Three Points on the International Monetary System

1. Financial markets are not efficient. They do not equalize rates of return across assets or countries. They are subject to fads and herd-like behavior. They allocate large amounts of capital in one direction and then reverse course suddenly, imposing substantial dislocations and adjustment costs.

Consequently, flexible exchange rates are not shock absorbers. Rather, they allow inefficient markets to inject noise into an important economic price (Flood and Rose JME 1995). This is why fixed exchange rates have an enduring appeal to many people.

The opening of capital markets in recent decades has vastly increased the flows of capital across borders. This poses problems for both fixed and floating rate regimes.

2. Despite point 1, floating exchange rates are preferred to flexible rates if a country has a capable central bank. Any hard constraint on exchange rates is anathema to independent monetary policy. Experience shows that a sound independent monetary policy framework, such as flexible inflation targeting or nominal GDP targeting, leads to the best outcomes (Gagnon 2011, 2013). Monetary policy is the most important shock absorber.

With fixed exchange rates, capital inflows tend to push up asset prices and boost domestic demand which supports higher imports and a trade deficit. A prime example is the euro area after 1999. With flexible exchange rates, capital inflows tend to push up the exchange rate, which supports higher imports and a trade deficit. However, monetary policy is free to respond as needed to keep output at potential. The run-up in asset prices is lower than under fixed rates and the economy does not overheat as much. Of course, flexible exchange rates do not guarantee an optimal monetary response. Many central banks, especially in emerging markets, make the mistake of damping exchange rate fluctuations too much.

3. Inefficient financial markets imply that sterilized foreign exchange intervention can have a meaningful effect. Although it cannot be used to reliably achieve any hard exchange rate target without sacrificing monetary independence, it can be used to lean against the wind of volatile capital flows. Capital flow measures, including taxation of foreign capital, are other tools that may be used against excessive capital inflows.

We don't know what exchange rate values are sustainable. We do know that large current account imbalances are not sustainable. Intervention and capital flow measures should be aimed at minimizing deviations of current accounts from norms based on demographics and growth trends that are not far from zero, especially for large economies. Monetary policy should focus on stabilizing inflation and output. Prudential regulation and macroprudential policy should combat financial sector risks.