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## Adjustable Peg Regimes

By an adjustable peg regime, I mean a currency regime where the authorities publicly announce a fixed parity (peg) for the exchange rate (against one of the G-3 currencies) and agree to defend the parity (with a narrow margin). But they also retain the option to “adjust” the parity to a new value if there is a sufficiently large change in fundamentals. As was suggested above, adjustable pegs have seen their reputation badly tarnished since 1994. For emerging-market economies with substantial private capital market involvement, adjustable pegs have at least three serious drawbacks.

First, in cases when the exchange rate has been fixed for several years or more, a sense of complacency often develops about currency risk—leading in turn to large, unhedged currency positions that can greatly increase the costs of a depreciation (if it occurs). Efforts to discourage such currency mismatching are apt to be particularly difficult with respect to private-sector borrowers.

Whereas a farsighted government debt manager may be able to internalize the externalities associated with large-scale foreign currency-denominated borrowing (i.e., the heightened risk of a currency, debt, or banking crisis), private-sector borrowers are likely to find the temptation of borrowing abroad in foreign currency at lower interest rates irresistible. After all, the latter can rationalize the decision by noting that their competitors are doing it and failure to go along could put them at a competitive disadvantage. Moreover, if the aggregate, private-sector currency mismatch is large, many borrowers may reckon that if the local currency is devalued, the systemic implications of such losses will be big enough to motivate a government bailout of the losers (that is, heads—I win, tails—the government loses); such expectations of a bailout may be

particularly strong when the borrower is a bank. In some other cases, market participants may simply overestimate the durability of the peg.

Although it is admittedly difficult to know the counterfactual, one can question whether the Asian crisis countries would have entered the crisis with such high ratios of short-term external debt to international reserves had there been a recent history of greater fluctuation of their currencies with respect to the US dollar.<sup>1</sup> Even though Thailand was the only one of the Asian crisis countries to have an officially announced parity during the precrisis period, Hernandez and Montiel (2001) show that Indonesia, Malaysia, the Philippines, and South Korea markedly restricted the degree of fluctuation of their currencies with respect to the dollar in the two-year run-up to the crisis. Eichengreen and Hausmann (1999), going back farther to the 1991-97 period as a whole, similarly observe that the five Asian crisis countries displayed both low average annual exchange rate changes and a low standard deviation of exchange rates in this longer precrisis period.

A second disadvantage of adjustable peg regimes is that in today's world of potentially large, rapid shifts in private capital flows and of large (and sometimes highly leveraged) players in medium-sized financial markets, speculators can pick their spots to attack and to push the costs of holding on to the peg above the costs of reneging on the exchange rate commitment.

Mussa et al. (2000) report that net private capital flows to developing countries, after hovering at about 0.5 percent of GDP throughout the 1970s and 1980s, increased sharply to roughly 3.5 percent of GDP during the mid-1990s. Calvo and Reinhart (1999) calculate that the "sudden stop" in capital flows surrounding currency crises has been approximately five times larger for emerging-market economies during the past 25 years than for industrial countries.

More important, experience suggests that few emerging economies will be able to sustain a high interest rate defense of the peg if they find themselves in a situation in which the banking system is fragile, the government has a heavy debt burden with a lot of short-term floating rate debt, the corporate sector is highly leveraged, or the economy is entering a period of sharply slowing growth and rapidly rising unemployment. An absence of constitutional constraints on abandoning the peg is likely to further tilt the balance in favor of an exchange rate change in extremis. In a sample of 87 episodes of pegging among developing countries in Latin America and the Caribbean during the 1957-90 period, Klein and Marion (1997) found that the average duration of pegs was about 10 months. And if we think of larger emerging-market economies with relatively

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1. See Goldstein (1998) for such debt-to-reserves ratios. Eichengreen and Hausmann (1999) similarly show high ratios of foreign liabilities to assets and of foreign liabilities to broad money supplies (M2) in the run-up to the Asian crisis.

open capital markets, there is now only one (Hong Kong) that has been able to maintain a fixed rate (of any kind) for longer than 5 years—and it operates a currency board—not an adjustable peg.<sup>2</sup>

When currency crises do occur, they can be costly indeed. The IMF (1998) has estimated that emerging-market economies suffer, on average, a cumulative real output loss (relative to trend) of 8 percent during a severe currency crisis.

One might surmise that, given the vulnerability of pegged rate regimes, the answer would be to exit to a currency regime of greater flexibility before the first hint of trouble arrives. But a third weakness of adjustable peg regimes is that such a noncrisis exit has proven difficult to engineer. Some emerging-market economies (e.g., Chile, Israel, and Poland) have pulled it off, but most have not.

As has been shown by Eichengreen et al. (1998), the typical exit has been one when the currency was already under pressure, international reserves were declining, and output and export growth had slowed. Reflecting the basic political instinct to let sleeping dogs lie, it is tough to convince the minister of finance or the head of state to abandon the pegged rate just because the real exchange rate has appreciated slightly—particularly if economic growth is satisfactory and if there is no strong market pressure to devalue. But once deteriorating conditions are clearly visible and market pressure is strong enough to grab policymakers' attention, it is usually already too late to make a graceful exit.

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2. When Obstfeld and Rogoff (1995) asked this same question in 1995, they found only two economies (Argentina and Hong Kong) that met the test; the recent collapse of Argentina's currency board has reduced the list to just one.