Fixed and flexible exchange regimes, what is best in case of Jordan

In 1995 CBJ fixed the exchange rate to the dollar in order to achieve financial stability in Jordan, and since then CBJs main mission became to maintain the exchange rate of JD=1.41$, and so the JD is a strong currency because it is not pegged to the strength of our economy

Theoretical overview

let us discuss the advantages and disadvantages of both exchange regimes:

1- Fixed exchange rate:

Advantages:

A- Countries can induce exports by fix exchange rate at low level

If a country wants to support competitiveness of its exports, it can fix the exchange rate at low level especially in countries with low cost of production that exports to countries that have strong domestic currency

B- Supports rising standards of living and overall economic growth

Foreign exchange swings are known to affects economies growth outlook, such as what happened in turkey last year when Turkish lira depreciated significantly against the dollar which caused high inflation rate and the living standard has declined

It also provides economic stability, which will attract more investors to the country because they will not be afraid of losing their gains due to fluctuations in exchange rates

Disadvantages:

A- Need for large reserves

When CB fixes the exchange rate, he is obligated to buy and sell DA and FA in order to fix the exchange rate at desired level

B- Surrendering domestic monetary policy

Under fixed exchange regimes, the CB do not have the authority to control the monetary bases, because any change in monetary base will change interest rates, and this will affect the exchange rate

This phenomenon is called trilemma, which means that no country can have free cash flows, fixed exchange rate and monetary authority, it can choose only two of them, and usually countries prefer to keep free cash flows because the regulations on cash flows will make investors unwilling to invest in the country, because no one want to invest in a country that he could not withdraw his money from

2- Flexible exchange rate

Advantages:

A- Can reduce economic volatility

According to studies, terms of trade shock have half of the effect on economies with flexible exchange rate

Terms of trade is defined as the ratio between index of export prices and index of import prices, and the shock may result from shift in exports or imports prices

B- Gives more flexibility for internal policies

CB and GOV have the choice to implement fiscal or monetary policy to achieve economic goals without fear of burning out the reserves

Disadvantages:

A- Uncertainty for traders and investors

There is risk for traders and investors to lose money due to exchange rate fluctuations, this risk could be reduced by forward exchange contracts, but high volatility could lead to loss in confidence in the economic system

we can take turkey as an example, with high volatility in exchange rates investors' confidence in Turkish lira and investment in turkey has dropped

B- Big effects when the currency depreciates

When the currency depreciates, the imports became more expensive which will lead to inflation in prices

Countries with flexible exchange rate faces both demand-pull and cost-push inflation when exchange rate increases, and here we can take turkey also as an example, because of big increase in exchange rate in the last year, PPI has increased nearly 45%

Even with pros and cons of both of these regimes, neither of them is better than other, and the choice of the regime depends on which one will work better for the economy, but we have some theories that could help to choose the exchange regime, and we can group these theories under two major two broad segments:

1- Political economy theories:

Emphasis political factors like political stability and tendency to inflate the economy as important factors affecting the choice of exchange rate regime

The theory Shows that countries with low political stability have incentive to float the exchange rate because it lacks the political ability and support for the measures than could be required to defend the exchange rate

It also shows that under flexible exchange rate the political costs of exchange rate policies are lower because its less visible to the public

2- Fear of floating approach:

States that countries with high unhedged foreign currency denominated debt tend to peg the exchange rate with the currency they have borrowed on

The inability to hedge the debts usually reflects reluctance of foreigners to buy the domestic currency, and that the country can't borrow abroad in its own currency

the case of Jordanian economy

There are several reasons why the Central Bank of Jordan (CBJ) has fixed the exchange rate, but the most important one is that Jordan heavily relies on imports for consumption and production. With an imports/GDP ratio of 42%, a strong currency with a fixed exchange rate is preferable because it makes imports cheaper. If Jordan were to have a flexible exchange rate, the country would likely experience cost-push inflation due to its high reliance on imported raw materials and energy. We can observe this phenomenon in other countries that have a

production base that heavily depends on imports and a flexible exchange rate. These countries tend to have high inflation rates. For example, Kyrgyzstan's imports/GDP ratio is 64%, and its currency has lost 50% of its value since 2012. The inflation rate was 2.77 in 2012, but it rose to 13% in 2021.

If CBJ were to change the exchange regime, we can look at Egypt's experience for insights. In 2016, the Central Bank of Egypt (CBE) fully floated the EGP, which had an imports/GDP ratio of 29% in 2017. As a result, the Egyptian pound depreciated by nearly 40%, and the inflation rate increased to 23% in 2017. Both inflation and imports/GDP eventually increased and decreased, and this can be explained by the low elasticity of demand due to a lack of substitutes in the short run. Over time, people started substituting away from imported goods as they became more expensive.

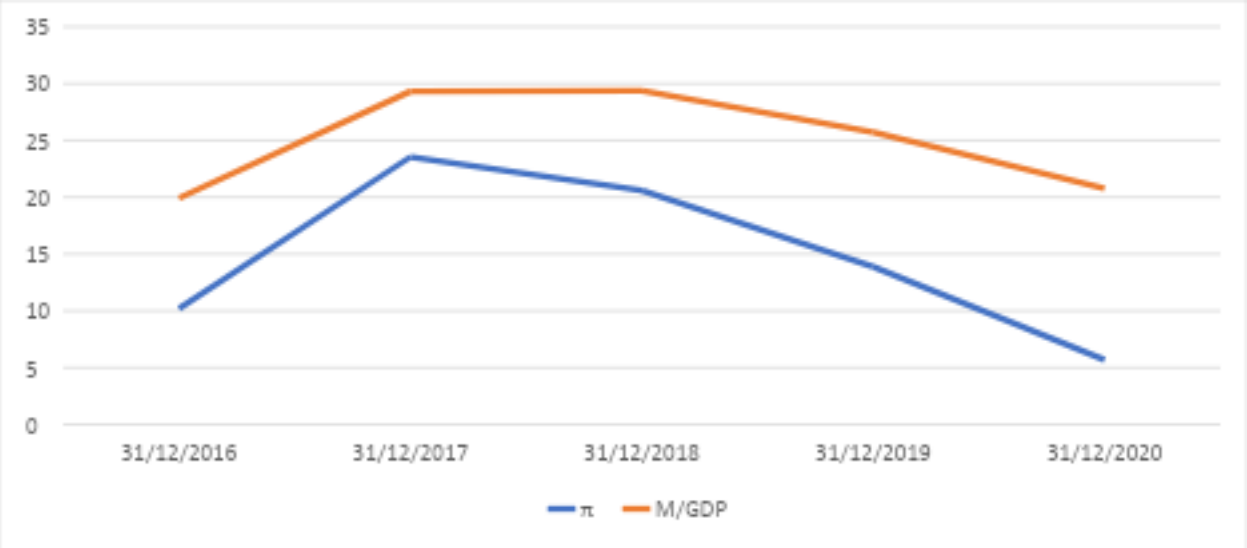


Figure 1M/GPD and inflation rate time paths

However, if Jordan were to implement a flexible exchange rate, it is unlikely to achieve the same results as Egypt. Inflation would increase and stabilize at some high level that corresponds to the real value of the Jordanian dinar (JD), but it would not decrease. This is because, unlike Egypt, Jordan has no domestic substitutes for energy and most raw materials used in production. Therefore, Jordan would keep importing but at higher prices.

If CBJ wants to float the exchange rate, some preparation must be made. The government should increase its dependence on domestic energy and other factors of production. For example, Jordan can use Ma'an for electricity generation, open domestic factories for fertilizers as it has large phosphate fields and use oily rock to extract oil and diesel. The government can also impose subsidies on water wells to reduce Jordan's dependence on imported water. After these steps are taken, CBJ could take floating the currency even if the JD depreciates, there are domestic substitutes for these primary goods.

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