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A Never Ending Story: Developing Countries' Choice of an Exchange Rate Anchor*

By Martina Metzger**

Summary

The paper discusses two different exchange rate regimes viewed from the perspective of a developing country. It analyses both economic arguments for a developing country's choice of a real or nominal exchange rate anchor and offers reasons for its failure. Yet recourse on South-East Asia and Latin America serve only to illustrate arguments that are put forward in general terms. The paper concludes that no universally adequate exchange rate regime for developing countries exists that would simultaneously satisfy the requirements both of maintaining competitiveness and supporting stabilisation efforts. Furthermore, it is pointed out that anti-inflation-mania by industrialised countries and increasing foreign indebtedness by developing countries severely destabilise developing countries' exchange rate regimes.

*Without fiscal austerity stabilization cannot start.
Without incomes policy it is unlikely to succeed.
(Rudiger Dornbusch)*

Financial sector related crises are not novel occurrences in industrialised and developing countries. In fact they date back to the beginnings of financial systems themselves and seem so intimately bound up with them that they can seem part and parcel of such systems, a vital ingredient like the evil-doer in the fairy-tale. But as with all tales passing on the problem means understanding the lesson to be learned and that is rather delicate every now and then. With regard to the Asian crisis it is no exaggeration to state that the only indisputable fact — exemplified by the contributions to this volume — is that we economists simply do not agree. The present paper focuses on a single aspect from a broad range of factors under discussion concerning the roots and accelerating elements of the crisis. We will discuss two different exchange rate regimes viewed from the perspective of a developing country. Our paper does not, however, claim to give a comprehensive overview of the countries affected by the crisis nor will it present an in depth examination of the exchange rate debate of the last decades. It is rather highly selective in offering an intersection of both the economic reasons for a developing country's choice for a special exchange rate regime — and the reasons for its failure. Hereby, we will not refer only to South-East Asia, but also to Latin America as Latin American countries display a wide range of experiences with divers exchange rate regimes. Furthermore, it serves to elaborate that the col-

lapse of Asian currencies is *not* a result of a constellation unique to Asian countries due to their supposed cultures or mentalities, and to pinpoint that all developing countries are exposed to exchange rate instability. So far both the South-East Asian and Latin American cases are used only to illustrate arguments that are put forward in general terms. With regard to their exchange rate regimes, only Thailand (until 1997) and Argentina were thought of as countries with an open nominal peg. Although Brazil and the other 4 Asian countries in question — Indonesia, Malaysia, Philippines and South Korea — were officially classified as managed or even free floaters until the crisis,¹ they all narrowly linked their currency to the US dollar or to a basket in which the overwhelming share fell to the US dollar with only marginal bands to float. Hence, we think it is justified to call them nominal peggers.

We shall start by reviewing both the rationality and limitations of nominal exchange rate pegs. This will be followed

* I am grateful to Karola Arndt and Barbara Fritz for helpful comments and critics.

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¹ See Caramazza/Aziz (1998), pp. 9-10.

by a discussion as to whether a real anchor is a viable alternative to nominal pegs. Thereby, the article focuses on decision variant exchange rate regimes, that allow monetary authorities some scope for discretionary intervention. Both real and nominal anchors can also be implemented in a formula variant.² But although the central bank can be administratively deprived of its scope for intervention due to clearly defined ex ante rules, it still nevertheless fully remains a market agent. And as formula variant exchange rate regimes severely damage the central bank's position as a market agent from the very beginning, they are rejected and will not be further considered in this article. A third section highlights the restricting impact of the international monetary order on developing countries' stabilisation efforts. Our final remarks sum up the main findings — regrettably without being able to offer a happy end.

1. Nominal Pegs in Pledge of Stabilisation?

In general terms a country's macroeconomic stability usually refers to low inflation rates and constant or even appreciating exchange rates. Thus a nominal anchor seeks to kill two birds with one stone: (i) an import of price level stability of the anchor currency; and (ii) an import of credibility in exchange rate stabilisation. A peg should result in a rise of the liquidity premium as it relies on the confidence of economic agents in the stability of a currency. In case of success the central bank is then in a position to cut down interest rates and so support the income generating process. In short, the long-term rationality of a nominal anchor lies in the stimulation of economic activities under conditions of importing macroeconomic stability. The problem of a weaker currency's peg to a hard currency, however, lies in the prevention of overvaluation. Overvaluation let export revenues shrink and import bills rise leading to a deteriorating current account balance which fuels depreciation expectations and puts the nominal anchor seriously at risk. Therefore, domestic inflation rate must be brought down very quickly to the level of the anchor currency inflation rate. Monetary and fiscal authorities are said to have three major policy areas at their disposal to do this: (a) interest rate policy; (b) fiscal policy and (c) incomes policy.

(a) It is commonly agreed that restrictive interest rate policy results in a slow-down of economic activities that dampens inflationary tendencies. Although both Argentina and Brazil have had outstanding success in bringing down their inflation from four digit to single digit figures, they needed at minimum four years to slash inflation rates to the US level. Eight years after the introduction of the Plano Cavallo, Argentina now has a marginal deflation, even though it is not enough to neutralise the overvaluation accumulated in the first four years. These countries even welcomed initial overvaluation as an instrument to limit price hikes of local producers. Tougher competition by international rivals would only precipitate the necessary

adjustment — so the Latin American line of reasoning. Argentina's marked deindustrialisation and Brazil's increased focus on raw material related exports are the lamentable consequences of it. But this problem does not only apply to countries that were once notorious for their high inflation. Although South-East Asian economies were once noted for their long tradition of single digit inflation rates, with the notable exception of Malaysia they all had on average higher inflation rates than the United States all about two to six percentage points per annum.³

Moreover, higher interest rates in comparison to those of the anchor currency set up to combat inflation, entice domestic economic agents with access to international capital markets to indebted themselves internationally and may attract portfolio investment inflows. That is exactly what happened in Asia and what is still going on in Latin America. All South-East Asian countries were subject to high net capital imports which surpassed by far their current account deficits. Malaysia even reinforced a restrictive interest rate policy in 1995 to curb domestic activity level which had widened the current account deficit up to around a huge 9 per cent of GNP.⁴ Apart from a small nominal appreciation of one per cent vis-à-vis the US dollar in 1995, net capital inflows kept pouring into the country.⁵ But foreign currency indebtedness by domestic economic agents along with hot money inflows aggravate the authorities' task of preventing an overvaluation that can be caused both by domestic inflation rates which are higher than world inflation, and by net capital imports.

(b) Fiscal policy aimed at a budget surplus by cutting down expenditures or by raising revenues in the form of taxes or a combination of the two is often regarded as a complementary instrument to interest rate policy. But cutting down public expenditures does not rely solely on the readiness and ability of those involved in the budgetary process as critics of public deficits often hold it to be. The overwhelming majority of expenditures must be considered as quasi-fix in the short-run. Almost all regularly effected payments can be classified among these quasi-fix expenditures, especially those for wages and salaries, rents, state enterprise deficits, debt service and public pension funds. While the latter two categories are long-term liabilities which have to be met come what may, the others are obligations based at an absolute minimum on one-year-contracts which cannot be rescinded on from one day to another. Both the restructuring of the civil service, including the privatisation of state-owned enterprises, and

² A formula variant real peg implies institutionalised devaluations of the exchange rate according to the expected or real positive inflation differential, whereas a currency board represents the formula variant of a nominal peg tying national money expansion to a change of net reserves.

³ See World Bank (1997), Appendix Table 2.

⁴ See Dornbusch/Park (1996), pp. 32-33.

⁵ See Radelet/Sachs (1998), Table 9.

reprioritisation of public expenditures are middle to long-term projects. So the scope for cutting expenditures to ease the burden on the budget at the beginning of a nominal anchor experiment is highly limited.

A government determines the tax base and the tax assessment rate. Tax yield, however, fluctuates according to growth rates and income generation. Hence, we would expect higher tax revenues in times of accelerated growth than in times of stagnation or depression. South-East Asian countries were famous for exceptionally high growth rates. Between 1985 and 1995 GNP per capita, excluding the Philippines, increased annually from close to six per cent in Malaysia and to more than eight per cent in Thailand.⁶ Annual average GDP growth expanded even more vigorously in the period 1980-1995 from at the lowest a substantial six per cent in Malaysia to almost 9 per cent in South Korea.⁷ Thus after years of sustained growth, by the middle of the 1990s, all South-East Asian countries under review here realised at minimum a balanced budget like South Korea or even a considerable surplus like Thailand.⁸ With the upheaval of 1997 and the following recession, however, a strong deterioration of public budgets has become manifest. For example, Thailand's overall public sector balance worsened sharply from a surplus of almost three per cent of GDP in 1996 to a deficit of three per cent of GDP in 1998 as a consequence of declining revenues and rising expenditures during the crisis.⁹

This is particularly relevant to a country that has to implement a restrictive interest rate policy to deflate in order to defend a nominal peg. Inland revenues will shrink *ceteris paribus*, while public expenditures will increase due to a higher domestic debt service and outlays on social affairs. In an extreme case, governments such as the Brazilian have to apply an expansionary fiscal policy as a result of their previous restrictive monetary policy.¹⁰ Yet expansionary fiscal policy does not reflect a politically determined abandonment of an austerity programme, but is simply enforced by economic recession. The 'Latin American way' of adjustment ends up in a reversed Oliveira-Tanzi effect, whereby under disinflation public revenues are shrinking steadily what requires another cut in social expenditures or subsidies.¹¹ And though Brazil has raised its national interest rates to unprecedented levels of about 40 per cent and more in real terms to cope with the aftermath of the Asian crisis, it nevertheless had to fall back on international financial credit lines mainly from the IMF to shore up its nominal peg.

Only when macroeconomic stability is already achieved, so that the central bank does not have to rely further on high real interest rates, and profit expectations are recovering, can an increase in inland revenues under a given tax system be expected. Hence, the amount of public revenues or a budget surplus are first and foremost market results and not policy variables and a budget surplus is an outcome of an high accumulation dynamic rather than a point of departure for a stabilisation process.

(c) Wage policy geared to increases of wages equivalent to increases in productivity both in times of high employment and unemployment is called incomes policy. A centralised institutionalisation of wage-fixing processes in the labour market is essential for implementing incomes policy. Apart from the government, trade unions and employers' associations are the key institutions involved in this process. However, to support the initial stage of a nominal peg, governmental strategy must aim at concluding agreements where nominal wage increases lie *below* the rise in productivity to compensate for the incipient price level push and a domestic inflation rate that is higher than that of the anchor currency. Whether trade unions are willing to accept wage losses to the necessary extent depends on their historical experience with such 'pacto sociales', the degree of assent by their members and their potential alternatives. These are all factors that the government can at a pinch try to influence, although the final decision is not under its control. Nonetheless, an operative incomes policy relies on a high level of organisation both in the workforce and among employers so that the outcome of negotiations on a central level will be accepted by the vast majority of local workers and enterprises. If a labour market is highly fragmented — as it is widespread reality in most Third World countries — or flexibilised — as neo-classical economists would call it — along lines of business, sectors, regions or different trade unions, incomes policy is almost impossible.

As we have seen, restrictive monetary and fiscal policy are neither infallible nor accurate instruments for combating inflation and preventing overvaluation, the two indispensable ingredients for a successful nominal peg. A restrictive policy has indeed a dampening effect on the upward trend of prices, but only by destroying production capacities so that the next upswing will see more rapidly restricted quantitative expansion, causing then inflationary pressures or a rising import bill. Hence, in first instance a restrictive interest rate and fiscal policy lead to a contraction of economic activities and allow public revenues to dwindle. Nevertheless, rising interest rates as such do not reduce or reverse depreciation expectations but are rather their expression in economic terms. The only factor that can be reduced is domestic demand for foreign exchange, that is observable on the market, and this comes about due to the crumbling of income levels. If income generation can-

⁶ See World Bank (1997), Annex Table 2.

⁷ See World Bank (1997), Annex Table 11; own calculations.

⁸ See Radelet/Sachs (1998), Table 8.

⁹ See IMF (1998a), pp. 121-125 for Thailand and pp. 66-70 for South Korea respectively; for the impact on Philipppinian fiscal accounts see also Deutsche Bank Research (1998), pp. 7-8.

¹⁰ Brazilian short-term interest rates have almost doubled between 1997 and end of 1998 to dampen portfolio switches in the aftermath of the Asian crisis. Consequently, the public domestic debt service and the budget deficit sharply increased.

¹¹ I am indebted to Barbara Fritz for pointing this out to me. See also her contribution in this volume.

not be suppressed to such an extent that allows the country a current account surplus, growing depreciation expectations will inevitably end up in a balance of payments crisis and in a wretched suspension of the peg. Thus from a pessimistic point of view — which some Latin American countries may well substantiate — rising short-term net capital imports, a stagnating or even increasing budget deficit¹², and (dependant on the extent to which national debt cannot be converted into international one) a slow down in growth and declining inflation rates will all emerge simultaneously as probable results of an adjustment process under conditions of a nominal peg.

A more optimistic scenario would proceed on the assumption that both inflation and the budget deficit are already under control before the peg is implemented so that a highly restrictive policy is rendered obsolete. Then the peg itself is only there to stabilise the exchange rate vis-à-vis the main trading partner(s), to ease capital and current account activities and to support expectation building of exporters, importers and wealth owners. But if the peg is credible to market agents, it is completely rational for both domestic borrowers and international creditors to enter more and more into international credit transactions due to the positive real interest rate gap between domestic and foreign currency. And the more credible the peg becomes the more unhedged foreign debt is accumulated, resulting in a so-called currency mismatch which recently achieved a sad eminence in South-East Asia. It was to this that the International Monetary Fund (IMF) was referring when it asked „What went wrong? Part of the answer seems to be that these countries became victims of their own success. [...] This success had led domestic and foreign investors to underestimate the countries' economic weaknesses.”¹³ But this kind of explanation is wide of the mark. What the IMF calls „success” is basically the very financial weakness in question: Asian countries were lavishly praised for their ability to attract net private capital inflows with which they used to finance their rapid growth process. However, continuous net private capital inflows or, in other words, an accumulation of foreign debt severely undermines both the stability of a nominal peg itself and the capacity of monetary and fiscal authorities to act when the exchange rate is under pressure. Thus investors did not *underestimate* financial weaknesses but contributed considerably to evoke them. This does not so much reveal an 'exchange rate stability illusion' as a 'main stream economics illusion' which generally interprets private net capital inflows as a sign of sustainability and stability of the economic process. In short, even if we assume an optimistic scenario of developing countries' nominal peg to a hard currency, we cannot but conclude that it is an awful risky strategy — alone on internal grounds.¹⁴

2. Are Real Pegs a Viable Alternative?

The literature emphasises that one of the crawling peg's major advantages is the way it can adjust the nominal ex-

change rate so as to stabilise the real exchange rate whose level determines the competitiveness of domestic products in the world market. While under a fixed exchange rate no adjustment at all is possible, flexible exchange rates are said to overshoot or overadjust. Thus a crawling peg seems to be the best possible compromise between flexibility and stability for developing countries in the light of both their assumed higher sensitivity to external shocks and their poor monetary performance. However, there are two problems with regard to adjustment: (a) in first instance, it is vital to identify the equilibrium level of the real exchange rate to which the nominal exchange rate could then be adjusted; and (b) even assuming that the equilibrium level could be identified, the adjustment process itself incurs the risk of a depreciation-inflation-spiral.

(a) As real exchange rates are not observable, various procedures to estimate and extrapolate them on the basis of particular countries have been developed.¹⁵ But specifying the search for equilibrium exchange rates on a technical level does not exempt us from defining the economic target by which an equilibrium is met. An equilibrium is said to be given when both the macroeconomic internal and external balance is matched under conditions of a sustainable current account, whereby "(a)ny path that satisfies intertemporal budget constraints, and that can be followed indefinitely without surprises that would make agents wish that they had not acted as they did, is sustainable."¹⁶ From our point of view, the so defined equilibrium real exchange rate does not exist, neither historically because in human history no path whatsoever could have been followed *indefinitely*; nor theoretically because a path *without surprises* implies that the expectations of every economic actor about an economic incident or a series of economic incidents in the future are perfectly matched by the occurrence of the incident or the series of incidents on which expectations have been built. It further requires that every actual economic event has given rise to expectations by all market agents in such a way as leaves no gap between those expectations and the actual happening. This is a constraint to which not even the rational expectations hypothesis adheres. In our view absolute security about future events and developments is not a special case of expectation-building about the future with a

¹² The official data with regard to e.g. Argentina and Mexico display comparatively low budget deficits. But this is somehow misleading as unique privatisation proceedings are part of normal revenues and the data given reflects only the central budget deficit and thus abstracts of local or regional communities' deficits.

¹³ IMF (1998b), p. 3.

¹⁴ A study of 87 Latin American US \$ pegs from the late 1950s to the early 1990s shows that on average a peg only lasted 29 months. See Klein/Marion (1994).

¹⁵ See Williamson (1985), p. 19 ff.; for an overview of recent works on calculating equilibrium exchange rates see Williamson (1994a).

¹⁶ Williamson (1994b), footnote 3, p.180 (emphasis not in the original).

variance of zero, but rather implies the suspension of the category future itself because the future in essence is characterised by insecurity. Edwards suggests a less restrictive definition by tying the equilibrium real exchange rate to an average current account of zero. But in his basic model he excludes capital mobility so that his definition is a result of pragmatic-mathematical rather than of economic considerations.¹⁷ Later he does indeed modify the model by including capital mobility, but this does not change the gist of argument: „The simplest way to incorporate capital flows into the model is by assuming that they are restricted to the government, and by treating them as exogenous.”¹⁸ Even, under conditions of capital mobility we suggest a balanced current account as an indicator for equilibrium exchange rates because a country then does not accumulate foreign wealth or debt. Hence, a current account of zero does not change the net foreign asset position of a country. But this definition still leaves the question open whether an equilibrium real exchange rate is conducive to a development process or not.

(b) Assuming that an equilibrium level for the real exchange rate can be found, the nominal exchange rate may be adjusted according to the positive inflation differential vis-à-vis the main trading partner(s).¹⁹ However, permanent depreciations have several negative side-effects: (i) an increase of foreign debt service and (ii) an increase of the domestic price level.

A depreciation of the exchange rate devalues national wealth and revalues foreign debt. The overwhelming majority of crawling peg advocates propose an equivalent compensatory interest rate increase to keep real interest rates unchanged, thus preventing large-scale capital outflows.²⁰ But an equilibrium in the foreign exchange market between supply and demand of domestic and foreign currency respectively can only come about when the sum of national real interest rates plus national liquidity premium equals real interest rate plus the liquidity premium on foreign currency. Consequently, depreciation requires an *overproportionate* interest rate increase to restore equilibrium due to the rate of devaluation and the reduction of the national liquidity premium. A revaluation of foreign liabilities accompanied by a rise in domestic real interest rates squeezes all national economic agents loaded with debt irrespective of its denomination. Thus the resulting profit squeeze puts considerable pressure on wage earners and decreases domestic production capacities so long as higher costs are not completely neutralised by nominal wage losses.

The second risk attached to permanent depreciations lies in fuelling inflation. The only condition under which there will be no price level push at all is if imports are completely depressed to zero. Otherwise devaluation always has a tendency to increase domestic inflation as it raises the absolute price of imported products. Both traditional imports and domestic production capacities determine how strong this price level push will be, while whether and

to what extent it will increase inflation depends on the stability of nominal wages or, in other words, on the acceptance of real wage losses. Traditional imports are goods that cannot be substituted within a short time horizon (e.g. energy) and therefore will persist even after a devaluation resulting in an higher import bill. But even under conditions of a high price elasticity of demand for most imported goods, devaluation can end in a strong price level push if the domestic industry is already producing near or at full capacity. Hence, the higher traditional imports and the less national supply is quantitatively able to satisfy a price-induced switch in national demand from imports to domestic products, the greater will be the price level push. And the greater the price level push and the more frequently it occurs, the less will be the willingness of wage earners to bear further income reduction.

Hence, the emergence of a depreciation-inflation-spiral is not tied to an exogenous shock or as Genberg puts it to "[...] a disturbance to exchange rates, due for instance to an unanticipated monetary expansion."²¹ If monetary authorities wish to adhere to a real anchor, they are not only forced to apply highly restrictive policies restraining domestic enterprises; they must also achieve wage losses to the extent of the rise of production costs and the price level push mentioned above in order to prevent the notorious wage-price-spiral. And while it is ex ante completely impossible to determine which level real interest rates must hit to thwart a portfolio shift by wealth owners, demand for foreign exchange by internationally indebted agents will definitely increase. Contrary to the supposed stabilisation of profit expectations by international investors, importers and exporters, inflation and depreciation expectations are widely stimulated if income generation cannot be severely suppressed by monetary authorities. So we cannot help but conclude that an exchange rate regime based on permanent devaluations is itself a disturbance of market conditions.

3. Impacts of the International Monetary Order

Beyond the internal restrictions discussed in the preceding paragraphs we identify at least two major obstacles of the current international monetary order which destabilise the exchange rate regimes of developing

¹⁷ See Edwards (1994), p. 65.

¹⁸ Edwards (1994), p. 70 (emphasis, of course, not in the original!).

¹⁹ The equilibrium real exchange rate is not only influenced by inflation rates. It also fluctuates due to productivity gaps, external shocks and an disproportionate change of income elasticities of import and export demand. This paper will not deal with these structural changes; incorporating them only strengthens but does not modify the line of argument.

²⁰ See e.g. Williamson (1981b), p. 11.

²¹ Genberg (1981), p. 90.

countries. The first is the anti-inflation mania of hard currency countries and the second is related to foreign indebtedness.

The goal of (re-)gaining international competitiveness while at the same time (re-)establishing national macroeconomic stability requires that developing countries bring down their annual inflation rates under the level of world inflation. Since the break-down of the Bretton Woods System the big three, and since the 1980s also members of the European Union have competed with one another to cut their annual inflation rates to the unprecedented depths of zero to two per cent compared with about 10 per cent on average in the 1970s. In the 1970s and well into the 1980s, nominal exchange rates of developing countries were frequently adjusted according to a crawling peg regime to maintain the competitiveness of their products on world markets even at the expense of macroeconomic stability. Problems of high or even hyperinflation, dollarisation, capital flight and financial disintermediation may serve here as indications of widespread monetary instability. Although we do not attribute them solely to exchange rate depreciations, what we have said about real anchors should have made it clear that there is no one-way-causality from domestic inflation to depreciation, but that causality operates also *in reverse*. During the 1990s, however, a significant number of developing (and transformation) countries turned to an exchange rate policy of nominal pegging as a support for their endeavours to get inflation under control and liberalise capital and foreign exchange markets. But as the reference value for their inflation targets has dropped with such severity, all current nominal peggers are affected by overvaluation. Hence, if developing countries today do not accept a far-reaching deflation over several years they must face regular erratic devaluations, completely irrespective of the exchange rate regime for which they have opted.

Overvaluation is accompanied by a loss of international competitiveness and a deterioration of the current account that slides gradually into a deficit. A country's current account deficit can stretch over several decades but its economic survival relies on constant external private or public financing. Through accommodating the deficit, however, a country accumulates foreign debt that causes a positive demand for foreign exchange in subsequent periods according to the maturity of the financing. Therefore, net debtor countries are forced to realise foreign exchange revenues in order to comply with their external liabilities on time and to prevent a default. In the short run an increase in domestic real interest rates may be enough to attract even more external financing with which both the current account deficit and the debt service can be paid. Apart from debt relief, only a switch of the current account from a deficit to a surplus provides the country with sufficient foreign exchange in the long run to serve *and* repay its debt stock.²² With a sharp devaluation of the domestic currency, international prices for domestic products are assumed to be reduced so as to allow a country to extend its

share in world markets thus bringing about a positive current account. This devaluation strategy does indeed function but only if direct competitors, whose share in world markets are *ceteris paribus* reduced, do not resort to any counter-measures. Since the amount of foreign debt owed by developing countries has risen steadily over the last five decades, with particular acceleration after the break-down of the Bretton Woods system, an acceptance of a further loss of competitiveness by direct competitors can hardly be expected. So unilateral strategies to get rid off foreign indebtedness by devaluations always involve the risk of a depreciation-spiral. But as long as multilateral negotiation solutions are omitted, individual net debtor countries are obliged either to continue their efforts to solve the problem on their own, which involves frequent depreciations, or to announce unilateral default.

The handling of the South-East Asian crisis by the IMF has become a matter of academic dispute that focuses on three main aspects: (a) whether the IMF did offer a bail-out of both involved countries and international private investors, thus promoting moral hazard; (b) whether providing international liquidity to South-East Asia does indeed fall within the scope of the IMF's functions; and (c) whether the IMF's programmes for Asia did ease the adjustment process. We will not try to outline this debate, but will rather concentrate on an assessment of the IMF's activities under the above mentioned aspects of the international monetary order. The IMF gave South-East Asian countries three basic recommendations: (i) depreciation of the exchange rate to a competitive level that would allow them to realise a current account surplus by 1999 at the latest;²³ (ii) support of their exchange rates with an international rescue package at a time when private investors were jumping out of Asian currencies, thus preventing both a deeper downfall and a temporary default; and (iii) severe reduction of internal demand to curb inflationary effects due to devaluation, thus limiting probable future depreciation rates. At the same time the IMF and the World Bank supplied additional credit lines to the competitors of South-East Asian countries most severely hit by the maxi-devaluations. Even if assistance to Russia was mainly motivated by fears of its military instability and the chaotic state of its politics, propping up Brazil's nominal peg definitely aimed at postponing another region's exchange rate collapse. As Brazil, and to a lesser extent Argentina, which is highly dependent on Brazil with regard to its exports, serve as Latin American benchmarks, devaluations of most other major Latin American currencies are expected to follow the floating of the Brazilian real and the Argentine peso in a domino effect.

²² Servicing foreign debt requires only a trade surplus to the extent of interest payments on the debt stock. But as already mentioned earlier, servicing the debt alone does not change the net asset position of a country.

²³ According to preliminary data all Asia-5 countries already turned around their current accounts from deficits to surpluses in 1998. See Deutsche Bank Research (1998), p.12.

Thus, the IMF's position is characterised by a mix of the 'alternatives' mentioned above: letting the exchange rates of the most affected countries float to the level necessary for debt repayment while limiting the impact and repercussions on the others by stabilising their exchange rate regimes. However, the IMF embarked on this course at the expense of an even higher external indebtedness on the side of the competitors under pressure. Provided that sufficient financial assistance is supplied by the G7 this game or case-by-case treatment can be played until the cows come home without sparking off a depreciation-spiral, thereby preventing the worst economic threat to international monetary order from materialising. But accommodating present current account deficits by public capital imports does not only postpone an exchange rate collapse for the moment, but also makes it more probable as new demand for foreign exchange is created. In other words, there is always another day.²⁴

4. Final Remarks

Development can be defined as a domestic income generating process under conditions of macroeconomic stability. Income generation is a result of a credit-financed accumulation process. Macroeconomic stability in the form of low inflation with no substantial depreciation of the exchange rate is the major restriction for a development process because it alone can insure that the income generating process is carried out in the domestic currency. The term 'developing countries' describes a group of countries which (still) have not succeeded in maintaining development as a long-term process as defined above. Developing countries are characterised by overvaluation combined with depreciation expectations and by an income-generating process partly, or even predominantly, financed by credit in foreign currency. Thus, both a crawling peg regime and a nominal anchor regime inhere severe problems for developing countries.

Assuming a positive inflation differential, a nominal anchor can only be maintained if the rise in national productivity less the change in nominal wages is equal to the positive inflation differential. In the middle to long run, however, domestic inflation rate has to be cut to the level of the anchor currency. As shown above, to achieve a successful nominal peg developing countries must have a highly sensitive fine-tuning capacity and capability in monetary, fiscal, incomes and — not under review here — trade policy. If developing countries can really provide this fine-tuning capacity and capability the question should be raised why they need a rigid nominal exchange rate anchor for stabilisation.

If monetary authorities fail to realise an inflation assimilation, overvaluation will definitely set in. The declining competitiveness of domestic products on world markets results in a widening current account deficit that adds further fuel to depreciation expectations. A process of slipping into

overvaluation needs a number of counter-balancing measures by fiscal and monetary authorities, namely an increase in real interest rates, administrated capital imports and/or a take-over of private investors' exchange rate risks. Even so, all these measures are not sufficient to prevent a suspension of the peg in the long run, but only leave monetary authorities with a worsening state of affairs.

A crawling peg is nonetheless no viable alternative. A real anchor also requires a reduction of the domestic inflation rate to the level of the main trading partner(s) if regular devaluation rates are to be continuously decreased. The difference to a nominal anchor consists in the fact that the adjustment does not have to occur in the course of a once-and-for-all-time depreciation with a subsequent nominal exchange rate stabilisation, but can be worked out on a step-by-step basis. Hence, a real anchor is attractive precisely because it is thought capable of maintaining a competitive exchange rate under conditions of a longer adjustment period — a period in which the external budget constraint seems to be softened. Actually, however, this is not the case. On the contrary, the main burden of adjustment will not only be transferred onto incomes, fiscal, and interest rate policy; it will also be aggravated. Compared with a nominal anchor, these three policy areas all have to compensate for a broad range of severe handicaps to avoid a depreciation-inflation-spiral, including permanent devaluations of domestic wealth and revaluations of foreign debt, stronger and more extensive depreciation expectations as well as regular price level pushes as a consequence of frequent depreciations.

Nonetheless, the successful implementation of an equilibrium real exchange rate regime is synonymous with an exchange rate policy that leaves the given status quo untouched. According to our definition an equilibrium real exchange rate is in line with a current account of zero and therefore does not alter the net wealth position of a country. Developing countries, however, are in the grips of widespread economic and social misery. But social and economic up-grading implies a recourse to policies which aim at changing actual conditions and therefore require a non-equilibrium or, in other words, an undervalued exchange rate, not characterised by an accumulation of reserves as is frequently suggested, but by a current account surplus. An accumulation of reserves is not necessarily a positive sign as it indicates that the unborrowed base of money creation in relation to the borrowed base is increasing, thereby reducing the central bank's intervention capability.

There are universal human rights, but, in our view, no universally adequate exchange rate regime for developing countries exists. The dilemma of net debtor countries consists in their need to raise international competitiveness

²⁴ For Brazil doomsday emerged all too soon: On January 15, 1999, the floating of the Brazilian real was announced after private net capital outflows caused a dramatic shrinking of foreign reserves.

both to earn sufficient foreign exchange flows to serve their foreign debt and support an income generating process whilst simultaneously being obliged to stabilise their exchange rate in order to dampen depreciation expectations and maintain their ability to repay foreign debt by preventing an increase in the debt stock. Rising competitiveness requires a depreciation of the exchange rate, driving internationally indebted agents into bankruptcy whilst the stabilisation of the exchange rate can occur only at the expense of competitiveness. Apart from qualitative differences, the widespread consensus between nominal anchor proponents and real anchor advocates suggests that with the implementation of the exchange rate regimes they

recommend, the dilemma of underdevelopment might be overcome. Actually, however, this widespread view restricts the problem of development to a pure question of the *design* of assumed correct absolute prices in the case of a nominal anchor or correct relative prices in the case of a real anchor. If, moreover, the economic survival of the recommended exchange rate regimes relies on conditions as tight as low or even no foreign debt, and an inflation rate and a budget deficit that are lower than that of the anchor currency, then we are assuming the presence of a market constellation at the beginning of the process from underdevelopment to development whose very absence causes underdevelopment.

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Zusammenfassung

Die Qual der Wahl: Wechselkursregime für Entwicklungsländer

Der vorliegende Artikel diskutiert zwei unterschiedliche Wechselkursregime aus der Sicht eines Entwicklungslandes. Dabei werden sowohl die Attraktivität von nominalen und realen Ankeren aus ökonomischer Sicht als auch Gründe für das Scheitern dieser Wechselkursregime präsentiert. Hierbei dient der jeweilige Verweis auf Südostasien und Lateinamerika lediglich zur Illustration der Argumentation und erhebt nicht den Anspruch, eine umfassende Analyse dieser Länder zu liefern. Der Artikel kommt zu dem Schluß, daß kein Wechselkursregime gleichzeitig den Erhalt der Wettbewerbsfähigkeit als auch makroökonomische Stabilität gewährleisten kann. Unabhängig von dem konkreten Wechselkursregime wird die Beibehaltung von relativ stabilen Wechselkursen auf Seiten der Entwicklungsländer durch die Inflationsraten der Industrieländer, die sich auf einem historisch niedrigen Niveau befinden, und die ansteigende Auslandsverschuldung der Entwicklungsländer erheblich erschwert.