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Which `corner' solution?

Introduction

1. The purpose of this note is to comment Berg, Borensztein and Mauro's paper on `An Evaluation of Monetary Regime Options for Latin America' (henceforth called BBM paper) prepared for the CASE International Conference on `Beyond Transition. Development Perspectives and Dilemmas", held in Falenty, Poland on April 12-13, 2002 as well as present my own remarks concerning the rationale of sovereign monetary policy in the era of globalization[1].

2. BBM paper contains the well-balanced presentation of the pros and cons related to each `corner' solution basing both on theoretical arguments and existing empirical findings related mainly to Latin America and, marginally, to Southeast Asia[2]. My remarks will address mainly some theoretical arguments and policy conclusions. Taking into consideration my own research and policy advising experience I will concentrate mainly on the former communist countries. While generally this group does not differ dramatically in its basic characteristics and experienced problems from the Latin American region the balance of some particular arguments may not be exactly the same.

3. The basic assumption of the BBM paper is that countries must choose between two `corner' solutions, i.e. between the independent monetary policy with floating exchange rate and the lack of monetary independence under the so-called hard peg. I consider this assumption as the absolutely correct. The intermediary (hybrid) regimes such as fixed but adjustable peg, crawling peg, crawling band, horizontal band, soft band and managed float are fundamentally inconsistent with a free capital movement, which has become the reality of most economies in the beginning of the 21st century[3]. Their continuous existence can be considered as the important source of currency crises in the last decade [Obstfeld and Rogoff, 1995; McCallum, 1999; Eichengreen and Hausmann, 1999; IIE, 1999].

Limited usefulness of the OCA theory

4. Following many other authors discussing the topic of potential monetary unification, BBM start their analysis from the optimum currency areas (OCA) theory and try to find some empirical evidence verifying the arguments of this theory in relation to the Latin American region. Although BBM seem to be aware of limitations of the OCA theory they do not articulate sufficiently its numerous shortcomings.

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[1] This is continuation of my earlier work, mainly of Dabrowski [2001].
[2] The same concerns the excellent Vittorio Corbo's comments to BBM paper, which are mainly addressed to Latin America – see Corbo [2002].
[3] The opposite view is expressed, among others, by Williamson [2000] who try to defend a rationale of the intermediate regimes (however, he recommends also resorting to some forms of capital controls).

5. The original OCA theory in the version proposed by Mundell [1961] and McKinnon [1963] reflected the post-WWII economic landscape with extensive trade, current account and capital account restrictions, increasing microeconomic rigidities and an universal activist approach to monetary and exchange rate policies (aimed at stabilizing output and employment rather than fighting inflation). Although the Bretton Woods system was designed to protect some exchange rate stability this was not definitely the stability forever. Exchange rates could be and were subject of corrections in the case of major imbalances, thus serving as the ultimate shock absorber and adjustment tool. If fact, the OCA theory seemed to discourage abandoning this instrument rather than promote the idea of monetary unification.

6. Today's world economy is different from that of 1950s. Most currencies are convertible and trade liberalization made a significant progress. Global product and financial markets are increasingly integrated. In fact, we live in the world of free capital and product mobility. Thus, international factor mobility being the key concern of Mundell [1961] model does not need to be a serious obstacle any longer. Even if labor mobility is still seriously restricted (internationally but also internally) it can be substituted by a far going capital mobility.

7. However, the biggest problem with the OCA theory in its original version relates to its static character. Asymmetric shocks and limitations in factor mobility are considered as exogenous. This is true in a short to medium term horizon. However, in the longer run they can become endogenous. Obviously, monetary union will promote trade and capital flows inside the common currency area, and push to synchronize macroeconomic policies. It may also encourage microeconomic reforms deregulating labor, capital and product markets (see below). All these factors will reduce occurrence of the asymmetric shocks and increase factor mobility.

What are the advantages of exchange rate flexibility?

8. Asking why flexible exchange rates are needed for policymakers the standard OCA theory answer is: as the ultimate shock absorber. What does it mean, however, in the world of a free capital movement? Obviously, policymakers have almost no direct influence on the real exchange rate at least through monetary policy means. Thus, engineering any competitive devaluation without big collateral losses becomes almost impossible[4]. However, nominal (and real) exchange rate may automatically adjust to changing terms of trade and direction of capital flows unless other factors will work in an opposite direction.

9. Flexible exchange rates also leave a certain room for an activist monetary policy aiming in achieving other goals than only the low inflation/ price stability. However, one must notice that hard peg does not fully eliminate the counter-cyclical role of monetary policy. If central bank of anchor currency does pursue such a policy and the business cycle of a hard peg country does not differ from the cycle of the former, monetary conditions will help to accommodate an output gap. The problem occurs when a hard peg country must deal with the asymmetric shock and asymmetric business cycle (in spite of influence of monetary union on harmonizing business cycles and promoting trade inside the common currency area – see above).

[4] Policymakers have still a big chance to provoke a currency crisis and resulting real depreciation of a national currency. However, side effects of such an experiment including the political costs for its authors well exceed any potential benefit.

10. There is, however, another question - to what extent a central bank of developing/ transition country is able to “lean against the wind”. BBM answer is tentatively “yes” but I think that this problem needs in further investigation both on the theoretical and empirical grounds, taking into consideration the credibility issue and political and technical constraints.

11. If developing/transition economy does not want to rely on credible exchange rate anchor (in order to retain exchange rate and monetary policy flexibility) they must find another nominal anchor. Both BBM and Corbo [2002] suggest the direct inflation targeting (DIT), the increasingly popular strategy in the contemporary world. This is really the most transparent variant of an independent monetary policy helping to discipline both monetary authorities and inflationary expectations. However, this strategy is not so easy in operating and many developing and transition economies may have serious problems with its effective adoption.

12. Let’s list some of the conditions, which must be met in order to guarantee the effectiveness of the DIT. First, because DIT involves, by definition, significant room for discretionary decisions, it needs to be backed by a strong anti-inflationary consensus both on the conceptual and political level. Second, this consensus should be materialized in the form of central bank independence, with strong legal guarantees respected in practice. Third, DIT is technically quite complex and sophisticated, and needs a well developed analytical and forecasting skills both inside and outside a central bank as well as a good quality of the monetary, fiscal, price, balance of payments and output statistics. Fourth, the effective transmission needs in a well-developed and transparent financial market what is not always the case in emerging-market economies. For example, banking sector fragility and extensive currency substitution can be serious obstacles to establishing such transmission channels.

13. But even overcoming all these technical problems does not eliminate other serious policy dilemmas, which face monetary authorities operating DIT strategy, particularly those of chronic high or moderate inflation economies (and this is a quite frequent case among developing/ transition countries). If central bank wants to build its credibility in order to achieve fast disinflation results at relatively low output/ employment costs (if possible at all) it must stick quite precisely to the low inflation target and cannot compromise it in favor of other goals. It means giving up the potential advantages of an independent monetary policy (comparing to the hard peg variant) at least for the period of disinflation and subsequent consolidation of low inflation environment.

Credibility and currency substitution

14. The insufficient credibility of monetary/macroeconomic policy and national currency in many developing/ transition countries seems to be the main argument in favor of giving up monetary independence and choosing a hard peg[5]. The credibility shortage can originate from moderate/ high inflation (or even hyperinflation) experience, past currency crises, political instability or lack of sustainable domestic political and intellectual consensus in favor of price stability. Building credibility is a long lasting and costly process (in terms of high real interest rates and increased macroeconomic vulnerability) without guarantee of the success. Joining one of major currency areas can eliminate this kind of problems as well as the danger of currency crisis.

[5] This argument was also raised in later Mundell’s works – see Mundell [1973].

15. However, the credibility problem does not need to be automatically solved by introduction of a hard peg variant. While the adoption of the other currency seems to be irreversible step, the currency board does not need to be considered as the definite peg forever. The economic history knows a lot of episodes of abandoning the hard pegs, for example, during the gold standard period [see Eichengreen, 1996] even if they were declared as unchangeable and based on the very solid legal foundations. The recent Argentina's episode may only increase such an uncertainty in countries running the currency board but lacking the credible macroeconomic policies and solid rule of law tradition.

16. The chronic lack of credibility is reflected, among others, in the low monetization level (particularly in domestic currency), high ratio of currency substitution (spontaneous dollarization or euroization using the BBM terminology), and inability to borrow long term in the domestic currency called by Hausmann [2001] as the *original sin*.

17. The increasing network of international trade and financial transactions and the rapid expansion of new financial techniques and instruments substantially increased opportunity of currency substitution. Contrary to the past experience, when currency substitution was the exceptional practice (during episodes of major political or financial instability), in the contemporary economy economic agents can freely choose the currency at least for saving and credit purposes[6] and they do so.

18. Currency substitution is caused not only by credibility problems, interest rate differentials or expected depreciation/devaluation of domestic currency but also by the fact that most of the international trade and financial transactions is conducted in few major currencies. Thus, even in the economies having a good track record in macroeconomic management but being small and open to international trade it can be difficult to avoid certain currency substitution caused by transaction needs.

19. Currency substitution (arbitrage), regardless whether it is conducted between countries or between currencies in one country, undermines the monopoly power of the monetary authority to issue the national currency and to collect *seigniorage*. In practice, monetary authorities must compete with central banks of other countries (particularly those of major currencies) what may remind, to certain extent, a model of *free banking*[7] or may refer to Hayek's [1978] idea of *denationalization of money*.

20. Consequently, the currency substitution and *de facto* competition among central banks decreases additionally a room for activist monetary policies (and, therefore, potential advantages of flexible exchange rates) at least in the countries, which monetary authorities do not enjoy sufficient reputation. This observation should also lead to rethinking of many textbooks macroeconomic models and macroeconomic policy proposals[8], which assume (either explicitly or implicitly) that economic agents must use exclusively the national currency and that currency substitution is not an effective option.

21. The idea of a new regional currency for Latin America discussed by BBM does not look reasonable from the credibility point of view. It is very unlikely that the experience of building the Euro zone in Western Europe (basing on the credibility of D-Mark and other

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[6] In most countries, there are still restrictions on using foreign currency in some types of domestic transactions such as paying wages and salaries, tax obligations or selling goods and services on a domestic market.
[7] For episodes of free banking in Scotland (18th and the first half of 19th century) and US (before the Civil War) – see Friedman and Schwartz [1986].
[8] At least in relation to countries, which do not run major international currencies.

European currencies) can be repeated either in Latin America, or in any other region in the foreseeable future. Exactly for the same reasons, attempts to build the ruble zone in the CIS in early 1990s after collapse of the USRR must be assessed ex post as completely unrealistic [see Dabrowski, 1997; Odling-Smee and Pastor, 2001][9].

22. The real choice for the countries willing to give up their monetary independence seems to be between the US dollar and Euro zone. All other currencies, including the Japanese yen would be less practical because of their limited role in the international trade and financial transactions. In addition, apart from a dozen EU candidates having the perspective to become eventually the full EMU member, all others can consider only the unilateral participation in the monetary union, i.e. without the possibility to influence the decisions of the Fed or ECB.

Political economy and politics

23. Credibility is closely related to the sphere of politics and incentives, which encourage or discourage politicians to carry out a responsible macroeconomic policy and needed policy reforms. Giving up monetary independence means domestic de-politicization of money following Rudi Dornbusch [2000, p. 15] suggestion that "*money is too serious to be left to politicians: in these matters, there is no such thing as a responsible politician; democratic money is bad money*". Depriving politicians of the monetary/ exchange adjustment tool may force them to think seriously about fiscal, structural and institutional reforms making an economy more balanced, flexible and competitive. These are the microeconomic reforms, which should go first in order to fix the existing inefficiencies and monetary/exchange rate accommodation is always the second best solution only.

24. While the hard peg creates strong incentives for politicians to put order in the fiscal accounts, liberalize the economy and make it more flexible, there is no guarantee that this kind of policy recommendations will be always followed seriously, to a satisfactory extent. This may lead to a major macroeconomic and credibility crisis, undermining even the hard peg regime (the case of Argentina). Moreover, introduction of the hard peg creates usually a more room of maneuver in the fiscal sphere (through a substantial decrease in interest rates) which may be used either to balance a budget (the positive scenario) or to expand non-interest payment expenditure (the negative scenario). The same concerns private investments: if banking and corporate sectors suffer major inefficiencies the increased capital inflow stimulated by the lack of exchange rate risk will be allocated in a distorted way causing dangerous imbalances (the case of Asia).

Network externalities

25. Another argument in the discussion about the preferred variant of a `corner' solution is connected with the prevailing monetary regimes outside the country, particularly in its close neighborhood. This is the problem of `network externalities' emphasized strongly by Eichengreen [1996]. For example, when all major economies followed the gold standard before the World War-I it was very difficult for any individual country to live outside this regime. But after the definite collapse of the Bretton Woods system of fixed but adjustable parities in 1973 when exchange rate between major currencies (US dollar, D-Mark and

[9] In addition, establishing a supranational currency needs also in adequate political and institutional infrastructure as it the case of the European Union. Such an infrastructure and international political commitment does not exist in any region other than Europe. Neither it existed in the former Soviet Union when the idea of ruble are was a serious subject of economic and political debate.

Japanese yen) started to float situation changed dramatically. A stable peg in relation to any major currency became difficult unless it was the dominant currency of trade and financial transactions.

26. As a consequence, even small open economy, which is not interested in using monetary policy for activist purposes, may have problem with giving up its monetary independence in favor of any specific currency because of the diversified currency structure of its trade and financial transactions. Although it can expect that entering the monetary union will affect this structure in favor of the anchor currency it will take a lot of time. In the meantime, it can suffer asymmetric shocks coming from the changing cross exchange rates of major currencies. The currency basket reflecting country's foreign transactions structure, being the standard solution under the intermediate regimes is rather technically difficult to operate under the currency board regime[10] not mentioning the adoption of the other country's currency.

27. On the contrary, if all country's major trade and financial partners belong the single currency area it could be difficult to stay outside this block without the risk on losing some important trade and investment opportunities.

28. Thus, according to the `network externalities' argument the increased number of countries, which join the specific currency block forever can push others to do the same. Such a snow-ball effect can be already observed in Europe where one may expect the progressive expansion of the Euro zone to the rest of continent as well as to the Mediteranian and North Africa region during the next two decades. Will the same happen in the Latin America in relation to the US dollar is the open question extensively discussed both in the BBM paper and Corbo [2002] comments.

29. Increasing number of countries using the international currency (US dollar and Euro) may also influence its monetary authority to take into consideration the economic situation outside the home country (area) in order to avoid negative feed-backs coming from its decisions through the international markets.

30. One could expect the IMF to play the important role in encouraging countries that are the proper candidates to adopt a hard peg (and there are plenty of such candidates among developing and transition economies) to do so and to help them in this process. It would be consistent with the historic mandate of this organization to facilitate exchange rate stability and discourage competitive devaluation, which damages the international trade. Unfortunately, this is not the case. After a very limited involvement in some currency boards experiments in 1990s (Bulgaria in 1997 was the last such episode) the IMF became increasingly hesitant to support this `corner' solution. Instead, many small developing and transition economies with low credibility of their currencies have been pushed by the IMF to experiment with an independent monetary policy and more flexible exchange rate arrangements (this relates, for example, to the FSU countries after 1998-1999 series of financial crises).

[10] An interesting example is provided by Latvia that fixes its currency to the SDR. While the country has not formally declared the introduction of the currency board, all the technical indicators are the same as in the currency board regime.

What is the choice for transition economies?

31. Most of transition economies must deal with legacy of high inflation, low credibility of their macroeconomic policies (reflected, among others, in high real interest rates, extensive currency substitution and low monetization level), and repeating temptations to use monetary policies for other purposes than achieving price stability. So, they seem to be the good candidates to give up their monetary sovereignty. Some of them already did so. Estonia, Lithuania, Bosnia and Herzegovina, and Bulgaria run currency boards. Latvia, Croatia and Macedonia although follow the conventional peg their monetary policy stance is not so distant from the currency board. In addition, Montenegro and Kosovo represent the cases of unilateral euroization.

32. Three countries – the Czech Republic, Poland and Hungary - decided to choose the opposite `corner', i.e. DIT strategy. Slovakia and Slovenia allowed for quite substantial exchange rate flexibility but without the clear nominal anchor. The remaining countries run the intermediate regimes, most frequently declared formally as the managed float but de facto closer to peg formula.

33. Looking at the detail trade and monetary characteristics one can obtain a differentiated picture of pros and cons related to the potential monetary unification. While Central European countries (particularly the Czech Republic and Slovakia) enjoy a relative macroeconomic credibility (comparing to other post-communist countries), their economies are already highly integrated (in terms of trade and investments) with the Euro area. Looking from credibility point of view they probably could continue sovereign monetary policies but the timetable of the EU accession push them to think how to join the Euro zone in the coming years. Moreover, the overall balance of arguments (including the `network externalities') seems to be in favor of acceleration of this process.

34. On the other extreme, CIS countries suffering extremely low credibility of their currencies represent a much more diversified trade structure (in terms of transaction currency) and do not have chance to join the EU in the foreseeable future. This reminds, to certain extent, the Central versus South American picture described by BBM. However, in the light of all the arguments discussed in this note the CIS countries do not have chances to sustain their own independent monetary policies at reasonable costs. Moreover, they can face problems with running the currency boards because of a general lack of credibility of their state institutions. This means that they should think about unilateral dollarization/ euroization as the best solution.

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