Discussion of Berg, Borensztein and Mauro's Paper

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Increased capital mobility coupled with rather violent exchange and payment crises of the 1990s and 2000s have led contemporary economists to re-think exchange rate arrangements. Today's consensus is that given capital mobility the choice is between floating and very hard peg exchange rate arrangements that is currency boards or dollarization.

The consequences of such choices "have been debated since the mid-1870s, when the gold standard based on the pound sterling began spreading from England to the rest of the world."[1] Still to these days, the discussion is rather inconclusive and it is why evaluating monetary regime options is so valuable.

Andrew Berg, Eduardo Borensztein and Paolo Mauro examine the choice of exchange rate regime for middle-income developing countries, with reference to Latin America. This paper starts with the assumption that given capital mobility, there is a straight choice between floating and very hard peg exchange arrangements.

Having established that an independent common currency in Latin America is not likely to emerge for at least a decade, the authors turn to independent floats and dollarization analysing in each case the gains from adopting respectively one or the other.

The authors concentrate on dollarization rather than or as well as currency boards, may be because the difference is not so important. I tend to follow (Roubini 1998) in failing to see what is so magical about currency boards and so different from fixed exchange rates. The credibility of such a system is said to be achieved because the monetary authorities' loss of freedom to print money is set by law, so the political cost of altering such exchange rate regimes is therefore high. But similar to all other fixed exchange rate regimes, if the fiscal position is unbalanced, and the banking sector poorly regulated, there is little chance for such a system to survive a speculative attack – or, put another way, the authorities cannot pay the political cost of resisting such an attack. In my view, the same constraints apply to dollarization. The authors identified three factors which they view as determinant in adopting complete unilateral dollarization: the gains in terms of monetary credibility; the existence of spontaneous dollarization which would facilitate complete unilateral dollarization, and the advantages of integration with the US. And from these three characteristics, the authors draw a country profile of unilateral dollarization regime, they found that "not many countries fit the bill" (p.11).

They could however have drawn more systematically on the insight of Braga de Macedo (2001, p.8) that "an instant fix does not provide a fast lane to credibility. Rules for budgetary adjustment (such as the zero deficit in Argentina or the EU Stability and Growth Pact) are necessary for any exchange-rate regime to deliver economic growth and

[1] (Braga de Macedo 2001), p.7

development."(Braga de Macedo 2001), p.8. Unsustainable fiscal policy rarely serves to build credibility whatever the exchange rate regime adopted.

So what about floating exchange rates? The authors define floating exchange rates as "the nominal exchange rate moves frequently and substantially in response (in part) to market forces, with the authorities not setting a particular level or rate of change."(p.12) They are careful in pointing out that floating exchange rate regime do not preclude intervention. Because indeed, in practice and despite the new conventional wisdom of corner exchange rates, these marriages of countries with exchange rate regimes come in all shades:

"The choice between fixed and floating exchange rates should not be viewed as dichotomous. In reality, the degree of exchange rate flexibility lies on a continuum, with exchange-rate target zones, crawling pegs, crawling zones, and managed floats of various other kinds residing between the extremes of floating and irrevocably fixed. Indeed, the notion of a "free" float is an abstraction with little empirical content, as few governments are willing to set monetary policy without some consideration of its exchange rate effects."[2]

Incidentally, a counter-example of this continuum in action may be found in the case of a middle-income country close to us here in Warsaw, and close to the research interests of many of us here, but not used as a case history in this paper. I refer, of course, to Russia, where the ostensible free-float adopted since the August 1998 financial debacle is a nice illustration of what the authors describe as a managed float, with the authorities intervening to prevent the exchange rate absorbing the full effect of external shocks (in this case, sharp fluctuations in the oil price), with adverse consequences for employment and output.

The most interesting question is whether the flexibility "in exchange rate and monetary policy achieve important domestic ends."(p.12). This summarizes the important role that exchange rate management will always have in countries' continuous management of the full range of their economic problems. As Eichengreen puts it, the choice of exchange-rate regime will continue to be determined by:

"the authorities' objective function, in particular the trade-off between a desire to control inflation (that is, to provide a nominal anchor) and a wish to limit fluctuations in competitiveness or to minimise output losses."[3]

Six case studies or 'anecdotes' are provided by the authors: Mexico, Chile, Peru and Singapore as floating exchange rate countries and Hong Kong and Argentina as hard pegs. These anecdotal evidences led the authors to several tentative observations regarding the effectiveness of floating exchange to respond to domestic disequilibria which they next develop more systematically. Their thorough analysis lead them to the conclusion that indeed there is some evidence that floating exchange rates "play a

[2] Obstfeld, M. (1998). "The Global Capital Market: Benefactor or Menace?" NBER Working Paper Series , National Bureau of Economic Research,(Working Paper 6559)., p.8.
[3] Eichengreen, B., P. Masson, et al. (1999). Transition Strategies and Nominal Anchors on the Road to Greater Exchange-Rate Flexibility. Essays in International Finance. Princeton, New Jersey., International Finance Section, Department of Economics, Princeton University., pp. 5-6

stabilizing role" and that "adjustments in the exchange rate leads to appropriate adjustments in relative prices in response to terms of trade shocks."p.28

This paper brings much to the debate by providing a very useful overview of the state of the literature and the empirical evidence, and advancing the case for floating exchange rates. Still the authors' conclusion is somewhat evasive with no apparent advance on the common-sense conclusion of Frankel being that "no single currency regime is right for all countries or all time"[4]. This is the reality that countries and exchange rate regimes continue to be wedded on a case-by-case basis, with the criteria ranging from economic fundamentals to political economy specifics. I therefore differ with the starting assumption that, given capital mobility, there is a straight choice between flexible and very hard peg exchange arrangements. (Granville 2001). I would also have found it very useful if the authors had concentrated more deeply on the case of Argentina. Perhaps this would have the greatest interest in terms of lessons to be learned. The results may not have been too far from the ones contained in our book "Don't Fix, Don't Float edited by Jorge Braga de Macedo, Daniel Cohen and Helmut Reisen where we found that neither floating exchange rates nor hard pegs are crisis-free and that credibility is better built at home rather than borrowed. (Braga de Macedo, Cohen et al. 2001), pp.48-49.

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[4] Frankel, J. (1999). "No Single Currency is Right for All Countries or at All Times." NBER Working Paper **7338.**