1

Introduction: What Is the Best Currency Regime?

This book examines currency regime choices for emerging-market economies that are heavily involved with private international capital markets.[1] I argue that the best regime choice for such economies would be "managed floating plus," where the "plus" is shorthand for a framework that includes inflation targeting and aggressive measures to reduce currency mismatching. If managed floating were enhanced in this way, it would retain the desirable features of a flexible rate regime (i.e., monetary policy independence and resilience to large external shocks), but it would also address the nominal anchor and balance sheet problems that have underpinned a past "fear of floating" and that have made the previous performance of managed floating in emerging economies less impressive than it could be.

Mine is but the latest entry into a crowded field. Calvo and Reinhart (2000, 2001) and Hausmann, Panizza, and Stein (2000) have made the case for dollarization and against floating. Edwards (2001) has accused the proponents of dollarization of engaging in "misleading advertising." Hanke (2002) and Ghosh, Gulde, and Wolf (1998) have championed currency boards. Williamson (2000) has proposed a "BBC" regime that combines a basket peg, a band, and a crawl. Larrain and Velasco (2001) have hailed the advantages of managed floating against "hard peg"

1. For the purposes of this volume, it is useful to think of emerging markets as including the following economies: Argentina, Brazil, Chile, China, Colombia, the Czech Republic, Hong Kong, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Pakistan, Peru, the Philippines, Poland, Russia, Singapore, South Africa, South Korea, Thailand, Turkey, and Venezuela. This is close but not identical to the IMF's classification.

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alternatives. Crockett (1994), Eichengreen (1994), Summers (2000), and Fischer (2001) have all adopted the "bipolar" view of currency regimes. And Frankel (1999) and Kenen (2001), while addressing a more heterogeneous group of developing countries, have provided comfort for agnostics by arguing that "no single currency regime is right for all countries at all times."[2]

Dissatisfaction with Currency Regimes

Dissatisfaction with the status quo on currency regimes for emerging-market economies reflects at least three developments. First, "soft pegs" and simple "crawls" displayed high vulnerability to crises in the 1990s. As has been noted by Fischer (2001), almost all the major capital market-related crises since 1994 (Mexico in 1994; Thailand, Indonesia, and South Korea in 1997; Russia and Brazil in 1998; Argentina in 2000 and 2001; and Turkey in 2000 and 2001) have involved a fixed peg or crawling band exchange rate regime.

A second development, highlighted by the recent crisis in Argentina, is that though forced exits from currency boards are rare, currency boards are neither immune from speculative attacks nor do they seem to offer a viable policy instrument to deal with recession when monetary policy is made abroad, when external debt fragilities preclude countercyclical fiscal pump priming, and when the domestic economy lacks the flexibility to correct a real exchange rate overvaluation on its own.

Development number three is that, whatever their declared currency regimes, developing countries have not "floated" in the same way as industrial countries. As has been demonstrated by Calvo and Reinhart (2000) and by Hausmann, Panizza, and Stein (2000), developing countries have tended to lean more heavily (than do industrial-country floaters) on interest rate policy and on exchange market intervention to limit the movement in the nominal exchange rate. As Calvo and Reinhart (2000) put it, most developing countries have exhibited a fear of floating.

In addition, several authors have maintained that developing countries have obtained less benefit from floating regimes than their industrial-

2. The bipolar view of currency regimes is that the only sustainable currency regime choices for emerging-market economies heavily involved with private capital markets are a "float" and a "hard fix." A hard fix is typically defined as encompassing currency boards and arrangements where a country gives up the national currency (either to become a member of a currency union or to adopt formally the currency of another country). Soft pegs or fixes are arrangements where the authorities announce publicly a commitment to defend the value of the exchange rate within a specified range but retain the option to change the rate if economic fundamentals change and/or if the exchange rate comes under very strong market pressure. See Fischer (2001) for an analysis of the bipolar view.

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country counterparts. In this latter connection, Hausmann, Panizza, and Stein (2000) and Calvo and Reinhart (2001) read the empirical evidence as suggesting that devaluations or depreciations in developing countries have typically been contractionary and have been associated with relatively large downgrades in their credit ratings; that independence of monetary policy seems no greater in floating rate countries than in fixed rate ones; that devaluations or depreciations are associated with larger domestic price pass-throughs than in industrial countries; that exchange rate volatility has a greater adverse effect on foreign trade in developing countries than in industrial ones; and that developing-country floaters have recorded smaller increases in the depth of financial markets than developing-country fixers.

Emerging-market economies thus appear to be facing a no-win situation in their choice of currency regimes. If they opt for soft pegs, the regime is likely to eventually "blow up" in a costly currency collapse.[3] Alternatively, they can reduce their crisis vulnerability by opting for either a "plain vanilla" managed floating regime or a hard peg—but then either fear of floating combined with the operation of private capital markets, or the structural and debt characteristics of their own economies, may well deliver relatively disappointing economic performance. The central question addressed in this book is whether there is another currency regime choice that would extricate emerging economies from this dilemma.

Why Managed Floating Plus?

In making the case for managed floating plus as the best of the currency regime choices on offer, it is worthwhile at the outset to highlight several of the ways in which it differs from other currency regime prescriptions.[4] What is objectionable about the popular bipolar view of currency regimes is not that it leaves out too much in the middle (i.e., all intermediate currency regimes), but rather that it does not go far enough in choosing between the two poles. Managed floating plus incorporates the judgment that the floating rate pole—because of both its ability to respond to the domestic requirements of monetary policy and its shock-absorbing properties—is to be preferred strongly to the hard fix pole.

Managed floating plus also differs significantly from plain vanilla managed floating. Whereas allowing the nominal exchange rate to move creates an indispensable incentive for hedging currency risk in the private sector, a managed floating plus regime reflects the view that this by

3. See Goldstein, Kaminsky, and Reinhart (2000) for a discussion of the costs of currency crises in emerging markets.
4. The arguments outlined below are discussed at length in chapter 7, along with references to supporting empirical studies.

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itself may not be sufficient to handle the currency mismatching problem; this is an area where it pays to have a belt *and* suspenders. As such, managed floating plus proposes additional measures to discourage mismatching.

Likewise, managed floating plus goes farther on the choice of a nominal anchor for monetary policy. Whereas plain vanilla floating typically does not specify what form this nominal anchor should take, managed floating plus argues that an inflation-targeting framework (as opposed, say, to targeting a specific monetary aggregate) would best serve the needs of emerging-market economies.

The currency-mismatching problem merits high priority because it has been a leading suspect in the large output declines observed in many emerging-market currency crises, particularly those of the 1990s. Also, when large currency mismatches already exist and a marked depreciation would threaten widespread insolvencies in the banking and/or corporate sectors, emerging economies will understandably be reluctant to let the exchange rate depreciate in response to market forces or to reduce domestic interest rates after a crisis has already struck. In other words, large currency mismatches can handicap both the operation of a floating exchange rate and the implementation of an effective crisis management strategy.

Implicit in the case for managed floating plus is a rejection of the view that currency mismatching can be addressed effectively only by having emerging-market economies adopt dollarization. Significant progress in reducing mismatching should be obtainable by having the International Monetary Fund (IMF) publish and analyze data on currency mismatching at both the economywide and sectoral levels, by strengthening and enforcing more rigorously prudential measures limiting currency mismatches on the part of banks, by adopting more conservative debt and reserve management practices in the public sector, and by encouraging hedging instruments and the development of domestic bond markets.

Some emerging-market economies have already made noteworthy strides in establishing markets for hedging currency risk and others are making headway. Several of the factors that had earlier impeded growth of domestic bond markets—particularly low government debt in Asia and high inflation in Latin America—are no longer the obstacles they were 10, or even 5, years ago. All this will not happen overnight, but it can happen if the official sector gives it appropriate priority and sets incentives accordingly.

If managed floating is going to improve on its past performance in emerging-market economies, it is essential that there also be a good monetary policy discipline. Although inflation targeting is hardly a panacea for all the ills that beset emerging economies and though the challenges of implementation are greater for emerging economies than for industrial ones, experience so far suggests that inflation targeting

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represents a promising monetary policy framework and a better nominal anchor than the leading alternatives.

Most analytical reviews of inflation targeting in emerging-market economies conclude, inter alia, that

- countries adopting inflation targeting have been relatively successful in meeting their announced inflation targets,
- track records in meeting inflation targets have been superior to those in meeting monetary growth targets,
- inflation targeting has also been associated with lower inflation forecast errors and lower inflation expectations,
- inflation targeting adopters have not been "inflation nutters" (i.e., they allowed monetary policy to respond to falls in output), and
- inflation targeting has usually not been associated with a breakdown in fiscal prudence.

The three components of a managed floating plus regime should reinforce one another. If currency mismatching is brought under better control, fear of floating should decline and the effectiveness of an inflation-targeting framework for monetary policy will be improved (because low inflation can then more easily serve as the primary objective of monetary policy). Symmetrically, if emerging-market economies are successful in meeting low inflation targets, foreign lenders should become more willing to write financial contracts in the borrower's own currency and for longer maturities, diminishing currency (and maturity) mismatches. A more consistent track record on low inflation should also give a boost to the further development of local bond markets, increasing the supply of local currency finance. And allowing the nominal exchange rate to move should give private market participants the incentive to purchase insurance, aiding the growth of hedging markets and complementing other measures to reduce currency mismatching.

Last but not least, managed floating plus differs from intermediate currency regimes. Because a managed floating plus regime has no publicly announced target for the exchange rate, it has more flexibility than intermediate regimes to deal with large and sudden shifts in private capital flows. In addition, the absence of an announced exchange rate target makes managed floating plus less susceptible to the one-way speculative bets that have often characterized the fragility of adjustable peg regimes or target zones once the rate nears the edge of the band or zone.

But is it not unfair to compare the managed floating plus regime with others that do not have their own "pluses"? Not really. Because most of the alternative currency regimes have an explicit exchange rate peg or target, the currency regime serves simultaneously as the monetary policy

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framework. Inflation targeting therefore is not a relevant plus for these regimes, because there cannot be two potentially competing nominal anchors.[5]

Similarly, in regimes where the credibility of the exchange rate target depends on convincing the market that the fixed rate is immutable (e.g., a currency board), anti-currency mismatching measures are usually seen as inconsistent with that pledge.

After all, if one peso is going to be equal to one dollar for all time, why worry about currency mismatches that have effects on the economy only if there is a *change* in the exchange rate. Hence, anti-currency mismatching measures also do not fit naturally as a plus to other regimes. There could of course be other pluses (e.g., fiscal policy rules) that might be added to other regimes, but our aim here is to compare currency regimes—not broad swaths of economic policy. The pluses that appear in the managed floating plus regime are few in number and are closely linked to the operation of the currency regime.

Plan of the Book

The rest of the book is organized as follows. Chapter 2 outlines some of the methodological pitfalls that limit the inferences one can draw from observed differences in macroeconomic outcomes across different currency regimes.

Chapters 3 through 6 in turn discuss what I regard as the inferior currency regime choices: adjustable pegs, the BBC regime, currency boards, and dollarization. When discussing hard pegs, I pay particular attention to the case of Argentina because of its size, its involvement with private capital markets, and its recent travails.

Finally in chapter 7, I put forward the case for managed floating plus, focusing on why I believe it can overcome earlier criticisms of floating rates and improve overall economic performance in emerging-market economies.

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5. Most target-zone schemes, including a BBC regime, have emphasized how the exchange rate mechanism would operate rather than what form the nominal anchor would take. Williamson (2001a), however, has recently argued that inflation targeting should be seen as a complement to a BBC regime. Presumably, the more weight that is placed on meeting the exchange rate objective in a BBC regime, the greater would be potential conflicts with an IT framework.

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