

Exchange Rate Regimes in Emerging Market Economies

International conference, 17-18 December 1999, Tokyo

Summary of the proceedings

by

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On December 17-18, 1999, the International Conference on Exchange Rate Regimes in Emerging Market Economies brought together 47 academics and policy-makers from 34 institutions worldwide for a high-level dialogue at ADB Institute in Tokyo. The conference was jointly organized by the French Leading Centre for International Economic Studies (CEPII), the Korean Institute for International Economic Policy (KIEP) and the Asian Development Bank Institute (ADBI).

Twelve papers were presented and discussed during the conference, covering both general issues as the choice of and exchange rate regime or the scope for regional cooperation, and case studies such as Chile, China, HongKong, Kazakhstan, Korea, Poland and other transition economies. In addition, Paul Krugman and John Williamson delivered two keynote speeches, and a panel discussion ended the conference (see the program in Annex). The papers can be downloaded from CEPII's website (www.cepii.fr). The discussion is summarized below.

1 Recent financial crises in emerging market economies have put into question the relevance of fixed exchange rate regimes.

Indeed, in a world of free capital movements, the management of fixed exchange rates is becoming very challenging :

Large capital inflows (attracted by high interest rates despite the risk of a devaluation) call for foreign exchange interventions in order to prevent the nominal exchange rate from appreciating. The often low development of the domestic money market reduces the scope for sterilization. Then, the expansion of the monetary base is inflationary and can also create a bubble on the domestic asset market. This point was illustrated on the case of various emerging and transition economies where, due to the needs to fight inflation, interest rates were kept higher than foreign interest rates, attracting portfolio inflows. The cost of sterilizing interventions was also mentioned. This cost arises because the central bank sells domestic bonds which bear a high interest rate, and buys foreign bonds which bear a lower interest rate. Some participants however minimized the role of coping with capital inflows as the root of the crises. Instead, they insisted on the weakness of domestic financial systems.

Over time, the combination of a fixed exchange rate with high inflation deteriorates the foreign account, which increases the risk of speculative attacks. The durability of the system depends on the inflation differential. According to one participant, a fixed nominal exchange rate target can be adopted only if the processes of price liberalization and of disinflation are completed. Past experiences in Europe show that, for a European transition economy, the inflation differential against the euro zone should not exceed 3 percent. Indeed, the conflict between stable monetary conditions and the equilibrium of the foreign exchange market increases the larger the inflation differential vis-à-vis the anchor currency.

Speculative attacks need interventions on the foreign exchange market which are not necessarily possible (lack of reserves) and/or efficient. Attacks generally lead to large swings in the domestic interest rate, even in a currency board arrangement which is supposed to protect the country against such attacks. This point was illustrated on the case of HongKong which has both a currency board and a sophisticated domestic capital market. These two factors together lead to a "double pay" speculation involving both the foreign exchange market and the domestic stock market, the link between those two being the domestic interest rate. In fact, the HongKong Monetary Authority used some discretion in several ways, which weakened the confidence in the system. The broadening of the reserve-backed monetary base finally reinforced the system through weakening the link between the foreign exchange and the stock exchange markets through interest rate variations.

The strength of currency board arrangements against speculative attacks was more generally questioned by several participants. Given that a currency board arrangement does not allow the central bank to play its role of lender of last resort, a rise in interest rates resulting from a speculative attack may have serious depressive effects on the economy. Another limitation of currency boards is that they require conservative fiscal policies and a strong fiscal system. In fact, most participants agreed on the fact that such an arrangement is advisable only for very open economies.

To put it in a nutshell, the sophistication of financial markets have reduced the costs of floating exchange rates, whereas they have increased the costs of fixed exchange rates. Hence, flexible regimes are generally viewed as more attractive today than they used to be. No participant challenged this view, although some argued that a floating regime does not provide an insurance against financial crises, and that the resilience to crises should not be the only criterion when selecting an exchange rate regime.

2. However, most participants agreed on the desirability of some exchange rate stability.

As a matter of fact, free floating is generally not a deliberate choice, and genuine free floating is rather scarce. This point was illustrated on the case of Korea which pretends to float its currency. Econometric inference comparing the fluctuations of stock prices to that of the exchange rate shows that Korean authorities have probably intervened quite frequently since the crisis. Being not a free floating, floating is not a corner solution.

Even though they agreed on the desirability of some exchange rate stability, the participants did not invoked the same reasons. Some highlighted the role of a nominal foreign anchor for reducing inflation at the early stage of disinflation or of the transition toward a market economy, when no alternative policy framework can provide an anchor for monetary policy. Others questioned the consistency between a fixed exchange rate and disinflation (see below). They stressed the necessity of managing the exchange rate in order to avoid misalignments and fluctuations in the trade balance. For them, stabilizing exchange rates is also a way of favoring regional integration, because a common peg leads to stable intra-regional exchange rates. Other participants highlighted the role of exchange rate stabilization to bring risk premia (and thus interest rates) down. Finally, some participants were mainly concerned by the low development of the foreign exchange market and the weakness of the financial system in many countries where hence exchange rate fluctuations would be very damaging. The latter argument was largely discussed however, the underdevelopment and weakness of the

financial system being viewed as partly due to excessive exchange rate stability (which removes the incentives to hedge and to maintain safe balance sheets).

The pros and cons of specific intermediate regimes were discussed. The experiences of Poland and of Chile were extensively commented on. The Polish crawling peg (1991-1994) was considered quite successful to fight inflation as well as to stabilize the current account. But when capital mobility improved, the central bank failed to give up its control on one of the three variables of the inconsistency triangle: the exchange rate, the interest rate and the monetary base (through sterilizing interventions). The case of Chile was presented as a failure due to the lack of credibility of the band, to frequent changes in the rules (central parity, rate of crawl, width of the band), and to the inconsistency between the inflation target and the exchange rate target.

The consistency between exchange rate targeting and inflation targeting was further discussed. Most participants agreed on the inconsistency between the two targets due to capital inflows and to the Balassa-Samuelson effect (productivity catch up in the tradable sector leads to wage increases that spread over the non tradable sector, pushing inflation up). They admitted that inflation targeting is difficult to implement in a developing country due to the delay in disclosing inflation figures and to possible falsification of the data. However, one participant noted the small difference between inflation targeting and exchange rate targeting in a crawling peg regime where the rate of crawl is lower than the inflation differential.

The consistency between exchange rate targeting and liberalizing the capital account was also discussed. One participant argued that restrictions on short run capital inflows can be avoided if the framework for exchange rate policy is compatible with the requirements of domestic interest rate policy, i.e. if the combination of the interest rate differential and of the exchange rate regime is justified by the size of the risk premium, without offering large expected profits for foreign short run investors. But this opinion was not shared by everybody. One participant proposed either to suspend further liberalization of capital transactions in countries that have not yet opened up their capital accounts until their structures have substantially converged towards those of industrialized countries; or to introduce temporary tax based capital controls on short run capital movements, in the form of reserves with the central bank.

Finally, it was widely admitted that there are more than two options (free floating and currency board arrangements) for exchange rate regimes in emerging countries. Three intermediate regimes were more specifically suggested: a flexible exchange rate target (where the band is adjusted in order to stay consistent with the inflation target through the uncovered interest rate parity), target zones with soft margins or buffers (in case of strong speculative pressure, the government has the possibility not to defend the band, but announce it will come back to it as soon as possible), reference rates with a commitment from the authorities not to intervene in a way that would push the exchange rate away from its equilibrium value, and monitoring bands (no intervention inside the band, but an announcement that it may intervene outside of it, to push the exchange rate back to the band). In all cases, the exchange rate regime must be simple and transparent.

3. The criteria behind the choice of an exchange rate regime were discussed.

Firstly, several global changes were thought relevant for the choice of an exchange rate regime. These changes are (1) rising capital mobility, with large inflows of capital in emerging countries; (2) rising trade flows, especially within each region ; (3) the move, for

developing countries, away from commodity exports towards manufactured exports, which leads to more stable terms of trade, but more sensitiveness of exports to the exchange rate; (4) lower inflation in the world.

Along these lines, it was concluded that free or "dirty" floating is relevant for economies largely involved in global capital markets, but such a regime needs strong institutions for implementing an alternative nominal anchor for monetary policy. Conversely, for many small or mid-sized developing countries without sophisticated institutions or major links to the world capital markets, pegs provide a simple and credible anchor for monetary policy (although it may be difficult to assess the costs of defending a peg ex ante). For many countries, optimum currency area criteria are still applicable and do provide some benchmark for choosing the appropriate exchange rate regime: pegs are most desirable for countries with a large trading partner (for goods and tourism receipts), facing similar shocks, with flexible labor markets and willing to give up monetary independence to benefit from the partner's credibility. However, because many countries get further involved both in the world capital market and in trade with a specific partner, some hierarchy must be introduced in the criteria. There was some disagreement among the participants on the hierarchy, some highlighting the importance of capital mobility whereas others were stressing real factors.

Finally, the participants agreed on the impossibility to provide a unique framework for exchange rate management. On the contrary, each country deserves a specific framework depending on the degree of openness to trade as well as capital flows, on the credibility of monetary institutions, on the sophistication, liquidity and supervision of domestic financial market, on the level of development, on the integration within a region or with a large country. Consequently, the exchange rate regime is to move over time according to the development of the country and to its integration within the world economy. But the evolution of the exchange rate regime must be consistent over time: when you are in a particular situation, you need to know what will be the next step, although steps should not be too frequent (because changing regimes are costly and reduce transparency). Being clear on long term goals would also help managing currency crises. On the contrary, currency board arrangements and, more importantly, dollarization/euroisation, do not carry any dynamics, and they make the evolution of the exchange rate regime very difficult.

The necessary move of the exchange rate regime over time was illustrated by the case of China which has stabilized its exchange rate against the dollar since 1994. The rise in trade and capital openness calls for a more flexible regime in China. Several options were mentioned, such as wider bands, a peg on a basket of currencies, some regional coordination or an independently floating regime. One participant favored a peg on a basket of currencies as the most practical way to exit from the present system. Another one underlined the need for an independent monetary policy in China in order to make an intermediate regime credible.

Considerable time was devoted to currency baskets. In the case of Asian countries (but also in South America), foreign trade is carried out with various regions in the world, so minimizing the fluctuations in the trade balance would entail stabilizing the exchange rate against a basket of currencies. This view was supported by those who considered pegs as a way to monitor external competitiveness (see point 2). It was challenged for those who viewed pegs as a way to reduce inflation and/or risk premia. In the two latter case, a peg to a single currency seems more credible because it is more transparent.

4. The regional dimension was discussed especially as a means to strengthen stability, with a special focus on Asia and on Europe.

The possibility of having a monetary union in Asia was first discussed on economic grounds. On the basis of optimum currency area criteria (symmetry of the shocks, trade integration), the ASEAN today appears to be less suitable for a common currency than the euro area before the Maastricht process began, but the difference is not very large. However the equivalent to the role of Germany as a focal point in EMU does not exist in the ASEAN. For some participants, the lack of a key currency in the ASEAN disqualifies the monetary union as an option, due to the lack of a credible anchor. For others, the lack of a leading country could be a good thing since it would not result in an asymmetric monetary policy like in the European Monetary System. Finally, most participants agreed that some convergence in GDP per capita would be necessary before a monetary union is introduced.

In the absence of regional cooperation, it was shown that Asian countries could come back to pegs on the dollar, which is not the best solution for the region as a whole. In addition, one participant argued that the similarity of many exchange rate regimes across the world (e.g. pegs on the dollars) could be detrimental to overall foreign direct investment to developing countries, due to increased substitutability across locations.

All participants agreed that a firm political commitment would be the key to the success of a common currency arrangement. Such a commitment would be demonstrated through a willingness to adopt a different policy stance than would be needed based upon purely domestic consideration, to take difficult policy decisions such as making central bank independent, and to accept supranational directives on issues such as factor mobility and competition policy. In the EMU experience, the political commitment was strong. Skepticism was clearly shared concerning the political commitment among ASEAN countries, a prerequisite for a successful monetary union, although one participant highlighted the fact that Asia could learn from the European experience and difficulties. As a first step, more dialogue among Asian policy makers would be useful. One participant highlighted the importance of sharing common objectives and improving reciprocal confidence, if not implementing close cooperation from the beginning. Instituting an Asian monetary fund was however thought counter-productive in a world of global financial markets.

The question of monetary integration is completely different in Central and Eastern Europe where there is a clear focal point (EMU). Hence, the problem is how to organize the transition to EMU rather than how to organize regional monetary cooperation. Several participants stressed the fact that a fixed exchange rate regime can be detrimental to transition countries. EMU should not be the first priority of these countries which should focus on structural reforms and on achieving the Maastricht criteria. After an initial period where a rigid framework is useful to stabilize prices and enforce monetary credibility (after a large devaluation), transition countries should move towards more flexible arrangements allowing for more frequent adjustments and wider fluctuations. The exact regime should depend on the degree of integration in world capital markets (which makes flexible regime recommended) and on the importance of maintaining the competitiveness of the tradable sector. When ready in terms of real and nominal convergence, the country would move directly to the monetary union, without being a member of ERM2. The stability of the exchange rate prior to entering EMU should be a proof that convergence has been achieved, without enforcement (but this view was not shared by all the participants).

Conclusion

It was concluded that the choice of an exchange rate regime is a practical issue where economic, historical and political factors must be taken into account. Corner solutions are appropriate for some countries at some stages, but the whole range of intermediate regimes should still be considered, at least in a dynamic framework. Regional cooperation would help in designing more robust exchange rate regimes.