

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

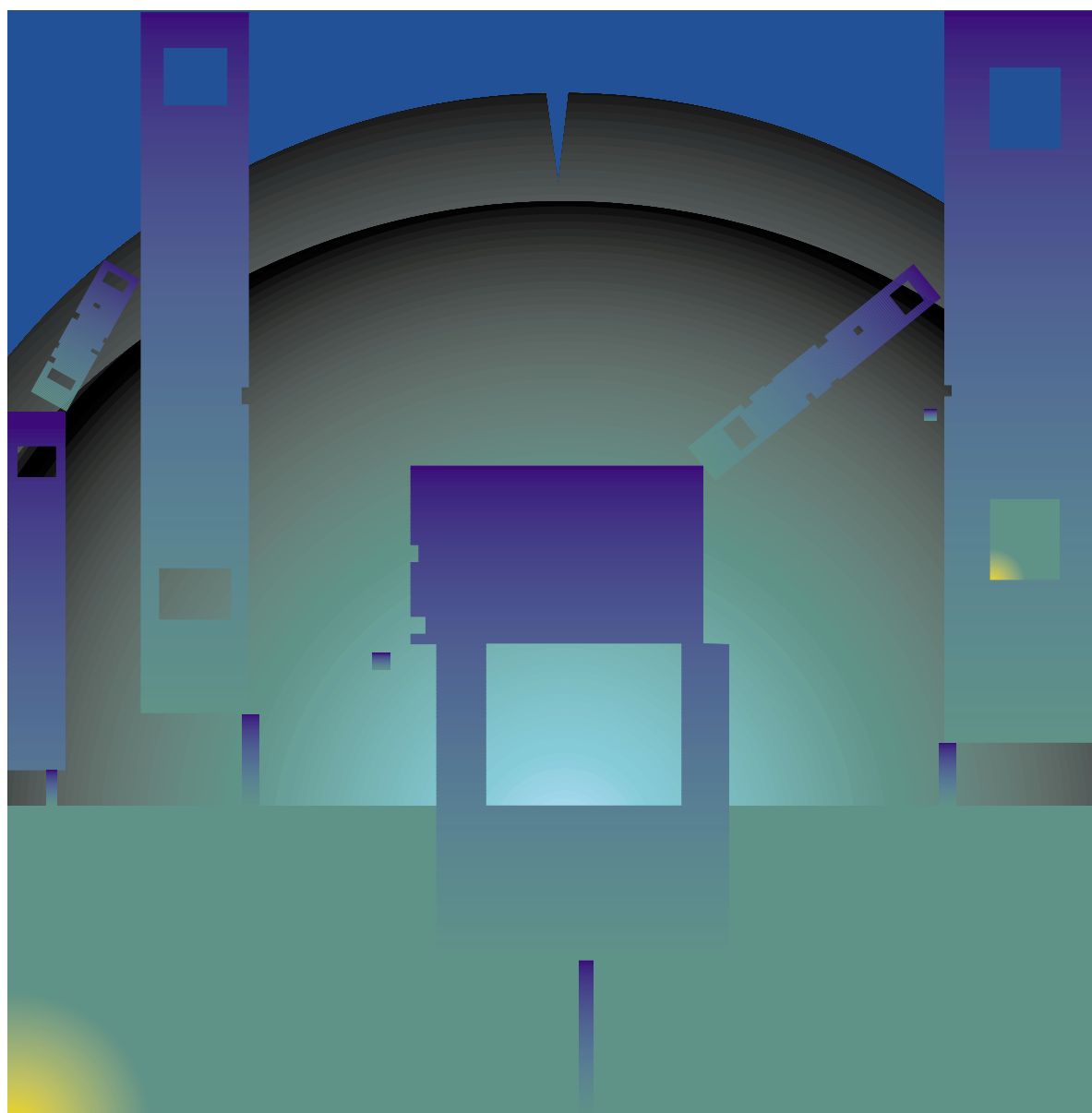
# TRADE AND DEVELOPMENT REPORT, 2001

*Global trends and prospects*

*Financial architecture*



UNITED NATIONS



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## EXCHANGE RATE REGIMES AND THE SCOPE FOR REGIONAL COOPERATION

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### A. Introduction

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Exchange rate regimes in developing countries and transition economies have attracted increased attention in the recent debate on the reform of the international financial architecture in view of their contribution to external vulnerability, and currency and financial crises. In countries that are closely integrated into international financial markets, adjustable peg regimes (the so-called soft pegs) are increasingly seen as the major cause of boom-bust cycles in financial flows. Consequently, the mainstream advice is that they either adopt a regime of freely floating exchange rates or that they make a credible commitment to defend a fixed exchange rate by locking into a reserve currency through currency boards or by adopting a reserve currency as their national currency (dollarization); in other words, they are advised to go for one of the so-called “corner” solutions as opposed to the intermediate regimes of adjustable pegs.<sup>1</sup> According to some estimates, almost two thirds of emerging-market economies were using intermediate exchange rate regimes in 1991, but by 1999 this proportion had fallen to 42 per cent, and the proportion using hard pegs or some variant of floating had risen to 58 per cent (Fischer, 2001, fig. 2). However, while many

countries afflicted by financial crisis in the past decade have subsequently adopted floating rates, the increased volatility associated with such regimes has become a source of concern. As a result, there now appears to be a greater interest among developing countries and transition economies in hard pegs. And increasingly, in a closely integrated global financial system, the existence of many independent currencies is being called into question (Hausmann, 1999).

For emerging-market economies, adjustable peg regimes are problematic under free capital mobility as they lead to boom-bust cycles and overshooting of exchange rates. However, neither free floating nor hard pegs constitute viable alternatives. Currency misalignments and gyrations associated with floating regimes can have serious consequences for developing countries with small and open economies and a relatively large stock of external debt denominated in reserve currencies. On the other hand, for most developing countries and transition economies, a policy of locking into a reserve currency and surrendering monetary policy autonomy can entail considerable costs in terms of growth, employment and inter-

national competitiveness – costs that far exceed the benefits such a regime may yield in terms of price and exchange rate stability. These conclusions are shared in a paper on exchange rate regimes for emerging-market economies jointly prepared by staff of the French and Japanese Ministries of Finance, on the occasion of the meeting of European and Asian finance ministers in Kobe, Japan, in January 2001:

There is no guarantee that currency board arrangements escape from the same drawbacks as pegged regimes. ... Free-floating strategies have their own costs of possible excessive volatility and free riding risks. (Ministry of Finance, Japan, 2001: 3–4)

A consequence of the mainstream advice is that developing countries with similar foreign trade structures and market orientation could end up at opposite ends of the spectrum of exchange rates – some with floating and others with fixed exchange rates against the dollar – even if there is a considerable amount of trade amongst them. Consequently, not only would their currencies be floating against each other, but also their bilateral exchange rates would be greatly influenced by the overall movement of the dollar against other currencies. Given the misalignments and fluctuations that characterize the currency markets, this would imply erratic, unexpected shifts in the competitive position of developing countries vis-à-vis each other. When there is considerable bilateral trade, as between Brazil and Argentina, such shifts can have an important impact on their economies, leading to tensions in trade relations. Briefly stated, unilateral corner solutions may result in inconsistent outcomes for the developing countries taken together.

The key question is whether there exists a viable and appropriate exchange rate regime for developing and transition economies that are closely integrated into global financial markets when major reserve currencies are subject to frequent gyrations and misalignments, and when the

size and speed of international capital movements can very quickly overwhelm the authorities in such countries and narrow their policy options. Can these countries be expected to solve their exchange rate problems unilaterally when the magnitude, direction and terms and conditions of capital flows are greatly influenced by policies in major reserve currency countries, and when international currency and financial markets are dominated by speculative and herd behaviour? Certainly, controls over capital flows can facilitate the prudent management of their exchange rates. Indeed, a few countries, such as China, have so far been able to pursue adjustable peg regimes without running into serious problems. However, several emerging markets have already made a political choice in favour of close integration into the global financial system and are unwilling to control capital flows. Furthermore, it may be very difficult for any single country to resist the strong trend towards liberalization of capital movements, particularly if it has close links with international markets through FDI and trade flows.

While all this implies that the solution should, in principle, be sought at the global level, the prospects for this are not very promising, given the stance of the major powers on the question of exchange rates. Since global arrangements for a stable system of exchange rates are not foreseeable in the near future, the question arises

as to whether viable solutions can be found at the regional level. In this respect, the post-Bretton Woods experience of Europe in establishing mechanisms to achieve a stable pattern of intra-regional exchange rates, and eventually move to a currency union, may hold useful lessons for developing regions, particularly East Asia and South America. However, while regional currency arrangements and monetary cooperation among developing countries could bring some benefits, they do not resolve the problem of what currency regime to adopt and how to achieve exchange rate stability vis-à-vis G-3 currencies. Even if they could achieve greater integration, developing countries could not neglect their exchange rates

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vis-à-vis such currencies. It thus appears that regional arrangements among developing countries may need to involve major reserve-currency coun-

tries or rely on a common regime of capital controls in order to achieve stability and avoid costly crises.

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## B. Exchange rate regimes

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### 1. *Soft pegs*

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It has long been established that an economy which is fully committed to free movement of capital (or which does not succeed in effectively controlling capital movements) cannot both fix its exchange rate (at a given value or within a narrow band) and pursue an independent monetary policy. Any attempt to do so will eventually run into inconsistencies that will force the country to abandon one of the objectives. One option would be to adhere to fixed exchange rates through currency boards or outright dollarization at the expense of autonomy in monetary policy. Another would be to move to floating exchange rates, thereby freeing monetary policy from defending a particular exchange rate (or a narrow band). The breakdown of the Bretton Woods system of adjustable pegs, the 1992–1993 crisis in the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) and the recent episodes of crisis in emerging markets are all seen as the outcome of the inconsistency between capital account openness, exchange rate targeting and independent monetary policy.

The Bretton Woods system of adjustable pegs operated with widespread controls over international capital movements. However, inconsistencies between the pattern of exchange rates and the domestic policy stances of major countries created serious payments imbalances and

incentives for capital to move across borders, circumventing the controls. This eventually led to the breakdown of the system and the adoption of floating rates. Even though the adjustable pegs in the EMS constituted a step towards monetary union (hard pegs) and were supported by extensive intraregional monetary cooperation, inconsistencies between macroeconomic fundamentals and exchange rates led to a crisis and breakdown of the ERM in 1992–1993. The adoption of soft pegs is also considered to be one of the root causes of recent financial crises in emerging-market economies such as Mexico, Thailand, Indonesia, the Republic of Korea, the Russian Federation and Brazil. The subsequent move by these countries to floating rates is often interpreted as the recognition that soft pegs are not viable for countries closely integrated into the global financial markets.

The role of soft pegs in contributing to external fragility and the outbreak of financial crises in emerging markets is well established.<sup>2</sup> Most emerging-market economies offer higher nominal interest rates than the industrialized world, in large part because of higher inflation rates. These create short-term arbitrage opportunities for international investors and lenders, as well as incentives for domestic firms to reduce their costs of finance by borrowing abroad. On the other hand, by providing implicit guarantees to international debtors and creditors, currency pegs can encourage imprudent lending and borrowing. The risk of depreciation

is discounted owing to the stability of the nominal exchange rate and the confidence created by rapid liberalization and opening up of the economy. The credibility of the peg as well as arbitrage opportunities are enhanced when the country pursues a tight monetary policy in order to bring down inflation or prevent overheating of the economy.

However, a nominal peg with a higher inflation rate also causes an appreciation of the currency in real terms and a widening of the current-account deficit. If external deficits and liabilities are allowed to mount, the currency risk will rise rapidly. Since there is no firm commitment to defend the peg, the worsening fundamentals eventually give rise to expectations of a devaluation and a rapid exit of capital. Not only does this cause liquidity shortages; it also forces the monetary authorities to tighten monetary policy and restrict liquidity even further. Sooner or later, the exchange rate peg is abandoned, leading to a free fall which, together with the hike in interest rates, causes enormous dislocation in the economy.

Despite the risk of costly currency swings and crises, many countries with relatively high rates of inflation have often favoured stabilizing the internal value of their currencies by stabilizing their external value through anchoring to a reserve currency with a good record of stability. This is true not only for the small and open European economies such as Austria, the Netherlands and Belgium, but even for a large economy such as Italy, which faced several speculative attacks against its currency and experienced disruptions throughout the process of convergence towards the inflation rates of its larger trading partners in the EU. Many emerging-market economies, notably in Latin America, have also used soft pegs for disinflation. Although it proved difficult to achieve an orderly exit from such pegs in order to realign their currencies, it is notable that these countries managed to avoid the return of rapid inflation in the aftermath of crises, despite sharp declines in their currencies. For instance, after the introduction of an exchange-based

stabilization plan (*Plano Real*) in 1994, Brazil succeeded in bringing down its inflation rate from a four-digit level to a single-digit level by 1998. Despite various adjustments in the value of the *real* and a relatively rapid decline in inflation, the Brazilian currency had appreciated by some 20 per cent at the end of the disinflation process. However, it was not possible to engineer an orderly realignment of the exchange rate, which came under severe pressure at the end of 1998, partly due to spillovers from the Russian crisis. But after an initial hike, inflation stabilized at low levels despite a sharp drop in the value of the *real* against the dollar (see *TDR 1999*, Part One, chap. III, sect. B).

Appreciation is generally unavoidable in exchange-based stabilization programmes because of stickiness of domestic prices. More fundamental-

ly, it is part of the rationale of successful disinflation, since greater exposure to international trade – resulting in lower import prices and increased competition in export markets – helps to discipline domestic producers and acts as a break on income claims. However, such programmes are often launched without adequate attention to the potential problems of real currency appreciation and without a clear exit strategy (i.e. when

and how to alter the peg and/or the regime and realign the exchange rate). Although economically it may appear simple to restore international competitiveness by a one-off adjustment in the exchange rate, this solution may be politically difficult. Indeed, problems in finding a political solution tend to be underestimated. Governments are often unwilling to abandon the peg and devalue after exerting considerable effort in attempting to convince people that the fixed rate has brought them more good than harm. They are also afraid of losing markets' confidence and facing a sharp reversal of capital flows and a collapse of their currency.

Given the herd behaviour of financial markets, such fears of a hard landing are not always unfounded, even though, as noted above, sharp currency declines rarely result in the return of

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rapid inflation. Forewarning an exit strategy is risky, since it is not always easy to judge how rapidly inflation will decline. The Turkish exchange-based stabilization programme of December 1999 had such a strategy. However, it failed to meet its inflation target and, after a series of economic and political crises, the Government was obliged to abandon the peg and move to the other corner, floating, before the preannounced exit date (see chapter II, box 2.1). In Europe, institutional arrangements in the context of the EMS that involved assistance from anchor countries have helped, on several occasions, to engineer necessary adjustments in the currencies of the pegging countries without leading to instability and contagion (see below). However, such arrangements are not easily replicable for emerging markets that peg unilaterally. Support from international financial institutions could help achieve orderly exits, but the experience so far has not been very encouraging.<sup>3</sup>

Soft pegs are not used only for disinflation. In East Asia, for example, exchange rate stability was an important ingredient of the export-oriented development strategy of the individual economies and was intended to support the regional division of labour in the context of the “flying-geese” process. Because of the concentration of Asian exports in dollar-denominated markets, nominal exchange rates in the region, although not fixed, had been kept generally stable within a band of around 10 per cent in relation to the dollar since the late 1980s. Given their low inflation rates, in most East Asian economies the appreciation of the currency was moderate or negligible. The combination of stable nominal exchange rates, rapid economic growth and relatively high nominal interest rates inspired confidence and attracted international investors and lenders. However, this led to a build-up of considerable currency risks and external financial fragility, resulting eventually in a rapid exit of capital, with spillover effects throughout the region through herd behaviour. Even in Indonesia, orderly currency adjustment was not possible despite sound macroeconomic fundamentals and the timely action taken by the Government to widen the currency band in order to stop conta-

gious speculation (*TDR 1998*, Part One, chap. III; Akyüz, 2000b).

One way out of these problems is to use controls over capital flows while maintaining a soft peg. Taxes and reserve requirements on inflows designed to remove short-term arbitrage opportunities can help preserve monetary autonomy, and a policy of high interest rates can be pursued without encouraging speculative capital inflows and a

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build-up of excessive currency risk. However, as long as domestic inflation is high, currency appreciation cannot be avoided. This is particularly serious when currency pegs are used for disinflation. In any case, a large majority of developing countries have been unwilling to impose controls on capital inflows during the boom phase of the finan-

cial cycle, as a means of deterring short-term arbitrage flows, for the same reasons that they were unwilling to exit from pegged exchange rates after successful disinflation. Again, as explained in the next chapter, they are even less willing to impose controls over capital outflows in order to stabilize exchange rates and free monetary policy from pressures in the currency markets at times of speculative attacks and crisis.

## 2. Floating

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Does free floating constitute a viable alternative for developing countries and transition economies? Can such countries really leave the external value of their currencies to the whims of international capital flows and dedicate monetary policy entirely to domestic objectives such as price stability or full employment? To what extent would such objectives be undermined by excessive volatility and misalignments associated with free floating?

Quite apart from how appropriate such a regime might be, for a number of reasons it is particularly unsuitable for developing countries and transition economies, as well as for smaller in-



dustrial countries. Compared to the major industrial economies, developing and emerging-market economies are much more dependent on foreign trade, which is typically invoiced in foreign currencies. On average, the share of international trade in their domestic production is twice as large as in the United States, the EU or Japan, so that the impact of exchange rate movements on their domestic economic conditions – including prices, production and employment – is much greater. Moreover, these economies have higher net external indebtedness, a larger proportion of which is denominated in foreign currencies. Consequently, sharp changes in their exchange rate tend to generate debt servicing difficulties, liquidity and solvency problems. In sharp contrast, a country such as the United States can borrow in its own currency, therefore effectively passing the exchange rate risk onto creditors.<sup>4</sup>

It is also argued that most developing and transition economies lack credible institutions, and this in itself is a cause of greater volatility in market sentiment and exchange rates, which is believed to have led to a widespread “fear of floating” among emerging markets. Consequently, a large number of those countries which claim to allow their exchange rates to float actually pursue intermediate regimes, and use interest rates and currency-market intervention to influence exchange rates. This finding also contradicts the claim that emerging markets have been moving away from adjustable peg regimes (Calvo and Reinhart, 2000; Fischer, 2001; Reinhart, 2000).

The experience of major industrial countries with floating rates during the interwar years as well as since the breakdown of the Bretton Woods system suggests that volatility, gyrations and misalignments in exchange rates cannot simply be attributed to lack of credible institutions. Rather, they are systemic features of currency markets dominated by short-term arbitrage flows. The French experience in the 1920s, for example, was lucidly described in a report of the League of Nations in 1944:

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The dangers of such cumulative and self-aggravating movements under a regime of freely fluctuating exchanges are clearly demonstrated by the French experience of 1922–26. Exchange rates in such circumstances are bound to become highly unstable, and the influence of psychological factors may at times be overwhelming. French economists were so much impressed by this experience that they developed a special “psychological theory” of exchange fluctuations, stressing the indeterminate character of exchange rates when left to find their own level in a market swayed by speculative anticipations ... The experience of the

French franc from 1922 to 1926 and of such interludes of uncontrolled fluctuations as occurred in certain currencies in the 'thirties demonstrates not only the difficulty of maintaining a freely fluctuating exchange on an even keel, ... it also shows how difficult it may be for a country's trade balance to adjust itself to wide and violent variations. (League of Nations, 1944: 118, 119)

Writing in 1937 about the same experience, von Hayek explained gyrations not only in terms of short-term capital flows; he also argued that floating rates encouraged such capital flows:

It is because ... the movements of short term funds are frequently due, not to changes in the demand for capital for investment, but to changes in the demand for cash as liquidity reserves, that short term international capital movements have such a bad reputation as causes of monetary disturbances. And this reputation is not altogether undeserved. ... I am altogether unable to see why under a regime of variable exchanges the volume of short term capital movements should be anything but greater. Every suspicion that exchange rates were likely to change in the near future would create an additional powerful motive for shifting funds from the country whose currency was likely to fall or to the country whose currency was likely to rise ... This means that if the original cause is already a short-term capital movement, the variability of exchanges will tend to multiply its magnitude

and may turn what originally might have been a minor inconvenience into a major disturbance. (von Hayek, 1937: 62–64)

As discussed in some detail in earlier UNCTAD reports, since the breakdown of the Bretton Woods arrangements, volatility, persistent misalignments and gyrations have also been the dominant features of the exchange rates of the major reserve currencies.<sup>5</sup> Despite a significant convergence of inflation rates and trends in unit labour costs during the past decade, the G-3 exchange rates have continued to show persistent misalignments and large gyrations. Such disorderly behaviour has caused serious problems for developing countries in the management of their currencies and external debt, and has often been an important factor in major emerging-market crises. But these problems have generally been ignored by the major industrial countries which, for the most part, have geared their monetary policy to domestic objectives, notably combating inflation. Only on a few occasions have the United States and Japan, for example, which are committed to free floating, resorted to intervention and ad hoc policy coordination when currency instability and misalignments posed serious threats to their economic prospects – in the second half of the 1980s, in order to realign and stabilize the dollar in the face of mounting protectionist pressures associated with large trade imbalances, and again in the mid-1990s, when the yen rose to unprecedented levels against the dollar.

Developing countries are encouraged to adopt floating on the grounds that the resulting exchange rate uncertainty would remove implicit guarantees and discourage imprudent lending and borrowing. However, experience shows that crises are as likely to occur under floating rates as under adjustable pegs (World Bank, 1998). Under financial liberalization and free capital mobility, nominal exchange rates fail to move in an

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orderly way to adjust to differences in inflation rates (i.e. the purchasing power parity is not preserved), while adjustment of interest rates to inflation is quite rapid. As a result, currencies of high-inflation countries tend to appreciate over the short term. Under soft pegs, excessive capital inflows (i.e. inflows in excess of current-account needs) attracted by arbitrage opportunities would increase international reserves, while under floating, they would lead to nominal appreciations, which reinforce – rather than temper – capital inflows and aggravate the loss of competitiveness caused by high inflation. Although appreciations also heighten currency risks, markets can ignore them when they are driven by herd behaviour. For instance, if the currencies in East Asia had been allowed to float in the early 1990s, when inflows were in excess of current-account needs, the result could have been further appreciations and widening payments imbalances. Indeed, in the face of such large capital inflows during the early 1990s, many governments in East Asia generally chose to intervene in order to prevent appreciation (*TDR 1998*, box 2).

As already noted, the post-war experience of emerging markets with floating is rather limited; it is largely concentrated in the aftermath of recent episodes of financial crisis. Nevertheless, it reveals a number of features that belie the promises of its advocates. In Latin America, for instance, domestic interest rates have been more sensitive to changes in United States rates, and more variable in countries with floating regimes than those with fixed or pegged rates, implying less – rather than more – monetary autonomy and greater risk to the financial system (Hausmann, 1999). Floating appears to promote pro-cyclical monetary policies as interest rates tend to rise during recession. It also leads to the shrinking of domestic financial markets and to high interest rates by increasing the risk of holding domestic assets.



### 3. Hard pegs

It thus appears that emerging-market economies with open capital accounts cannot achieve sustained economic and financial stability by either pegging or floating their currencies. There remain the options of hard pegs, currency boards or outright dollarization. At the end of the 1990s, the currencies of 45 economies, members of the IMF, had hard pegs, of which 37 (including the then 11 euro-currency countries) had no independent legal tender, and the remainder (including Argentina, Hong Kong (China) and the transition economies of Bulgaria, Estonia and Lithuania) had currency boards (Fischer, 2001). With the exception of EMU, most economies without an independent legal tender were small. More recently, Ecuador and El Salvador have adopted the dollar as their national currency and Guatemala is in the process of doing so.

Such regimes are considered particularly appropriate for countries with a long history of monetary disorder, rapid inflation and lack of fiscal discipline (i.e. where there is “exceptional distrust of discretionary monetary policy”) (Eichengreen, 1999: 109). They effectively imply abolishing the central bank and discarding discretionary monetary policy and the function of lender of last resort. Not only do they remove the nominal exchange rate as an instrument of external adjustment, but also they subordinate all other policy objectives to that of maintaining a fixed nominal exchange rate or dollarization. However, these same features also provide the credibility needed for the success of such regimes since they imply that governments are prepared to be disciplined by external forces, particularly by a foreign central bank with a record of credible monetary policy. The expected economic benefits include low inflation, low and stable interest rates, low cost of external borrowing and, if there is outright dollarization, the ability to borrow abroad in the currency circulating domestically. Furthermore, dollarization is expected to deepen the financial

sector, extend the maturities of domestic financial assets and encourage long-term financing. It is often favoured by private business in emerging markets because it increases predictability and reduces the cost of transactions.

Some of these benefits can be significant. For a small economy which is closely integrated with, and dependent on, a large reserve-currency country such benefits may also offset the potential costs of no longer being able to use interest and exchange rates in response to domestic and external shocks, and to manage business cycles as well as the loss of seigniorage from printing money. However, for most developing countries, currency boards and dollarization are not viable alternatives over the long term, even though they may help to quickly restore credibility after a long history of monetary disorder, fiscal indiscipline and rapid inflation. In particular, large and unpredictable movements in the exchange rates of major reserve currencies

make the option of unilaterally locking into and floating with them especially unattractive.<sup>6</sup>

Hard pegs do not insulate economies from external financial and real shocks, any more than did the gold standard. Unless the anchor country experiences very similar shocks and responds in a manner that is also appropriate to the anchoring country, the costs of giving up an independent monetary policy and defending a hard peg can be very high in terms of lost output and employment. But for obvious structural and institutional reasons, a combination of developing and industrial countries does not constitute an optimal currency area, and they are often subject to asymmetric shocks, especially if the developing countries are highly dependent on primary exports. Furthermore, in the absence of close economic integration, the business cycles of anchor and anchoring countries are unlikely to be synchronized, so that a particular monetary policy stance pursued by the former may be unsuitable for the latter. Thus, a country with a hard peg may find its currency and interest rates rising at a time when its economy is

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already suffering from recession and loss of competitiveness in international markets, as Argentina has over the past two years (see chapter II, box 2.2).

It is often suggested that asymmetric shocks and asynchronous cycles do not matter as long as wages and prices are fully flexible. In this respect, there is a certain degree of ambivalence in the orthodox thinking on exchange rate policy, since one of the original arguments in favour of floating rates was that sticky wages and prices prevented rapid adjustment to internal and external shocks without sacrificing growth and employment (Friedman, 1953). Even when wages and prices are reasonably flexible, the adjustment process can entail large costs because it is not instantaneous. With an absolutely fixed exchange rate, the only instrument at hand to correct real appreciation is a cut in nominal wages, but that cannot be achieved without reducing aggregate domestic demand and increasing unemployment. Furthermore, for the reasons explained by Keynes more than 60 years ago, such cuts, will, in turn, reduce aggregate demand and add to deflationary pressures when they result in lower real wages. Thus it would be very difficult to restore competitiveness without deflation. Fiscal austerity designed to reduce external deficits would only deepen the crisis, leading to what Robert McKinnon described nearly 40 years ago as a situation of the “tail wagging the dog” (McKinnon, 1963: 720). It is therefore surprising that the most important argument advanced in favour of flexible exchange rates, namely the sluggishness of nominal wage and price adjustment, is overlooked by the advocates of currency boards or dollarization.

Nor can currency boards ensure that domestic interest rates remain at the level of the country to which the currency is pegged. When the economy suffers from loss of competitiveness and large payments deficits, the resulting decline in reserves leads to a reduction in liquidity, pushing up inter-

est rates and threatening to destabilize the banking system. It has indeed been shown that a currency board regime makes payments crises less likely only by making bank crises more likely (Chang and Velasco, 1998). International investors may not take the hard peg for granted and may demand a large risk premium, as demonstrated by the large spreads that most currency board countries have had to pay over the past few years. Speculative attacks against a currency can occur in a currency board system as in any other exchange rate regime, and costs incurred in defending a hard peg may exceed those incurred by countries experiencing a collapse of soft pegs. For instance, in terms of loss of output and employ-

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ment, Argentina and Hong Kong (China) suffered as much as or even more than their neighbours which experienced sharp declines in their currencies during recent emerging-market crises. For financially open economies, differences among such regimes are due less to their capacity to prevent damage to the real economy and more to the way damage is inflicted.

Historically, exits from currency boards have occurred in the context of decolonization, when the pound sterling was often the anchor currency. Unlike their modern counterparts, the rationale for establishing such regimes was not to gain credibility; rather, they were imposed by the colonial power with a view to reinforcing trade ties with its colonies. In principle, by retaining a national currency, currency board regimes – as distinct from dollarization – allow for devaluation and even exit. However, there is no modern currency board regime with a known exit strategy; indeed, making such a strategy known would defeat its very purpose. For this reason, an orderly exit from a currency board regime is unlikely to be possible, especially when the economic costs of adhesion militate in favour of change. By contrast, when the regime works well, governments feel no need for exit.

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## C. Regional arrangements: the European experience

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Given the difficulties that developing countries have been facing in finding unilateral solutions to the problem of managing their currencies and preventing financial crises, and given the resistance of the major powers to genuine reform of the international financial architecture, attention has increasingly focused on regional solutions (Chang, 2000; Mistry, 1999; Park and Wang, 2000). In this context, there is growing interest in the lessons provided by the European experience with regional monetary cooperation and currency arrangements in the post-Bretton Woods era, which culminated in a monetary union at the end of the 1990s.

The first response of Europe to the collapse of the Bretton Woods system in the early 1970s consisted of “snake” and “snake in the tunnel” arrangements that were designed to stabilize the intra-European exchange rates within relatively narrow bands in an environment of extreme volatility. This was followed by the creation of the EMS in 1979 with the participation of the members of the European Economic Community (EEC), and eventually by the introduction of the euro and the establishment of the European Monetary Union (EMU) in 1999.<sup>7</sup> Thus it took some 30 years to pass from soft pegs to hard pegs.

After the collapse of the Bretton Woods system, European countries were able to avoid inflationary spillovers from the United States by ap-

preciation of their currencies vis-à-vis the dollar, and floating against the dollar was seen as consistent with their objective of stabilizing the internal value of their currencies. However, given the relatively high degree of regional integration, a move towards free floating among the European currencies posed a potential threat of instability and disruptions to intraregional trade and resource allocation, particularly for small and open economies.

A policy of establishing a stable pattern of intraregional exchange rates and collectively floating against the dollar was seen as an appropriate solution, since the trade of the region as a whole with the rest of the world was relatively small. In effect, regional integration and monetary cooperation was designed to establish Europe as a single large economy – like that of the United States – with limited dependence on international (extra-European) trade.

Although the decision to join such arrangements (or, in the Austrian view, to “tie their own hands” in monetary affairs) was taken unilaterally by each country, the system that emerged involved multilateral commitments at the regional level. Since the deutsche mark had been the most stable currency after the war and Germany was the largest market in the region, the German currency provided a natural anchor for many European countries following the collapse of the Bretton Woods arrangements. Given the political will of the participating countries to move towards

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greater integration, Germany did not simply provide an anchor currency; it also assumed responsibilities vis-à-vis the anchoring countries in securing the stability of the arrangements through such means as intervention in the currency markets and provision of lender-of-last-resort financing, although the latter role has never been explicitly stated. As for the smaller countries, although they sacrificed part of their monetary autonomy, they were considerably strengthened vis-à-vis currency markets and became less dependent on international financial institutions.

In the process leading to a common currency, the adjustable pegs adopted were crucially different from the unilateral soft pegs used by emerging markets in recent years in that both anchoring and anchor countries shared the common objective of achieving monetary convergence and internal and external stability for their currencies. The system was also designed to reduce one-way bets, which might have been encouraged by inflation and interest rate differentials, by establishing bands around the so-called “parity grids”. It established obligations for symmetric interventions as well as unlimited short-term credit facilities among central banks designed to maintain bilateral exchange rates within the band. It also made available to member countries various types of external payments support to enable ERM participants both to keep their currencies within prescribed fluctuation limits and to cope with circumstances that might threaten orderly conditions in the market for a member country’s currency.<sup>8</sup> In addition, it stipulated concrete procedures for realignment of the bands. Furthermore, European integration allowed special arrangements in the ERM for the less advanced countries – Greece, Ireland, Portugal and Spain – including the provision of considerable fiscal compensation, which did much to enable them to achieve monetary and fiscal convergence and meet the EMU stability criteria.

These arrangements were also supported by a European Community regime for capital movements, which, until a directive in 1988, provided

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Currency arrangements were also supported by a European Community regime for capital movements, which, until a directive in 1988, provided governments with some leeway for restricting different categories of transaction.

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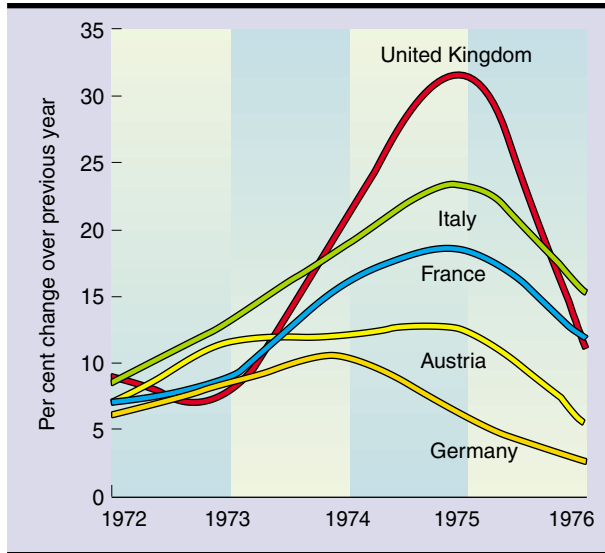
governments with some leeway for restricting different categories of transaction, along with some liberalization obligations which were less stringent for short-term and potentially speculative transactions. The 1988 directive abolished restrictions on capital movements between residents of European Community countries, subject to provisos concerning the right to control short-term movements during periods of financial strain.<sup>9</sup> The directive also stated that European Community countries should endeavour to attain the same degree of liberalization of capital movements vis-à-vis third countries as among themselves. However, governments retained the right to take protective measures with regard to certain capital transactions in response to disruptive short-term capital movements. Upon adoption of the single currency, such measures could be taken only in respect of capital movements to or from third countries.

Despite the establishment of institutions to support the exchange rate arrangements and integration, the path to monetary union has not been smooth; it has often been disrupted by shocks and policy mistakes. In some instances disruptions were similar to currency crises experienced by emerging markets under soft pegs. As in emerging markets, occasionally pressures developed as a result of differences in the underlying inflation rates: at the high end of the inflation spectrum was Italy (and subsequently the United Kingdom), followed by France with moderate inflation, while Germany and Austria were at the lower end. For high-inflation countries, therefore, currency realignments were needed from time to time until their inflation rates converged towards that of the anchor country. On many occasions inflation differentials were widened by external or internal shocks which, in effect, tested the resilience of the system and the commitments of the participating countries to internal and external stability. The first shock came soon after the collapse of the Bretton Woods arrangements in the form of a hike in oil prices. In the United Kingdom and Italy unit labour costs rose much faster, and inflation

Chart 5.1

**UNIT LABOUR COSTS IN SELECTED EUROPEAN COUNTRIES AFTER A NEGATIVE SUPPLY SHOCK, 1972–1976**

(Per cent change over previous year)

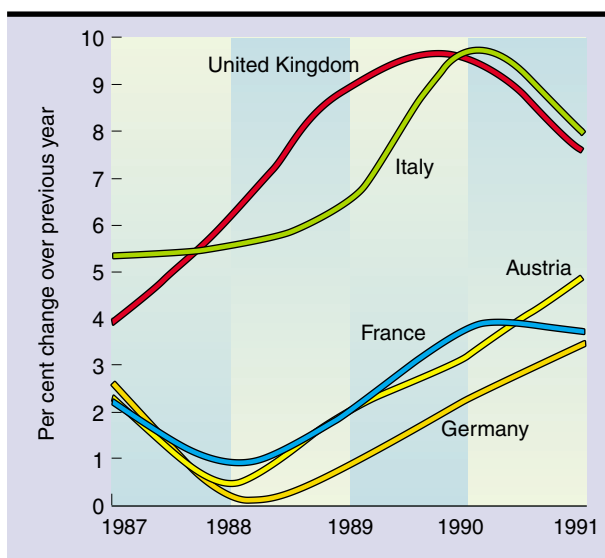


Source: AMECO database, European Commission, 2000.

Chart 5.2

**UNIT LABOUR COSTS AFTER A POSITIVE DEMAND SHOCK, 1987–1991**

(Per cent change over previous year)



Source: See chart 5.1.

persisted longer than in France, Austria and Germany (chart 5.1). In consequence, the parities between the currencies of these countries became unsustainable, necessitating realignments.

However, such realignments have not always been an orderly process. The events leading to the 1992–1993 EMS crisis provide useful lessons on how regional currency arrangements, even with supporting institutions, can break down when exchange rates are inconsistent with underlying inflation and interest rates. The beginning of this crisis originated from the policy response to the 1987 global stock market crash, when central banks in the United States and Europe lowered interest rates to historical lows. This provided a strong monetary stimulus at a rather late stage of recovery, pushing up growth rates in Europe to 4 per cent or higher, with the United Kingdom leading in the late 1980s and Germany in the early 1990s (owing also to the impact of unification). Acceleration in growth, however, was associated with greater divergence of inflation rates; unit labour costs went up drastically in Italy and the United Kingdom, compared to Germany and France (chart 5.2). However, the nominal exchange rate of the lira against the deutsche mark was kept virtually stable from 1987 until 1992, implying a real appreciation of 23 per cent. For the United Kingdom, which had entered the ERM in 1990 with an already overvalued currency, the rate of appreciation was even higher. In both countries, loss of competitiveness was reflected in a sharp swing in the current account from a surplus to a deficit. Until the outbreak of the crisis, these deficits were sustained by large inflows of capital, notably from Germany, on account of sizeable interest rate differentials. Thus the EMS crisis that forced Italy and the United Kingdom to leave ERM and devalue in September 1992 was similar in many respects to emerging-market crises. For these two countries, such an adjustment in nominal rates was certainly preferable to maintaining the grids and trying to restore competitiveness through a deflationary adjustment. By contrast, as discussed in *TDR 1993* (Part Two, chap. I, sect. B), the attack on the French franc could not be depicted as a case of the market eventually imposing discipline, because the underlying fundamentals of the French economy were as strong as those in Germany.



This experience shows that, just as with unilateral pegging or fixing, regional currency arrangements, even with supporting institutions, can run into trouble in the absence of appropriate policy actions to bring exchange rates into conformity with underlying fundamentals. Again, while it is true that the hegemony of an anchor country in regional arrangements is balanced by responsibilities that are not present in unilateral pegging or fixing, policies pursued by such a country may still turn out to be too restrictive for other members. Indeed, tight German monetary policy appears to have been a factor in the speculative attack on the French franc during the EMS crisis.

With the move to a single currency, smaller members of the EMU are expected to exert a some-

what greater influence on the common monetary policy. Furthermore, strong trade linkages can be a force for stability and convergence, with expanding economies providing additional demand and export markets for those members experiencing a downturn. Even though asymmetric shocks and structural differences may still produce significant divergence of economic performance among countries at different levels of development, such differences do not need to cause serious policy dilemmas if countries are prepared to use the various instruments they still have at their disposal. However, under certain circumstances, the constraints imposed on fiscal policy by the Stability and Growth Pact could impair the ability to smooth out intraregional differences in economic performance.

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#### **D. Options for developing countries: dollarization or regionalization?**

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Despite the temporary setbacks in 1992–1993, and shortcomings in the design of policies and institutional arrangements which constrained policy options, European monetary cooperation has been successful in securing stability in intraregional exchange rates, containing financial contagion and dealing with fluctuations vis-à-vis the dollar and the yen. To what extent can such arrangements be replicated by developing countries as a means of collective defence against systemic instability? Is it feasible for developing countries to establish regional arrangements among themselves without involving G-3 countries, and to follow a path similar to that pursued by Europe – from a regionally secured exchange rate band to a currency union? Alternatively, could they go directly to currency union by adopting a regional currency?

Interest in regional monetary arrangements and cooperation in the developing world has increased rapidly since the outbreak of the Asian crisis. For example, at the 1997 Annual Meetings of the IMF and the World Bank, soon after the outbreak of the crisis, a proposal was made to establish an Asian Monetary Fund. Subsequently, an initiative was launched in May 2000 involving swap and repurchase arrangements among member countries of the Association of South-East Asian Nations (ASEAN), China, Japan and the Republic of Korea (see box 5.1). More recently, the joint French-Japanese paper cited in section A above (Ministry of Finance, Japan, 2001: 5–6) has given support to the strengthening of regional cooperation in East Asia, drawing on the European experience:

**Box 5.1****REGIONAL MONETARY AND FINANCIAL COOPERATION AMONG DEVELOPING COUNTRIES**

At present there are few regional financial and monetary arrangements among developing countries, apart from those in East Asia described in box 5.2. Such arrangements as do exist range from agreements to pool foreign exchange reserves, such as the Andean Reserve Fund and the Arab Monetary Fund, to currency pegging (Rand Monetary Area) and a regional currency (Eastern Caribbean Monetary Union). The *Communauté financière africaine* (CFA) also has a common currency, but is unique in that it involves an agreement between its members and a major European country on cooperation in monetary and exchange-rate policy.

The *Andean Reserve Fund* was established in 1976 by the members of the Andean Community – Bolivia, Colombia, Ecuador, Peru and Venezuela – and has a subscribed capital of \$2 billion. The Fund provides financial support to its members in the form of loans or guarantees for balance-of-payments support, short-term (liquidity) loans, emergency loans, loans to support public external debt restructuring, and export credit. Conditionality for drawing on these facilities is softer than that of IMF. The Fund also aims at contributing to the harmonization of the exchange-rate, monetary and financial policies of member countries. It is thus intended to promote economic and financial stability in the region and to further the integration process in Latin America.<sup>1</sup>

The *Arab Monetary Fund* was established in 1976 with a structure similar to that of IMF and comprises all members of the League of Arab States (except the Comoros). It has a subscribed capital of 326,500 Arab accounting dinars, equivalent to about \$1.3 billion. The Fund aims at promoting exchange-rate stability among Arab currencies and at rendering them mutually convertible, and it provides financial support for members that encounter balance-of-payments problems. It is also intended to serve as an instrument to enhance monetary policy cooperation among members and to coordinate their policies in dealing with international financial and economic problems. Its final aim is to promote the establishment of a common currency.

In the *Rand Monetary Area*, Lesotho and Swaziland, both economically closely integrated with South Africa, peg their currencies to the South African rand without formally engaging in coordination of monetary policy.

The *Eastern Caribbean Monetary Union* is an arrangement for a common currency among the members of the Organization of Eastern Caribbean States, a group of small island developing countries.<sup>2</sup> The currency is pegged to the dollar, but in contrast to France with respect to the CFA (see below), the United States does not play an active role in the pegging arrangement.

The creation of the *Communauté financière africaine* goes back to 1948, but the agreements governing the current operation of the CFA-zone were signed in 1973. There are two regional groups, each with its own central bank: the Economic and Monetary Union of West Africa, and the Central African Economic and Monetary Community.<sup>3</sup> The 14 countries involved have a common currency, the CFA franc, that is not traded on the foreign exchange markets but is convertible with the French franc at a fixed parity. There is free capital mobility within the CFA-zone, and between these countries and France, and the foreign exchange reserves of its members are pooled. The French Treasury guarantees the convertibility of the CFA franc into French francs at a fixed parity and assumes the role of lender of last resort. On the other hand, the arrangement includes a mechanism that limits the independence of the two regional central banks, and the French Treasury can influence monetary policy in the CFA zone as well as determination of the parity with the French franc.

Each of the two central banks has an operations account with the French Treasury into which they have to deposit 65 per cent of their foreign exchange reserves, but which also provides an overdraft facility (at market-related interest) that is, in principle, unlimited. On the other hand, in their operations the central banks have to observe two rules that are designed to check the supply of CFA francs: (i) their sight liabilities are required to have a foreign exchange cover of at least 20 per

**Box 5.1 (concluded)**

cent, and (ii) their lending to each member Government is limited to 20 per cent of that Government's revenue of the previous year. Moreover, France has seats on the Boards of both central banks.<sup>4</sup>

It appears that membership in the CFA has helped to keep inflation in the CFA countries concerned considerably below the average of other African countries; between 1975 and 1985, per capita income also grew faster. However, the system came under increasing strain after 1985 due to external shocks and weakening macroeconomic fundamentals (Hadjimichael and Galy, 1997). The CFA countries suffered from severe terms-of-trade losses as world market prices for some of their major export commodities (cocoa, coffee, cotton and oil) dropped sharply and the French franc appreciated markedly against the dollar following the Plaza Accord of 1985. Consequently, the nominal effective exchange rate of the CFA franc rose by almost 7 per cent annually between 1986 and 1993. CFA countries' exports lost competitiveness in world markets as domestic costs could not be reined in; both the combined current-account and the fiscal deficit of the CFA zone increased by 6.5 per cent of GDP, and the 20 per cent limit of monetization of government debt was substantially exceeded by several countries.

In 1994 it was decided to adjust the parity of the CFA franc with the French franc, from 50 CFA francs to 100 CFA francs to one French franc (see also *TDR 1995*, chap. 1, box 1; Clément, 1996). This was the first – and so far only – devaluation since 1948, but it demonstrated the vulnerability of the arrangement, especially in the absence of a mechanism that would allow for a gradual adjustment of the nominal exchange rate in the light of macroeconomic and balance-of-payments developments. The probability that these developments diverge between commodity-dependent developing countries and the developed country whose currency serves as an anchor is relatively high, given the difference in their exposure to external shocks.

The stability and proper alignment of exchange rates of the CFA countries vis-à-vis their trade partners and competitors exert a major influence on their overall economic performance. First, trade in these countries accounts for a very high share of GDP. Second, intra-CFA trade is limited, accounting, on average, for only 8 per cent of its members' total trade.<sup>5</sup> Third, because of structural differences, CFA and EU countries do not constitute an optimal currency area. Even though half of the total trade of CFA countries is with the EU, their export and import structures are very different and the CFA countries face competition from third parties in commodity exports both to the EU and elsewhere. Thus, while bringing a certain amount of monetary discipline and protection against speculative attacks, a policy of locking into the French franc (and, hence, subsequently into the euro) and floating with it against other currencies poses problems for trade and international competitiveness.

<sup>1</sup> For more detailed information, see FLAR (2000).

<sup>2</sup> The member States are Antigua and Barbuda; Dominica; Grenada; Montserrat; St. Kitts and Nevis; Saint Lucia; and St Vincent and the Grenadines. The British Virgin Islands and Anguilla are associate members.

<sup>3</sup> The Economic and Monetary Union of West Africa comprises Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo; and the Central African Economic and Monetary Community comprises Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea and Gabon. The two groups maintain separate currencies, but since both have the same parity with the French franc, they are subject to the same regulatory framework. And because there is free capital mobility between each of the two regions, the CFA franc zone can be considered as a single currency area. The Comoros has a similar arrangement but maintains its own central bank.

<sup>4</sup> For a detailed treatment of the institutional aspects of the CFA, see Banque de France (1997).

<sup>5</sup> Trade with countries within the CFA franc zone ranges from 1.5 per cent of total trade in Congo to 23.3 per cent in Mali. By contrast, trade links with Europe are very close. They are slightly closer for the member States of the Central African Economic and Monetary Community (50 per cent of exports and 66 per cent of imports) than for the members of the Economic and Monetary Union of West Africa (49.3 and 46.3 per cent, respectively).

Strengthened regional co-operation is a way of ensuring both stability and flexibility ... The European Monetary Union process provides a useful example of how further integration can be achieved ... In this regard, an important step was taken in Chiang Mai on 6 May 2000 to establish a regional financial arrangement to supplement existing international facilities ... Regional co-operation frameworks should be fully integrated into the overall monetary and financial system.

Interest has also been expressed in establishing regional currencies, as opposed to dollarization, in Latin America. A recent statement made by the President of the Inter-American Development Bank stated:

The issue (of dollarization) is very controversial and has both its defenders and detractors, but we do not think the conditions are appropriate in most countries for taking that route ... We believe, however, that the important conditions are in place for thinking about sub-regional currencies. (Reported in *SUNS*, 11 January 2000.)

If established and sustained, regional currencies among developing country groupings can bring considerable benefits, similar to those expected from the introduction of the euro. They can reduce transaction costs of doing business within a region and eliminate exchange rate spreads and commissions in currency trading associated with intraregional trade and investment. For example, such effects are estimated to raise the combined GDP of the euro area by some 0.5 per cent. The adoption of the euro is also expected to raise intraregional trade, primarily through trade diversion (*TDR 1999*, Part One, chap. III). Furthermore, a supranational central bank can reduce the influence of populist national politics on monetary policy, while nevertheless being accountable to member countries. Unlike dollarization, such an arrangement would also bring benefits in terms of seigniorage (Sachs and Larrain, 1999: 89).

Establishing regional arrangements – including regional currencies – among developing countries would also reduce the likelihood of synchronous cycles and asymmetric shocks to the extent that there are similarities in their economic structures and institutions. In other words, a grouping of developing countries alone is more likely to meet the conditions of an optimal currency area than one which also involves developed countries.

However, in drawing lessons from Europe for developing countries, it is necessary to take into account certain differences between the two. The European experience shows that small and highly open economies with close regional trade links can establish and sustain a system of stable exchange rates around a major reserve currency so long as there are clear guidelines regarding the maintenance and alteration of members' currency bands, appropriate allocation of responsibilities and supporting institutions and policies. Such arrangements can be operated for quite a long time without major disruptions and can help to deepen integration (see box 5.2). For larger groups and for countries of equal size or economic power, however, there could be significant difficulties in establishing and sustaining such systems. There would be an additional difficulty when the group does not contain a major reserve-currency country.

Consequently, unless they are organized around a major reserve-currency country, developing countries of comparable size may find it difficult to form a group to establish and sustain ERM-type currency grids and ensure that the monetary and financial policies pursued independently by each country are mutually compatible and consistent with the stability of exchange rates. Moreover, without the involvement of a large reserve-currency country, it could be difficult to put in place effective defence mechanisms against speculative attacks on individual currencies. Under these conditions, while a rapid move to monetary union through the adoption of a regional currency might be considered desirable, it would face similar problems of implementation as the introduction of an exchange

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Is it feasible for developing countries to establish regional currency arrangements among themselves without involving G-3 countries, and to follow a path similar to that pursued by Europe?

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## Box 5.2

**THE CHIANG MAI INITIATIVE**

Even before the financial crisis of 1997, there had been a growing interest in East Asia in pursuing regional policy coordination and monetary cooperation. Various swap arrangements and repurchase agreements had been introduced, and these initiatives intensified during the Mexican crisis in the mid-1990s. However, none of these moves prepared the region for the currency runs of 1997 and 1998.

In a Joint Statement on East Asia Cooperation issued at the summit of “ASEAN plus 3” (the 10 members of ASEAN plus China, Japan, and the Republic of Korea) in November 1999, it was agreed to “strengthen policy dialogue, coordination and collaboration on the financial, monetary and fiscal issues of common interest” (Ministry of Finance, Japan, 2000a: 8). Against this background, the region’s Finance Ministers launched the so-called “Chiang Mai Initiative” in May 2000, aimed at building networks for multilayered financial cooperation to match the growing economic interdependence of Asian countries and the consequently greater risk that financial shocks could lead to regional contagion.<sup>1</sup> The Initiative envisages the use of the ASEAN+3 framework to improve exchange of information on capital flows and to launch moves towards the establishment of a regional economic and financial monitoring system. The core of the Initiative is a financing arrangement among the 13 countries that would strengthen the mechanism of intraregional support against currency runs. This arrangement, building on the previous ASEAN Swap Arrangement (ASA), is intended to supplement existing international financial cooperation mechanisms. It is also expected to contribute to the stability of exchange rates within the region.

The previous ASA, which dates back to 1977, comprised only five countries (Indonesia, Malaysia, the Philippines, Singapore, and Thailand). Total funds committed under the arrangement were \$200 million – a negligible amount compared to the combined loss of foreign exchange reserves of \$17 billion that the five countries experienced between June and August 1997.

The new ASA envisaged under the Chiang Mai Initiative includes Brunei Darussalam and allows for the gradual accession of the four remaining ASEAN countries (Cambodia, Lao People’s Democratic Republic, Myanmar and Viet Nam). But its most important element is the inclusion of bilateral swap and repurchase arrangements between the ASEAN countries and China, Japan, and the Republic of Korea. Funds available under the new ASA total \$1 billion. However, the commitments of the three non-ASEAN countries to the bilateral swap arrangements are likely to be substantially greater than this; they will be determined by the level of their foreign currency reserves and the amounts that were involved in earlier agreements between Japan and the Republic of Korea (\$5 billion) and Japan and Malaysia (\$2.5 billion). The conditions for drawing on the facilities and a number of technicalities remain to be agreed in negotiations among the countries concerned, but it appears that assistance under the bilateral swap arrangements will, in principle, be linked to IMF support (Ministry of Finance, Japan, 2000b).

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<sup>1</sup> For further information on the Initiative, see Ministry of Foreign Affairs of the Kingdom of Thailand (2000); Ministry of Finance, Japan (2000a and 2000b); “Asia finance: Central banks swap notes”, *The Economist*, 16 May 2000.



rate mechanism. Recognition of such difficulties and adoption of appropriate mechanisms to overcome them are essential if developing countries are to succeed in their attempts to form regional monetary groupings aimed at attaining greater exchange rate and financial stability.

The absence of a major reserve-currency country in regional arrangements also poses problems of credibility. It may be especially difficult for countries with a long history of monetary disorder and inflation to form a credible monetary union without involving a major reserve-currency country with a good record of monetary discipline and stability. In this regard, Latin America is clearly less favourably placed than East Asia.

More fundamentally, for developing countries to manage on their own regional exchange rates vis-à-vis the G-3 currencies is a daunting task, whether it is undertaken within the framework of a monetary union or under ERM-type arrangements. They cannot simply float their currencies and adopt an attitude of benign neglect towards the value of their currencies vis-à-vis the rest of the world, even under conditions of deep regional integration. For instance, in East Asia, while intraregional trade among the countries of the region (ASEAN, first-tier NIEs and China) is important and constantly growing, it still accounts for less than half of their total trade (*TDR 1996*, Part Two, chap. I, sect. E), compared to two thirds in the EU. Furthermore, as a proportion of GDP, the trade of East Asian developing countries with the rest of the world is more than twice as large as that of the United States, the EU or Japan. Accordingly, their exchange rates vis-à-vis G-3 currencies can exert a considerable influence on their economic performance. Furthermore, regional arrangements would not protect them against financial shocks, since they carry large stocks of external debt in G-3 currencies.

These factors thus render floating against G-3 currencies unattractive and raise the question of

what constitutes an appropriate exchange rate regime at the regional level. One option is to establish a crawling band, with the central rate defined in terms of a basket of G-3 currencies.<sup>10</sup> The joint French-Japanese paper cited above suggested that such an intermediate regime could be a possible step towards monetary union:

A possible solution for many emerging market economies could be a managed floating exchange-rate regime whereby the currency moves within a given implicit or explicit band with its centre targeted to a basket of currencies. ... managed free-floating exchange rate regimes may be accompanied for some time, in certain circumstances, by market-based regulatory measures to curb excessive capital inflows. (Ministry of Finance, Japan, 2001:3–4)

The paper went on to argue that a “group of countries with close trade and financial links should adopt a mechanism that automatically moves the region’s exchange rates in the same direction by similar percentages”. This would imply fixed bands for currencies of members, as in the ERM. But as the European experience shows, there would also be a need to alter such bands in line with changes in inflation rates, for example. Such a regime, pursued collectively, may need to be supported by a collective system of control over capital movements. For reasons already mentioned, control over capital flows – both inward and outward – can be more easily agreed upon when countries act together rather than separately. In such an arrangement, intraregional capital flows may be deregulated – as in the EMU – but capital flows to and from non-member countries would have to be controlled – as in the formative years of the EMS – in order to restrict short-term, potentially destabilizing movements.

Any regional monetary arrangement would need to include mechanisms to support the regional currency, or currencies, in order to keep exchange rates in line with targets and stem specu-

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For developing countries to manage on their own regional exchange rates vis-à-vis the G-3 currencies is a daunting task, whether it is undertaken within the framework of a monetary union or under ERM-type arrangements.

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lative attacks. Since the East Asian crisis, various proposals have been put forward to establish regional support mechanisms for intervention in currency markets and for the provision of international liquidity to countries facing a rapid exit of capital. The 1997 proposal to establish an Asian facility of \$100 billion was “derailed quickly by the United States Treasury and IMF for fear that it would detract from the role (and power) of the latter and make it even more difficult to get the United States’ contribution to the IMF’s latest quota increase authorized by the United States Congress” (Mistry, 1999: 108).<sup>11</sup> Another proposal made was to pool and deploy national reserves to defend currencies facing speculative attacks and to provide international liquidity to countries without the stringent conditions typically attached to such lending by international financial institutions. For instance on the eve of the Thai crisis in 1997, the combined net reserves of East Asia – including Japan – exceeded \$500 billion, and by 2000 had risen to about \$800 billion (Park and Wang, 2000). Pooling of reserves can also be supplemented by regional agreements to borrow among regional central banks, modelled on the IMF’s General Arrangements to Borrow (GAB), as recently proposed by Singapore as a form of mutual assistance.

Arrangements such as pooling of national reserves or swap facilities among central banks can undoubtedly do much to stabilize exchange rates, even when they involve only developing countries of the region. However, they are likely to be more effective in smoothing out short-term volatility and responding to isolated currency pressures than in stalling systemic crises. Given the herd behaviour of financial markets, the speed of spillovers and extent of contagion, it may be impossible to sustain an ERM-type currency band at times of crisis simply by drawing on a

pool of national reserves, if there is no possibility of recourse to a regional lender of last resort. Besides, maintaining a high level of reserves for this purpose would be a very expensive way of securing insurance against financial panics. As discussed in the next chapter, a more viable alternative would be to resort to unilateral standstills and exchange and capital controls at times of speculative attacks.

In a world of systemic and global financial instability, any regional arrangement designed to achieve exchange rate stability in order to prevent crises, and manage them better if they nonetheless occur, should also incorporate a number of other mechanisms, with the aim of ensuring enhanced regional surveillance, information-sharing and early warning. Domestic reforms would still be needed in many of the areas discussed in the previous chapter in order to provide a sound basis for regional cooperation. Just as domestic policy actions without appropriate global arrangements would not be sufficient to ensure greater financial stability, regional arrangements could fail in the absence of sound domestic institutions and policies.

As European experience has shown, progress towards a currency union can be a long and drawn-out process, requiring political will and a “culture” of regionalism. Regional monetary arrangements linking several national currencies through exchange rate bands can encounter serious problems even when there are supporting institutions. It would not be easy for developing countries to replicate the European experience, with or without the help of G-3 countries. However, the threat of virulent financial crises, together with the lack of genuine progress in the reform of the international financial architecture, has created a sense of urgency in emerging markets, notably in East Asia, for building col-

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Any regional monetary arrangement would need to include mechanisms to support the regional currencies in order to keep exchange rates in line with targets and stem speculative attacks.

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As European experience has shown, progress towards a currency union can be a long and drawn-out process, requiring political will and a “culture” of regionalism. Recent initiatives and proposals in East Asia, however modest they may be, constitute an important step forward.

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lective defence mechanisms at the regional level. In this context, recent initiatives and proposals, however modest they may be, constitute an important step forward. ■

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## Notes

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- 1 For instance, the report of the International Financial Institutions Advisory Commission set up by the United States Congress (commonly referred to as the “*Meltzer Report*”), recommended “that countries avoid pegged or adjustable rates. The IMF should use its policy consultations to recommend either firmly fixed rates (currency board or dollarization) or fluctuating rates” (IFIC, 2000: 8). Similar views have been expressed by the former Treasury Secretary of the United States concerning the choice of an appropriate exchange rate regime, “... which, for economies with access to international capital markets, increasingly means a move away from the middle ground of pegged but adjustable fixed exchange rates towards the two corner regimes of either flexible exchange rates or a fixed exchange rate supported, if necessary, by a commitment to give up altogether an independent monetary policy” (Summers, 2000b: 8).
- 2 For an earlier account of this process, before the recent surge in capital flows to emerging markets, see *TDR 1991* (Part Two, chap. III, sect. F); *TDR 1998* (Part One, chap. III, sect. B); and *TDR 1999* (Part Two, chap. VI).
- 3 For instance, the 1998 Brazilian programme with the IMF had stipulated an orderly exit from the peg through gradual devaluations throughout 1999, as well as emergency financing, but this did not prevent the crisis.
- 4 This inability of a country to borrow in its own currency has been coined the “original sin hypothesis” (Hausmann, 1999; Eichengreen and Hausmann, 1999). A corollary of this hypothesis is that “... the country’s aggregate net foreign exposure must be unhedged, by definition. To assume the ability to hedge is equivalent to assume that countries can borrow abroad in their own currencies but choose not to do so, in spite of the fact that the market does not appear to exist” (Eichengreen and Hausmann, 1999: 25).
- 5 For an assessment of the experience in the 1980s, see UNCTAD secretariat (1987); Akyüz and Dell (1987); and also *TDR 1990* (Part Two, chap. I). For the more recent experience, see previous *TDR 1993* (Part Two, chap. I); *TDR 1994* (Part Two, chap. II); *TDR 1995* (Part Two, chap. I); *TDR 1996* (Part Two, chap. I); and *TDR 1999* (chap. III).
- 6 For a debate on the relative costs and benefits of hard pegs and floating rates, see Hausmann (1999) and Sachs and Larrain (1999).
- 7 The first major political initiative for a European monetary union was taken in 1969 with the adoption of the Werner Report, which proposed: for the first stage, a reduction of the fluctuation margins between the currencies of the member States of the Community; for the second stage, the achievement of complete freedom of capital movements, with integration of financial markets; and for the final stage, an irrevocable fixing of exchange rates between the currencies. In its first effort at creating a zone of currency stability, the EEC attempted in 1971 to fix European parities closer to each other than to the dollar, but with some flexibility (“the snake”). The “snake” rapidly died with the collapse of the dollar-based Bretton Woods system, but was reborn in 1972 as the “snake in the tunnel”, a system which narrowed the fluctuation margins between the Community currencies (the snake) in relation to those operating between these currencies and the dollar (the tunnel). During the currency turmoil that accompanied the 1973 oil crisis, this arrangement could not function well, leading to various exits and floating, until the establishment of the EMS in 1979. The United Kingdom was a member of the EMS but did not participate in the ERM until 1990. For the history of European monetary integration and

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- the functioning of the EMS, see Bofinger and Flassbeck (2000).
- 8 For a useful survey of mechanisms for external payments support in the EEC, see Edwards (1985: 326–346). As part of the establishment of the Economic and Monetary Union, the European Monetary Cooperation Fund – the body which administered short-term facilities under the heading of mutual external financial support – was dissolved and its functions taken over by the European Monetary Institute (EMI).
- 9 In addition, there was an obligation to take the measures necessary for the proper functioning of systems of taxation, prudential supervision, etc. For more details, see Akyüz and Cornford (1995).
- 10 Such a regime is coined BBC (basket, band and crawl) (Williamson, 2000).
- 11 This source also provides a detailed discussion of other proposals for regional arrangements.