NO SINGLE CURRENCY REGIME IS RIGHT FOR ALL COUNTRIES

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The international financial policy-making community has, over the last eight months, made a variety of modest reforms to try to reduce the frequency and severity of international financial crises such as those of the last two years -- steps to improve transparency, strengthen financial systems, and involve the private sector more fully in rescue packages. Some critics have pronounced these steps too small to merit the title "New Financial Architecture," and have said they are more like remodeling the house, or at most redoing the wiring and plumbing. Whether or not this characterization is right, I consider these steps to have been useful.

There are several areas where reform would be so fundamental as to merit unquestionably the appellation "financial architecture." One is the question of a global lender of last resort, and how big it should be. Another is the question of further liberalization of international capital flows, and how rapid it should be. But in this session we are concentrating on a third: the question of exchange rate regimes, and how flexible they should be.

My overall theme is "No Single Currency Regime is Right for All Countries or at All Times."

The choice of exchange rate arrangement should depend on the particular circumstances facing the country in question. This proposition may sound obvious or vacuous. But I believe it needs to be said. There are some who have drawn lessons from recent experience that they are in danger of over-generalizing, of applying to all countries regardless of circumstances.

One such proposition is that countries should generally move to increased exchange rate flexibility. I hear this from some of those policy-makers who have tried to help fight speculative pressures against exchange rate targets, in countries where the attempt ended in a costly crash (Thailand, Korea, Indonesia, Russia and Brazil). When exchange rates float, there is no target that needs defending. Another (diametrically opposed) proposition is that all countries should move toward enhanced exchange rate fixity. After all, none of those crisis-impacted currencies had been literally or formally fixed to the dollar. Enthusiasts point to currency boards that have successfully weathered the storm in Hong Kong and Argentina. Some even go further and suggest full official dollarization. They take encouragement from the euro-eleven's successful move to a common currency on January 1, a project that has gone more smoothly than most American economists forecast as recently as a few years ago.

My own position is that it is indeed appropriate that some countries, including the crisis currencies, float for the time being; and it is also appropriate for some other countries, such as small countries in Central America, and perhaps also Argentina, to dollarize. It may sound as though I am next going to subscribe to the currently-popular conclusion that countries in general must move

increasingly in either direction -- free floating or firm fixing -- but that the intermediate regimes such as target zones are no longer tenable. However I believe that this proposition too is in danger of being overgeneralized. Each exchange rate regime, including the intermediate ones, is right for some countries and at some times.

By my count there are nine major exchange rate regimes. Ranged along the continuum from the most flexible to the strongest fixed-rate commitment, they are as follows:

1. Free floating -- defined as the absence of regular intervention in the foreign exchange market;
2. Managed float -- defined as the absence of a specific target for the exchange rate;
3. Target zone, or band -- defined as a margin of fluctuation around some central parity;
4. Basket peg -- defined as fixing, not to a single foreign currency, but to a weighted average of other currencies;
5. Crawling peg -- defined as a pre-announced policy of devaluing a bit each week;
6. Adjustable peg -- defined as fixing the exchange rate, but without any open-ended commitment to resist devaluation or revaluation in the presence of large balance of payments disequilibria;
7. "Truly fixed" peg -- defined as fixing with a firm and lasting intention of maintaining the peg;
8. Currency board -- defined by three characteristics: fixing not just by policy but by law, backing increases in the monetary base one-for-one with foreign exchange reserves, and allowing balance of payments deficits to tighten monetary policy and thereby adjust spending automatically; and
9. Monetary union -- defined as the adoption of a foreign currency as legal tender; this includes the

special case of official dollarization.

Economists believe that most decisions involve tradeoffs. The choice of exchange rate regime is a tradeoff between the advantages of fixing and the advantages of floating. The main advantages of each can be stated succinctly. The two big advantages of fixing the exchange rate, for any country, are: (1) to reduce transactions costs and exchange rate risk which can discourage trade and investment, and (2) to provide a credible anchor for non-inflationary monetary policy. The big advantage of a floating exchange rate, on the other hand, is the ability to pursue an independent monetary policy. When an economy suffers a downturn, it may want to soften the impact via a monetary expansion and/or devaluation; for either response, it needs an independent currency. For some countries, perhaps a majority, the exchange rate regime that optimally trades off the advantages of stability with the advantages of flexibility is probably somewhere in the middle between fixing and floating. On the list, I classify 3 through 6 as the intermediate regimes.[1]

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[1] Proponents of target zones and other intermediate regimes include C. Fred Bergsten, 1991, "The Collapse of Bretton Woods: Implications for International Monetary Reform," in Retrospective on the Bretton Woods System, Michael Bordo and Barry Eichengreen, eds., University of Chicago Press, Chicago ; and John Williamson, 1985, *The Exchange Rate System*, Policy Analyses in International Economics, Institute for International Economics, Washington, D.C.; and 1996, *The*

Countries that should fix firmly

What are the characteristics that make a country more suited for fixity rather than flexibility? The classic list is as follows: small size, preponderance of economic fluctuations that originate domestically rather than abroad, openness to trade, high labor mobility, availability of a fiscal mechanism to cushion downturns, and a high correlation of the local business cycle with that of the country to which a currency peg is contemplated. (These attributes are well-known among economists as criteria for political units to join in an "optimum currency area.") Countries that have these characteristics are likely to see big benefits from exchange rate stability, and are also less likely to have need for monetary independence in the first place. Easy examples are the Panamanian link to the dollar and Luxembourg's link to the euro.

As a result of recent history, I would be inclined to modify the list of criteria, particularly if we are talking about pre-requisites for the most rigid institutional arrangements -- a currency board, full dollarization or monetary union. Argentina, for example, is not an especially small open economy. But

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Crawling Band as an Exchange Rate Regime: Lessons from Chile, Colombia, and Israel, Institute for International Economics, Washington DC.

it has had a sort of currency board since 1991 (which it calls convertibility) that has been largely successful in the face of severe challenges. The government announced in January that it was considering going even further, abandoning the peso in favor of full and official adoption of the U.S. dollar as legal tender. I would add to the list of firm-fixing criteria, first and foremost, a strong need to import monetary and financial stability due to a history of hyperinflation, an absence of credible public institutions, or unusually large exposure to nervous investors. The willingness of Argentina to give up monetary independence derives from its past history of hyperinflation and a domestic political consensus that the experience must not be repeated.

It is also useful for a candidate to have extensive integration with one particular large trading partner or currency area, or a craving for future integration of this sort. The appropriateness of currency boards in Estonia (1992), Lithuania (1994), Bulgaria (1997), for example, derives from their desire for integration with the EU.

The next requirements are access to an adequate level of reserves, and a strong, well supervised and regulated financial system. Otherwise, the country might simply convert currency-crisis vulnerability into banking-crisis vulnerability. Finally the existence of the rule of law is a necessary condition for a currency board, though not necessarily for dollarization. Proclaiming a currency board does not, as sometimes asserted, automatically guarantee the credibility of a fixed rate peg. Little credibility is gained from putting an exchange rate peg into the law, in a country where laws are not heeded or are changed at will. A currency board is not credibility in a bottle. It is unlikely to be successful unless accompanied

by solid fundamentals.

In the case of full monetary union, another desirable characteristic is a willingness of the foreign country whose currency is used to allow input into monetary policy, or at least to share seignorage. Argentina understands that it is not going to be given a vote on US monetary policy. In that sense, dollarization in Latin America differs fundamentally from the sort of monetary union that has taken place in Europe. The Argentines would like some sort of official agreement with the United States if they were to dollarize, including some sharing of seignorage revenue. Although this is a perfectly reasonable request -- for the U.S. to get all the seignorage would amount to a de facto transfer from Argentina to our Treasury -- my reading is that we are unlikely to give it to them.

Even so, it might be worthwhile for Argentina or (especially) some smaller countries located close to the United States to dollarize unilaterally, provided they have sufficient political support domestically to abandon all monetary sovereignty. In the past, giving up the domestic currency has been a political non-starter for most countries, regardless of the economics. But the world has changed, as illustrated by the fact that talk of dollarization in January was said to have earned the current Argentine President positive political popularity, rather than the reverse.

The case in favor of currency boards or dollarization for some of these countries is somewhat stronger than in the past, in light of recent experience. By this I do not mean simply that they should give up their independent currencies because serious crises have recently occurred in countries where

commitments to exchange rate targets were incomplete. What I have in mind, more specifically, is that *emerging market countries have found that an independent monetary policy has not in practice been a useful instrument*. A standard argument against rigidly fixing the exchange rate in terms of the currency of a particular partner is that it requires that the country be subject to the same monetary policy as that of the partner. It is true that when the Fed raises interest rates, the increase is rapidly and fully passed through to Panama, Hong Kong and Argentina, even though it may not be appropriate to current local economic conditions. But the situation is even worse for countries such as Brazil and Mexico that have only a loose link to the dollar. There an increase in U.S. interest rates has a big negative effect on capital inflows, and on average causes the local interest rates to rise by *more* than the U.S. increase.[2] International investors are nervous without the airtight currency peg. They require an extra premium to compensate them for perceptions of risk -- not just risk that their local-currency holdings will lose value directly through devaluation, but also that devaluation will force local borrowers to default even on dollar-denominated obligations, as happened in East Asia. Perhaps this nervousness is due entirely to the past record in emerging markets of mismanaged macroeconomic policies; perhaps it is in part the fault of investors themselves, who are subject to bandwagon effects, excessive alternating swings of optimism and pessimism. Either way, if monetary independence is not a tool that emerging

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[2] E.g., Ricardo Hausmann, Michael Gavin, Carmen Pages-Serra, and Ernesto Stein, 1999, "Financial Turmoil and the Choice of Exchange Rate Regime," InterAmerican Development Bank. For further statistical estimates and references, see Frankel, "No Single Currency Regime is Right for All Countries or at All Times," Graham Lecture, Princeton University, April 20, 1999; and Frankel with Chudozie Okongwu, "Liberalized Portfolio Capital Inflows in Emerging Markets: Sterilization, Expectations, and the Incompleteness of Interest Rate Convergence," International Journal of Finance and Economics 1, no. 1, Jan. 1996, 1-23.

market countries currently can use effectively, then they are giving up relatively little if they give up their currencies.

A country that should float freely

But fixing is not the right course for *all* countries. To begin with a case at the opposite extreme, the United States meets the criterion for an independent free-floating currency. We have a large economy. Thus the states of the union are more highly integrated with each other than they are with the rest of the world: There is more movement of trade, labor, and fiscal transfers within our borders, and a higher correlation of the business cycle within our borders, than across our borders. Fluctuations in the exchange rate are simply not as important to us as they are to most countries. Furthermore we have a strong and well-functioning central bank, and the confidence of international investors. We do not want to have to subordinate our monetary policy to conditions abroad. Thus the advantages of floating overwhelm the advantages of fixing.

This does not mean that the U.S. authorities should never intervene in the foreign exchange market at all. An occasional purchase or sale of foreign exchange is appropriate, if necessary to maintain in the marketplace a sense of two-way risk, or to nudge the dollar exchange rate on those few occasions when it is far out of line, perhaps because the authorities' intentions have been misperceived. But if the authorities were to proclaim a target for the dollar (a level at which it would buy or sell yen and euros), it would not be long before speculators took it as a challenge. And ultimately the speculators win.

Purely parenthetically, I have been asked what U.S. exchange rate policy might be like under the newly-nominated Secretary of the Treasury. I can't resist putting forward the alliterative theory of the dollar. Four of the Treasury Secretaries who have served in the last 25 years have names that begin with the letter "B." Each has been perceived as "bashing" the dollar. In each case the accusation may be unfair, but it is in fact true that the dollar depreciated on average during the terms of each of the four [against G-10 currencies]. Two of the other Treasury Secretaries have names beginning with the letter "R." Under each of them, the dollar has "revived." The name of the new nominee begins with "S." To find a corresponding predecessor we have to go back to the Secretary who served in the mid-1970s. At that time, the dollar was relatively "steady." I think this is the appropriate characterization for the current outlook as well.

Are intermediate regimes no longer feasible?

I would like to cover one more topic: intermediate exchange rate regimes. Most countries are somewhere in between the United States and Luxembourg. Until recently, I think that many experts believed that countries that were intermediate with respect to size, openness, and the other optimum currency area criteria were probably suited to intermediate exchange rate regimes: adjustable pegs, crawling pegs, basket pegs, and target zones. Suddenly the view has become common that such regimes are not sustainable in a world of large-scale financial flows, and that countries are being pushed

to the corners of either firm fixing or free floating.[3]

From where did the hypothesis of the "vanishing intermediate regime" come? Its intellectual origins date from the aftermath of the 1992-93 crises in the European Exchange Rate Mechanism, which previously had maintained target zones for member currencies, with a width of 2 1/4 percent (or 6 per cent in a few cases).[4] This band had been conceived as an intermediate step toward full European Economic and Monetary Union. But in 1993 the bands had to be widened to a very wide 15 percent. In January 1999 the leap to EMU for 11 currencies proved successful, confirming that a transition

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[3] E.g., Lawrence Summers, testimony before the Senate Foreign Relations Subcommittee on International Economic Policy and Export/Trade Promotion, January 27, 1999; and Zanny Minton-Beddoes, 1999, "From EMU to AMU? The Case for Regional Currency Blocs," Foreign Affairs, July/August.

[4] Barry Eichengreen, 1994, International Monetary Arrangements for the 21st Century, Brookings Institution, Washington DC.

through an intermediate regime was not a requirement.

What is the logic behind the proposition that countries must choose between firm fixing and free floating? It does not follow from increased capital mobility alone. It is true that a country that is perfectly open to international capital markets cannot both maintain a fixed exchange rate and set its interest rate independently of its partners. But there is nothing in theory to stop the country from seeking to impose an intermediate degree of exchange rate stability, simultaneously buying an intermediate degree of monetary independence.

Recent history makes it understandable that some would flee the soft middle ground of the intermediate regimes and seek the bedrock of the corners. Monetary union and pure floating are the two regimes that cannot be subjected to speculative attack. Most of the intermediate regimes have been tried and failed, often spectacularly so. Mexico, Thailand, Indonesia, Korea, Russia and Brazil were following varieties of bands, baskets, and crawling pegs when they crashed. Perhaps when international investors are lacking in confidence and risk-tolerance -- the conditions that have characterized emerging markets during 1997-99 -- governments can reclaim confidence only by proclaiming policies that are so simple and so transparent that investors can verify instantly that the government is in fact doing what it claims it is doing. If a central bank, for example, announces a band around a crawling basket peg, it takes a surprisingly large number of daily observations for a market participant to solve the statistical problem (either explicitly or implicitly) of testing the hypothesis that the central bank is doing what it says it is doing. This is particularly true if the central bank does not

announce the width in the band, the rate of the crawl, or the weights in the basket (as is often the case). By contrast, market participants can verify the announcement of a simple dollar peg instantly, by looking up today's exchange rate and seeing if it differs from yesterday's.

An alternative interpretation is that the search for a single regime that will eliminate currency speculation as an issue is a search that cannot be successful (short, perhaps, of restrictions on international capital flows). Large swings and speculative bubbles intrude on the nirvana of pure floating. Even the central bankers' oblivion of currency union does not offer an end to earthly sorrows, as political upheavals intrude from time to time. The rejection of the middle ground is then explained simply as a rejection of where most countries have been, with no reasonable expectation that the sanctuaries of monetary union or free floating, will in fact be any better. The grass is always greener at the corners of the pasture, if you have previously been grazing in the middle. Only when you have spent some time in the corners does the middle start to look good again. I suspect that many countries are fated to switch back and forth among various regimes over time. If this is right, the only recommendation one can give most central bankers in vulnerable countries, excepting those whose country characteristics suit them for a corner solution, is to keep alert to any signs of serious overvaluation. A blanket recommendation to avoid the middle regimes in favor of firm fixing or free floating would not be appropriate.