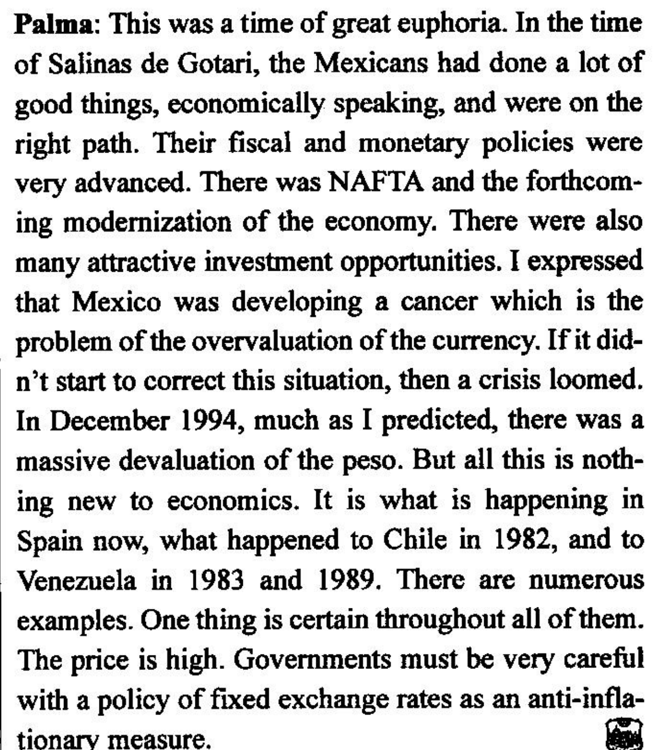
speculative capital) but also investment that had come in starts to leave the country. This creates a deficit in the capital account that only ameliorates that of the current account. So, unless we have a huge level of international reserves,[3] there will be a great deal of pressure on the exchange rate. This will then force the devaluation. This is precisely what happened in Mexico. The experience of Mexico is only one of many that have occurred in Latin America countries.

Business Review: *But are healthy international reserves alone sufficient enough to prevent a devaluation of the currency?*

Palma: Let me give you an example. In 1992 Spain underwent a similar experience to Mexico, not because they fixed the exchange rate but because the peseta started to appreciate considerably. This meant that the dollar was worth less and less in terms of pesetas (i.e. 93 pesetas per dollar). At that time, there was a big movement of Spaniards to foreign countries. Since Spain was part of the EEC (European Economic Community) and the European monetary union, they received support from France, England and other countries with strong currencies to maintain currency parities. Spain, with international reserves of $85 billion, had the third largest reserves in the world. In September 1992 the crisis hit. The deficit of the current account was so large that the people became convinced that a devaluation was impending. So the Spaniards started to protect their investment and there was a massive flight of capital. Spain devalued the currency. To defend the peseta against a very severe devaluation, it lost in one month $22 billion in international reserves. So even with the huge reserves combined with the EEC support, Spain could not support the pressure on its currency.

Business Review: *Sr. Palma. You went to Mexico in November 1992 to give your opinion on the Mexican economy. What did you say?*

Palma: This was a time of great euphoria. In the time of Salinas de Gotari, the Mexicans had done a lot of good things, economically speaking, and were on the right path. Their fiscal and monetary policies were very advanced. There was NAFTA and the forthcoming modernization of the economy. There were also many attractive investment opportunities. I expressed that Mexico was developing a cancer which is the problem of the overvaluation of the currency. If it didn't start to correct this situation, then a crisis loomed. In December 1994, much as I predicted, there was a massive devaluation of the peso. But all this is nothing new to economics. It is what is happening in Spain now, what happened to Chile in 1982, and to Venezuela in 1983 and 1989. There are numerous examples. One thing is certain throughout all of them. The price is high. Governments must be very careful with a policy of fixed exchange rates as an anti-inflationary measure.



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[3] International Reserves are foreign assets held by central banks. Transactions in official international reserves are known as the official reserve component of the capital account. The sum of the current account and the nonreserve component of the capital account is the balance of payments. A balance of payments deficit means that a country is running down its international reserves, and can signal a currency crisis due to an overvalued exchange rate.